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NEW NBFC REGULATORY REGIME: SCALE BASED REGULATION DIRECTIONS 2023

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Introduction

The Reserve Bank of India (RBI) published the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions 2023 (SBR Master Directions) on 19 October 2023. The SBR Master Directions brings an end to the basic categorisation of NBFCs into systemically important and non-systemically important NBFCs.

The SBR Master Directions have been issued in supersession of the: (i) Non-Banking Financial Company–Non-Systemically Important Non-Deposit taking (Reserve Bank) Directions, 2016, and (ii) Non-Banking Financial Company–Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 (collectively, the Erstwhile Regulatory Regime). The SBR Master Directions bring about the long-awaited harmonisation of the Erstwhile Regulatory Regime with the Scale Based Regulation framework for NBFCs, published by the RBI on 22 October 2021 and effective from 1 October 2022 (SBR Framework).

CATEGORISATION OF NBFCs PRIOR TO SBR FRAMEWORK:

Prior to the issuance of the SBR Master Directions and the SBR Framework, the regulatory framework applicable to NBFCs classified all NBFCs based on the following factors: (i) deposit taking and non-deposit taking NBFCs, (ii) depending on the asset size, as systemically important NBFCs, if the asset size of the NBFC was INR 500 crore and more, or non-systemically important NBFCs if the asset size was less than INR 500 crore, and (iii) depending on the nature of the activity undertaken by an NBFC (for e.g., microfinance lending, housing finance, P2P lending, account aggregation, factoring business, etc.)

SCALE BASED CATEGORISATION OF NBFCs:

Effective from October 2022, the SBR Framework categorised all the NBFCs into the following four categories:

(i) base layer (NBFC-BL), which includes non-deposit taking NBFCs with an asset size of less than INR 1,000 crore, NBFC P2P, NOFHCs, NBFCs not availing public funds and not having any customer interface etc.;

(ii) middle layer (NBFC-ML), which includes all deposit taking NBFCs, non-deposit taking NBFCs with asset size of INR 1,000 crore and more, HFCs, IDF NBFCs etc.;

(iii) upper layer (NBFC-UL), which includes NBFCs which are specifically identified by the RBI; and

(iv) top layer (NBFC-TL), which will include NBFCs which the RBI shifts from the upper layer to the top layer if such NBFCs have potential systemic risk.

However, the categorisation of NBFCs based on acceptance of deposits and the nature of activities (from the Erstwhile Regulatory Regime) continues to remain in force. The categorisation of the NBFCs under the SBR Framework is detailed in our earlier Ergo available here.

ANALYSIS OF THE SBR MASTER DIRECTIONS:

Clarity on the regulatory regime

While the SBR Framework was enforced in October 2022, the regulatory regime was yet to be harmonised. The Erstwhile Regulatory Regime continued to be in effect during the interim period from 1 October 2022 until 18 October 2023 which led to an ambiguity as to whether the NBFCs having asset size of more than INR 500 crore but less than INR 1,000 crore would be categorised as NBFCs-BL, and whether such NBFCs should continue to comply with all the requirements applicable to the systemically important NBFCs. Such NBFCs were required to comply with the Erstwhile Regulatory Regime along with the various notifications and circulars issued pursuant to the SBR Framework. The SBR Master Directions have now consolidated the SBR Framework with the Erstwhile Regulatory Regime, into a comprehensive set of directions. The SBR Master Directions have fully replaced the previous categorisation of NBFCs as systemically and non-systemically important and have clarified that:

(i) all references to NBFC-ND (non-systemically important non-deposit taking NBFC) would now be referred to as NBFC-BL, and all references to NBFC-D (deposit-taking NBFC) and NBFC-ND-SI (systemically important non-deposit taking NBFC) would be known as NBFC-ML or NBFC-UL, as applicable; and

(ii) existing systemically important non-deposit taking NBFCs with an asset size of INR 500 crore and above but below INR 1,000 crore (except those necessarily categorized as NBFC-ML) would be reclassified as NBFC-BL.

Classification of multiple NBFCs in a group

The SBR Master Directions prescribe the method for classification of multiple NBFCs in a group and clarifies that in case of multiple NBFCs in a group, the consolidated asset size will be taken into account for such classification.

Illustration – A group has 6 NBFCs consisting of: (i) an NBFC-ICC and an HFC, each having asset size of INR 300 crore, (ii) NBFC-IFC with asset size of INR 500 crore, (iii) NBFC-MFI with asset size of INR 100 crore, (iv) NBFC-P2P with asset size of INR 50 crore, and (v) NBFC without public funds and customer interface with asset size of INR 70 Crore. The asset size of NBFCs in the group (after consolidation) becomes INR 1320 crore (higher than the asset size threshold of INR 1,000 core for classification in NBFC-ML) and therefore as per the SBR Master Directions: (i) NBFC-ICC and the NBFC-MFI be NBFC-ML, since the consolidated asset size is above INR 1,000 crore, (ii) NBFC-IFC and NBFC-HFC would irrespective of the asset size (either on consolidation basis or otherwise) be NBFC-ML, due to the nature of activity carried out by them, and (iii) NBFC-P2P and the NBFC without public funds and customer interface would continue to be NBFC-BL (irrespective of the consolidated asset size of more than INR 1,000 crore), since the SBR Master Direction classifies them as NBFCs-BL.

Identification of non-cooperative borrowers

NBFC-Factors, deposit taking NBFCs and non-deposit taking NBFCs with asset size of INR 500 crore and above will have to identify 'non-cooperative borrowers' as per the parameters provided in the SBR Master Directions and will have to make reporting of the early recognition of stress to the Central Repository of Information on Large Credits.

Key regulatory changes and clarifications

The key regulatory changes introduced by the SBR Master Directions, as applicable to each layer of NBFCs, are set out below:

(i) **Base Layer**:

All existing non-systemically important NBFCs and systemically important NBFCs with an asset size of less than INR 1,000 crore are now categorised as NBFCs-BL. Set out below are the key regulatory changes which were earlier applicable to NBFCs having an asset size between INR 500 crore and INR 1,000 crore, and are now no longer be applicable to such NBFCs as these NBFCs will be classified as NBFCs-BL:

(a) **Asset classification**: Under the Erstwhile Regulatory Regime, non-systemically important NBFCs were required to classify their assets differently than systemically important NBFCs. While systemically important NBFCs were on par with banks (with a NPA classification to be made once an asset had remained overdue for more than 90 days), non-systemically important NBFCs were required to classify an asset as an NPA once it had remained overdue for more than 6 months. Under the SBR Master Directions, the NPA classification norm applicable to all NBFCs-BL (including formerly non-systemically important NBFCs) stands changed to the overdue period of more than 90 days. While the SBR Master Directions have come into effect from the date of their publication, the RBI has prescribed a glide path to NBFCs-BL in relation to this requirement, as follows:

NPA NORMS	TIMELINE
>150 days overdue	by 31 March 2024
>120 days overdue	by 31 March 2025
>90 days overdue	by 31 March 2026

(b) **Credit concentration norms**: Under the Erstwhile Regulatory Regime, systemically important NBFCs were required to comply with specified concentration norms for lending and investment. This has now been done away with for NBFCs-BL, and existing systemically important NBFCs that are NBFC-BL, no longer have to comply with this requirement.

(c) **Capital adequacy ratio**: Under the Erstwhile Regulatory Regime, systemically important NBFCs were required to maintain a minimum capital ratio of Tier I and Tier II Capital not less than 15% of its aggregate risk weighted assets. This requirement has now been done away with for NBFCs-BL and is only applicable to NBFCs-ML and NBFCs-UL. Accordingly, existing systemically important NBFCs that are NBFC-BL no longer have to comply with this requirement.

(d) **Tier I Capital and Tier II Capital**: NBFCs-BL are not eligible to categorise perpetual debt instruments as part of their Tier I Capital and Tier II Capital. Perpetual debt instruments issued by systemically important NBFCs earlier formed part of their Tier I Capital and Tier II Capital.

(e) **Dividend declaration**: NBFCs-BL are now exempt from reporting details of dividend declared during a financial year, a requirement which was earlier applicable to systemically important NBFCs.

(f) **Corporate governance**: Certain board committees such as an audit committee and nomination and remuneration committee which were earlier required to be constituted by systemically important NBFCs are no longer required to be constituted by NBFCs-BL. Other requirements such as fit and proper criteria for directors and appointment of a chief risk officer are also no longer required to be complied with by NBFCs-BL.

(g) **INR 500 crore distinction**: While the categorisation of NBFCs on INR 500 crore threshold has been phased out, this threshold has been explicitly mentioned for certain compliances. For example, all non-deposit taking NBFCs above the asset size of INR 500 crore (as well as all deposit taking NBFCs) irrespective of asset size, have to continue to follow the instructions set out in the RBI circular titled '*The Prudential Framework for Resolution of Stressed Assets*' dated 07 June 2019.

(ii) **Middle Layer**:

All non-deposit taking NBFCs with asset size of INR 1,000 crore and above (unless otherwise stated) have been re-classified as NBFC-ML and all the compliances applicable for NBFC-BL as set out in Paragraph (i) above will be applicable to such NBFCs-ML, over and above the specific regulatory compliances applicable to NBFCs-ML. Such additional compliances applicable to NBFCs-ML include inter alia a capital adequacy ratio of 15%, an internal capital adequacy assessment process, disclosures to be made in financial statements, credit concentration norms, enhanced corporate governance requirements and regulatory restrictions on loans. To clarify, these compliance requirements are also applicable to NBFCs-UL, but are not applicable to NBFCs-BL

(iii) **Upper Layer**:

(a) All directions prescribed in the context of each of NBFCs-BL and NBFCs-ML shall remain applicable to an NBFC-UL, unless specified otherwise.

(b) The SBR Master Directions have consolidated all requirements in relation to an NBFC-UL that were prescribed during the course of 2021 and 2022, on prudential regulations, differential standard asset provisioning, large exposures framework, governance guidelines, and listing requirements. The transition path for NBFCs-UL also remains the same as what was prescribed under the SBR Framework.

(c) The SBR Framework had prescribed that NBFC-UL will also be subjected to leverage requirement to ensure that their growth is supported by adequate capital, among other factors. The ceiling for leverage for these entities is still awaited and has not been prescribed in the SBR Master Directions.

(iv) **Top Layer**:

There has been no specific change in the regulations applicable to NBFCs-TL. While NBFCs-TL shall continue to abide by the applicable regulations (prescribed in context of each of NBFC-BL, NBFC-ML, and NBFC-UL), they shall be subject to higher capital charge, which shall be specifically communicated to the NBFC-TL at the time of its classification in the top layer.

Comments

The SBR Master Directions are a welcome move as they bring about a well-structured and harmonised framework to implement the scale-based regulations. They have brought in much awaited clarity by clarifying the regulatory regime applicable to NBFCs basis asset size and activity; as well as retained the construct of dedicated guidelines for NBFCs (such as HFCs, CICs, SPD, MGC, NBFC- P2P) based on their activities, which is in line with the previously prescribed regulations. A clarification has also been issued that the consolidation in the SBR Master Directions is only for the regulations as issued by Department of Regulation of the RBI. Therefore, any other directions / guidelines issued by any other department of the RBI, as applicable to NBFCs are to be complied with.

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