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Regulatory Tax Alert

January 25, 2021

Reserve Bank of India releases discussion paper on revised regulatory framework for NBFCs – A Scale-Based Approach

On January 22, 2021, the Reserve Bank of India ('RBI') released the discussion paper[1] on revised regulatory framework for NBFCs – A Scale-Based Approach. With a view to aligning the regulatory interventions with the objective of preserving financial stability and reducing systemic risks, RBI has proposed a regulatory framework anchored on proportionality[2]. The RBI has proposed that the regulatory framework of NBFCs shall be based on a four-layered structure – Base Layer (NBFC-BL), Middle Layer (NBFC-ML), Upper Layer (NBFC-UL) and Top Layer. A snapshot of the proposed four layered Scale-Based regulatory framework is as under:

NBFC Layers	Covers[3]	Applicability of regulations
NBFC-BL	Existing NBFC-ND, Type I NBFCs, NOFHC NBFC-P2P and NBFC-AA	• Existing regulations applicable to NBFC-ND will apply (with certain modifications)
NBFC-ML	NBFC-ND-SI, NBFC-D, HFCs, IFCs, IDFs, SPDs and CICs	• Existing regulations applicable to NBFC-ND-SI and NBFC-D will apply (with certain modifications) • Also, regulations applicable to NBFC-BL will apply, unless there is a conflict or otherwise stated
NBFC-UL	Systemically significant NBFCs	• Regulations applicable to NBFC-ML will apply • Additional regulations (as proposed) will apply
Top Layer NBFC	NBFCs-UL with extreme supervisory risk perception would be pushed to Top Layer	• Not specified currently. NBFCs in this category may be subject to higher capital charge, including capital conservation buffers. There may be more enhanced and intensive supervisory engagement with these NBFCs

[1] The discussion paper is placed on RBI's website for comments of stakeholders. Comments on the discussion paper may be submitted by February 22, 2021.

[2] The principle of proportionality expounds that the degree of regulation of a financial entity should be commensurate with the perception of risk the entity poses to the financial system and it scale of operation.

[3]Non-Systemically important Non-deposit taking NBFC; Non-Operative Financial Holding Company; Non-Banking Financial Company – Peer to Peer Lending Platform; Non-Banking Financial Company – Account Aggregator; Systematically Important Non-Deposit taking NBFC; Deposit taking NBFC; Housing Finance Company; Infrastructure Finance Company; Infrastructure Debt Fund; Standalone Primary Dealer; Core Investment Company

A non-deposit taking NBFC is classified as NBFC-ND when the asset size of such NBFC is below INR 500 crore. However, the revised regulatory framework proposes to increase the said threshold to INR 1000 crore. Thus, NBFC-ND with an asset size of INR 1000 crore or more is proposed to be regarded as NBFC-ND-SI.

For identification of entities to be categorised as NBFC-UL, a parametric analysis will be carried out, comprising quantitative and qualitative parameters/ supervisory judgment. The quantitative parameters will have weightage of 70% whereas qualitative parameters/ supervisory inputs will have weightage of 30%. The parameter-based measurement approach may be based on a sample of NBFCs, which will work as a proxy for the NBFC sector. The NBFCs fulfilling certain criteria can be included in such sample. The criteria being a) The sample will exclude the top ten NBFCs (as per asset size), as they will automatically fall in the Upper Layer of regulation; b) The sample will consist of next 50 NBFCs based on the total exposure, including off-balance sheet exposure; c) NBFCs designated as NBFC-UL in the previous year (unless supervisors agree that there is a compelling reason to exclude any one of them); and d) NBFCs added to the sample by supervisors using their supervisory judgment.

Based on the data received from NBFCs in the sample on the above indicators, a composite score will be calculated for identification of NBFC-UL.
NBFCs having scores above a threshold (to be decided by the Reserve Bank) will be classified as NBFC-UL. The discussion paper states that top ten NBFCs as per asset size will automatically be identified as NBFC-UL and lie in the upper layer, irrespective of the fact whether they fit in to the other parameters or not.

The proposed four layered Scale-Based regulatory framework (key points) has been summarized below.

S.no.	Parameters	NBFC-BL	NBFC-ML	NBFC-UL
			Capital Regulation	
1.	Net Owned Fund	Increase of minimum stipulated Net-Owned fund from INR 2 crores to INR 20 crores	Same as NBFC-BL	Same as NBFC-BL
2.	NPA Classification	Harmonisation from 180 days to 90 days overdue	Presently, NPA norm of 90 days over -due is followed	Presently, NPA norm of 90 days over -due is followed
3.	Common Equity Tier 1[4] ('CET 1') capital	Not stipulated	Not stipulated	9%
4.	Leverage Ratio	Presently, a leverage ratio of 7 is required	Not stipulated	A suitable ceiling for leverage will be prescribed for these entities
5.	Standard Asset provisioning	Presently, a standard asset provisioning of 0.25% is required	Presently, a standard asset provisioning of 0.40% is required	Differential standard asset provisioning on the lines of bank are being proposed
6.	Internal Capital Adequac Adequacy Assessment Process ('ICAAP')	Not stipulated	Requirement of having a Board approved policy on ICAAP is proposed	Same as NBFC-ML
			Concentration norms	
7.	Computed as a % of	Owned funds	Tier 1 capital	Tier 1 capital

[4] Currently, CET requirement is only applicable to banks.

S.no.	Parameters	NBFC-BL	NBFC-ML	NBFC-UL
8.	Credit Concentration Norms and Applicability of Large Exposure Framework ('LEF')	Extant guidelines as applicable for NBFC-NDs	Merger of lending and investment limits into a single exposure limit	LEF as applicable to banks with suitable modification is proposed
			Governance and Disclosure norm	
9.	Compensation Guideline Nomination and Remuneration Committe	Not stipulated	Following is proposed - a) constitution of a Remuneration Committee, b) principles for fixed/ variable pay structures, and c) malus/ claw back requirements.	On similar lines as applicable for Private Sector Banks, including guidelines on general compensation policy & remuneration committee.
10.	Rotation of Statutory Auditors ('SA')/ Firms	Not stipulated	A uniform tenure of 3 consecutive years is proposed. Further, after completion of 3 years, mandatory cooling period of 6 years (two tenures) before reappointment is also proposed.	Same as NBFC ML
11.	Key Managerial Personn ('KMP')- whole Time employee in the nature c CEO, CFO, CS and WTI	As per Companies Act, 2013	It is proposed that KMP will not hold any office (including directorships) in any other NBFC-ML or NBFC-Upper Layer. Further, it is also proposed that an independent director shall not be on the board of more than two NBFCs (NBFC-ML and NBFC-UL) in total.	Same as NBFC-ML
12.	Appointment of Chief Compliance Officer ('CCO')	Not stipulated	It is proposed that an independent corporate compliance function and a strong compliance risk management programme, a functionally independent CCO should be appointed, who should be sufficiently senior in the organization hierarchy.	Same as NBFC-ML
13.	Listing requirements	Not mandatory	Not mandatory	It is proposed that such NBFCs should be subject to mandatory listing requirement and should follow the consequent Listing Obligations and Disclosures Requirements.

S.no.	Parameters	NBFC-BL	NBFC-ML	NBFC-UL
14.	Expertise for Board Members	It is proposed to prescribe that the Board will have adequate mix of Experience and educational qualification among its members. Further, at least one of the directors shall have experience in retail lendin bank/ NBFC.	Same as NBFC-BL	Same as NBFC-ML. Specific expertise may be prescribed in addition.
15.	Sensitive Sector Exposures ('SSE')	Not stipulated	It is proposed that NBFC's Board to decide internal limits separately for capital market exposure and commercial real estate sector, supplemented by adequate disclosures. Further, a sub-limit within the commercial real estate exposure ceiling should be fixed internally for financing land acquisition.	In addition to NBFC-ML, NBFCs may fix SSE ceilings based on internal board approved policy.
16.	IPO financing	Not stipulated	It is proposed to fix a ceiling of INR 1 crore per individual for any NBFC. NBFCs are free to fix more conservative limits.	Same as NBFC-ML
17.	Core Banking Solution ('CBS') for NBFCs	Not Mandatory	It is suggested that NBFCs with 10 and more branches shall mandatorily be required to adopt CBS.	Same as NBFC-ML

Dhruva Comments:

The RBI vide the proposed regulatory framework is attempting to segregate larger entities and subject them to a stricter set of 'bank-like' rules. This is aimed at ensuring financial stability while making sure that smaller NBFCs continue to enjoy light-touch regulations and grow with ease. While NBFC-UL is proposed to be subject to bank-like regulations, this may aid such NBFCs in easier transition (if, desired) into a private bank (subject to RBI's acceptance of the report of the internal working group to review Extant Ownership Guidelines and Corporate Structure for Indian Private Sector Banks). The discussion paper is placed on RBI's website for comments of stakeholders. Comments on the discussion paper may be submitted by February 22, 2021.

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