CONTENTS

SBR – REVISED REGULATORY FRAMEWORK FOR NBFC

Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 of India, they operate in the financial sector providing a variety of financial services. These are financial institutions that offer various banking services, similar to banks, but they do not hold a banking license. NBFCs can provide services such as loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by government or local authorities, leasing, hire-purchase, etc. However, there are certain activities that are explicitly excluded from the scope of NBFC. These excluded activities include those related to agriculture, industrial activity, purchase or sale of goods (other than securities), provision of services, and sale/purchase/construction of immovable property.

HISTORY AND EXISTING APPROACH OF RBI

1. Reserve Bank of India (RBI) acquired the powers to regulate and supervise NBFCs in 1964, since then with various amendments and recommendations of Shah Working Group, RBIs powers have been enhanced over NBFCs. In 1997, RBI Act, 1934 was further amended and regulation over NBFCs was made more comprehensive, since then the NBFCs regulatory framework has taken a huge turnaround.
    - In 1998 framework NBFCs were categorised into Public Deposit Accepting, Non Deposit Accepting Core Investment Companies and Non-Public Deposit Accepting.
    - In 2006 framework classification of NBFCs was based on Asset size.
    - In 2014 RBI revised the regulatory framework and included Net Owned Fund (NoF) requirement of minimum INR 2 Crore, harmonised deposit acceptance, differentiated regulatory approach based on customer interface and source of funds and etc.
2. The regulatory regime governing the NBFC sector is built on the principle of proportionality such that adequate operational flexibility is available to the sector through calibrated regulatory measures. However, there are rapid developments in the last few years, which have led to a significant increase in size and interconnectedness of the NBFC sector. There is, therefore, a need to review the regulatory framework in line with the changing risk profile of NBFCs.
3. The present approach of RBI is based on the size of the NBFCs and failure of any large and deeply interconnected NBFC is capable of transmitting shocks into the entire financial sector and causing a disruption even to the operations of the small and mid-sized NBFCs. Considering the said reason, RBI decided to introduce a legal framework on Scale-Based Regulatory (SBR) structure for NBFCs comprising of four layers based on their size, activity, and perceived riskiness.

INTRODUCTION TO SBR

The 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 bring 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).

KEY HIGHLIGHTS

1. The SBR Master Direction, effective immediately, intends to consolidate the various regulations for NBFCs of different scales and functions in one place. The consolidation has streamlined various regulations issued under the SBR Framework governing the different layers of NBFCs. It brings clarity to compliance requirements and ensures that all NBFCs operate within a framework that is consistent and transparent.
2. The specific regulations issued by the RBI would still be relevant and continue to be applicable for Housing Finance Companies, Core Investment Companies, NBFC-P2P, NBFC-Account Aggegator, Deposit taking NBFCs, Residuary Non-Banking Companies, Mortgage Guarantee Companies and Asset Reconstruction Companies. Additionally, based on the classification under the SBR Framework (Base Layer or Middle Layer), the relevant provisions of the SBR Master Directions shall be applicable.
3. The SBR Master Directions 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.
4. The 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.

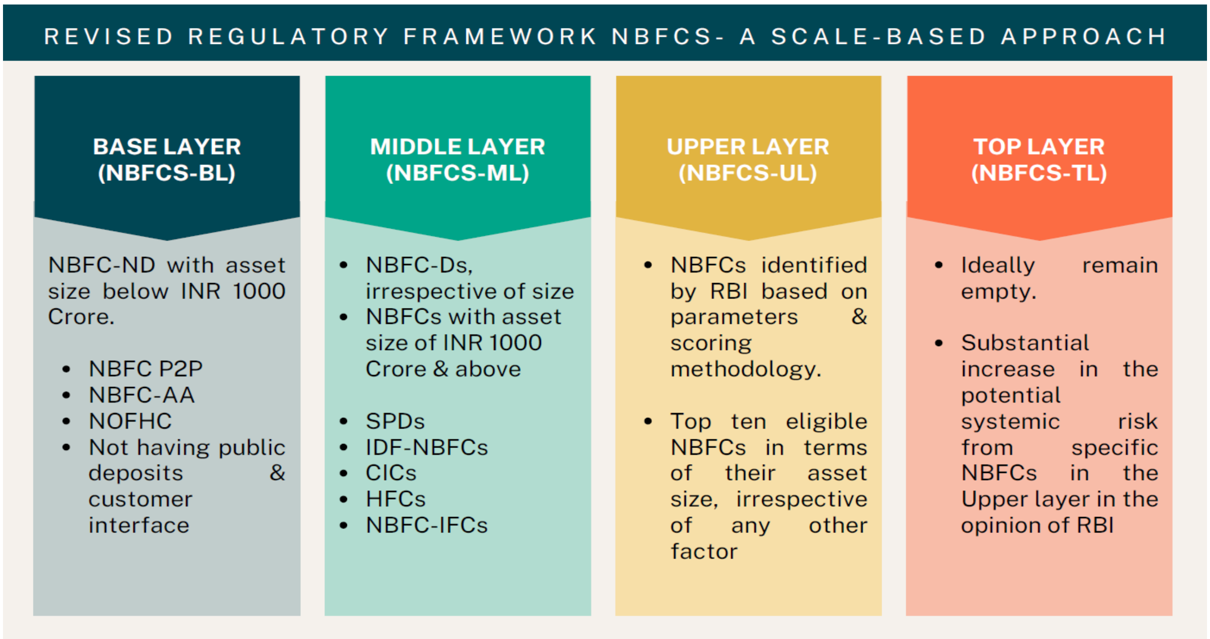
APPLICABILITY OF THE PROVISIONS[1]

1. Every NBFC-D, NBFC-ICC, NBFC-MFI, NBFC-IFC and IDF-NBFC registered with the Reserve Bank under the provisions of the RBI Act, 1934; and
2. Every NBFC-Factor registered with the Reserve Bank under section 3 of the Factoring Regulation Act, 2011 and every NBFC-ICC registered with the Reserve Bank under section 3 of the Factoring Regulation Act, 2011.

[1] *“**NBFC-ICC**” means any company which is a financial institution carrying on as its principal business - asset finance, the providing of finance whether by making loans or advances or otherwise for any activity other than its own and the acquisition of securities; and is not any other category of NBFCs as defined by the Reserve Bank in any of its Master Directions.*
*“**NBFC-IFC**” means a non-deposit taking NBFC which has a minimum of 75 per cent of its total assets deployed towards infrastructure lending.*
*“**NBFC-MFI**” means a non-deposit taking NBFC which has a minimum of 75 per cent of its total assets deployed towards microfinance loans.*
*“**NBFC-Factor**” means NBFC as defined in clause (f) of section 45-I of the RBI Act, 1934, which has its principal business as mentioned in the Directions and has been granted a certificate of registration under section 3 of the Factoring Regulation Act, 2011.*
*“**IDF-NBFC**” means a non-deposit taking NBFC which is permitted to refinance post commencement operations date (COD) infrastructure projects that have completed at least one year of satisfactory commercial operations; and finance toll operate transfer (TOT) projects as the direct lender.*

LAYERS OF NBFCs UNDER SBR

Over some time, different types of NBFCs based on the activity have been adopted by RBI and recognized by different names, whereas SBR Master Directions categorises NBFCs in the following manner:



1. **NBFCs-BL**

   NBFCs in the lowest layer shall be known as NBFCs-Base Layer (NBFCs-BL). The NBFCs Base Layer shall comprise of non-deposit taking NBFCs below the asset size of ₹1,000 crore and NBFCs undertaking the following activities:

   - NBFC-Peer to Peer Lending Platform (NBFC-P2P);
   - NBFC-Account Aggregator (NBFC-AA);
   - Non-Operative Financial Holding Company (NOFHC); and
   - NBFC not having any customer interface.

Important points:

i. Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis.

ii. Income from bonds and debentures of corporate bodies and from Government securities/ bonds shall be taken into account on accrual basis.

iii. NBFCs shall disclose comparative information in respect of the previous period for all amounts reported in the current period's financial statements.

iv. NBFC shall not lend against its own shares.

v. NBFCs which are in the business of lending against collateral of gold jewellery, shall obtain prior approval of the Reserve Bank to open branches exceeding 1,000. However, NBFCs which already have more than 1000 branches shall approach the Reserve Bank for prior approval for any further branch expansion.

vi. A public notice of at least 30 days shall be given before effecting the sale of, or transfer of the ownership by sale of shares, or transfer of control, whether with or without sale of shares.

vii. Overseas investment shall not involve multi layered, cross jurisdictional structures and at most only a single intermediate holding entity shall be permitted.

Compliance requirements for BL NBFC:

1) Maintenance of dividend pay-out ratio
The dividend payout ratio is defined as the ratio of the total amount of dividends paid out to shareholders relative to the net income of the company. It is the percentage of earnings paid to shareholders via dividends. The amount that is not paid to shareholders is retained by the company to pay off debt or to reinvest in core operations.
2) Maintenance of net owned fund requirement (NOF)
The Reserve Bank of India has specified certain limits as net owned fund (NOF) required for all the categories of non-banking financial companies to commence or carry on the business of non-banking financial institutions.
3) Maintenance of leverage ratio
A leverage ratio is a kind of financial ratio that indicates the level of debt incurred by a company against several other accounts in its balance sheet, income statement. This ratio provides an indication of how the company's assets and business operations are financed. The ratio shall have to be below 7x at any point of time for BL NBFC.
4) Financial accounts to be prepared as per Indian Accounting Standards (Ind AS) as per the Companies (Indian Accounting Standards) Rules, 2015.
5) Framing and implementation of investment policy
An investment policy outlines the guidelines, principles, and strategies that govern the investment activities of the company. NBFCs are financial institutions that offer various banking services but do not hold a banking license. Policy will be defining the factors which need to be complied in case of investment related activity.
6) Maintenance of net NPA ratio
The NPA (Non-Performing Asset) ratio is a financial metric used to assess the quality of a bank loan portfolio. It measures the proportion of non-performing assets, typically loans, to the total assets or loans held by the institution. NPAs are loans where the borrower has defaulted on interest or principal payments, or where the loan is classified as non-performing based on regulatory criteria.
7) Adoption of policies regarding threshold and issuance of loans
The board shall form policy regarding grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding. The board approved policy shall include a threshold beyond which loans to abovementioned persons shall be reported to the Board.
8) Compliance of guidelines on Liquidity Risk Management
These guidelines are mentioned under RBI notification and deals with the Liquidity Risk Management Policy, Strategies and Practices, Management Information System (MIS), Internal Controls, Maturity profiling, Currency Risk and with other factors.
9) Complying with the KYC norms.
10) Disclosure requirements relating to types of exposure, related party transactions, loans to Directors/ Senior officers & customer complaints.

2. NBFCs-ML

NBFCs in middle layer shall be known as NBFCs-Middle Layer (NBFCs-ML). The NBFCs Middle Layer shall consist of all the deposit taking NBFCs (NBFCs-D), irrespective of asset size and non-deposit taking NBFCs with asset size of ₹1,000 crore and above and NBFCs undertaking the following activities:

- Standalone Primary Dealer (SPD);
- Infrastructure Debt Fund-Non-Banking Financial Company (IDF-NBFC);
- Core Investment Company (CIC);
- Housing Finance Company (HFC); and
- Non-Banking Financial Company-Infrastructure Finance Company (NBFC-IFC).

Important points:

i. The Reserve Bank specifies in the regulation to maintain a minimum capital ratio consisting of Tier 1 and Tier 2 capital which shall not be less than 15 percent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items.

ii. NBFCs shall put up to the Board of Directors, at regular intervals, regarding the progress made in putting in place a progressive risk management system and risk management policy and strategy followed by the NBFC.

iii. NBFCs shall also disclose the following in their Annual Financial Statements:

- Registration/license/authorisation, by whatever name called, obtained from other financial sector regulators;
- Ratings assigned by credit rating agencies and migration of ratings during the year;
- Penalties, if any, levied by any regulator;
- Information namely, area, country of operation and joint venture partners with regard to joint ventures and overseas subsidiaries; and
- Asset-Liability profile, extent of financing of parent company products, NPAs and movement of NPAs, details of all off-balance sheet exposures, structured products issued by them and other disclosures.

Compliance requirements for ML NBFC:

1) Guidelines as applicable to NBFC-BL.
2) Maintenance of capital ratio
   The capital ratio refers to the regulatory requirement that specifies the minimum amount of capital NBFC must maintain in relation to its risk-weighted assets. This ratio ensures that NBFCs have adequate capital to absorb losses and maintain financial stability.
3) Adoption of policies regarding threshold and issuance of loans
   The board shall form policy regarding grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding. The board approved policy shall include a threshold beyond which loans to abovementioned persons shall be reported to the Board.
4) Constitution of committees and appointment of credit risk officer
   Constitution of committees (like the Audit Committee and the Nomination and Remuneration Committee) and officer are important governance measures that help ensure effective risk

management, regulatory compliance, and transparency in operations. As it helps in Internal Controls, Risk Management, Stress Testing and Scenario Analysis, Regulatory, Compliance and in other major factors.

5) Maintenance of liquidity coverage ratio
A liquidity coverage ratio is a kind of financial ratio that explains the company's overall structure of debt and equity or to meet its obligation incurred by a company against several other accounts in its balance sheet, income statement. This ratio provides an indication of how the company's assets and business operations are financed.
6) Framing and implementation of investment policy
An investment policy outlines the guidelines, principles, and strategies that govern the investment activities of the company. NBFCs are financial institutions that offer various banking services but do not hold a banking license. Policy will be defining the factors which need to be complied in case of investment related activity.
7) Particulars to be mentioned in the Balance Sheet:
    - Capital to risk assets ratio (CRAR);
    - Exposure to real estate sector, both direct and indirect; and
    - Maturity pattern of assets and liabilities.

3. NBFCs-UL

NBFCs in upper layer shall be known as NBFCs- Upper Layer (NBFCs-UL). The Upper Layer shall comprise of those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters as provided in these Directions.
The top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.

Important points:

i. NBFC shall report its Large Exposures to the Reserve Bank (Department of Supervision, Central Office).
ii. Specific Directions applicable for Non-Banking Financial Company –Micro Finance Institutions (NBFC-MFIs) and Microfinance Loans of other NBFCs.
iii. Specific Directions applicable for NBFC-Factors and NBFC-ICCs Registered under the Factoring Regulation Act, 2011.
iv. Specific Directions applicable for Infrastructure Debt Funds - Non-Banking Financial Company (IDFs-NBFC).

Compliance requirements for UL NBFC:

1) Guidelines as applicable to NBFC-BL and NBFC-ML.
2) Maintenance of common equity capital
Maintenance of equity capital restricts the ability of a shareholder to demand a return on the value of the money they transferred to company in exchange for shares. Maintain Common Equity Tier 1 Capital of at least 9 % of Risk-Weighted Assets. This compliance is for protecting company's creditors.
3) Large exposure framework Reporting (LEF) to RBI

The Large Exposures Framework (LEF) is a set of guidelines issued by the Reserve Bank of India (RBI) to regulate the exposure of banks to individual borrowers or groups of connected borrowers . The framework aims to address the concentration risk that arises from a bank's exposure to its counterparties.

4. NBFCs-TL

The NBFCs in top layer shall be known as NBFCs- Top Layer (NBFCs-TL). The Top Layer will ideally remain empty. This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

The remaining NBFCs, viz., NBFC-Investment and Credit Companies (NBFC-ICCs), NBFC-Micro Finance Institutions (NBFC-MFIs), NBFC-Factors and Mortgage Guarantee Companies (MGCs) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework. Government owned NBFCs shall be placed in the Base Layer or Middle Layer, as the case may be.

OTHER APPLICABLE DIRECTIONS ISSUED BY DEPARTMENT OF REGULATION:

NBFCs shall ensure compliance with the applicable instructions, as prescribed in the following Directions:

- Master Direction - Know Your Customer (KYC) Direction, 2016, as amended from time to time.
- Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021, as amended from time to time.
- Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, as amended from time to time.
- Master Direction – Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022, as amended from time to time.
- Master Direction – Credit Card and Debit Card – Issuance and Conduct Directions, 2022, as amended from time to time.
- Guidelines on Digital Lending, 2022, as amended from time to time.

The categories of NBFCs, mentioned below, shall be subject to extant regulations governing them, as under:

- NBFC-P2P - Master Directions - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017, as amended from time to time.
- NBFC-AA - Master Direction- Non-Banking Financial Company - Account Aggregator (Reserve Bank) Directions, 2016, as amended from time to time.
- CIC - Master Direction - Core Investment Companies (Reserve Bank) Directions, 2016, as amended from time to time.
- SPD - Master Direction - Standalone Primary Dealers (Reserve Bank) Directions, 2016, as amended from time to time.
- MGC - Master Directions - Mortgage Guarantee Companies (Reserve Bank) Directions, 2016, as amended from time to time.
- HFC - Master Direction – Non-Banking Financial Company – Housing Finance Company (Reserve Bank) Directions, 2021, as amended from time to time.

ABBREVIATIONS USED

Abbreviation	Full Form
CIC	Core Investment Companies
NBFC	Non-Banking Financial Company
NBFC-AA	Non-Banking Financial Company – Account Aggregator
NBFC-D	Deposit-taking Non-Banking Financial Company
NBFC-HFC	Non-Banking Financial Company – Housing Finance Company
NBFC-ICC	Non-Banking Financial Company – Investment and Credit Company
IDF-NBFC	Infrastructure Debt Fund – Non-Banking Finance Company
NBFC-IFC	Non-Banking Financial Company – Infrastructure Finance Company
NBFC-MGC	Non-Banking Financial Company – Mortgage Guarantee Company
NBFC-MFI	Non-Banking Financial Company – Micro Finance Institution
NBFC-ND	Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company
NBFC-P2P	Non-Banking Financial Company – Peer to Peer Lending Platform
NBFC-ND-SI	Non-Banking Financial Company – Systematically Important Non-Deposit taking Company
NOFHC	Non-Operative Financial Holding Company
SPD	Standalone Primary Dealer