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NON-BANKING FINANCIAL COMPANIES

- A non-banking financial company, also known as non-banking financial institutions, are companies that offer financial services and products but are not officially recognized as a bank with a full banking license.
- Generally, the distinction between a recognized bank and a non-banking financial company is the fact that non-bank companies cannot accept traditional demand deposits.

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 engaged in the business of loans and advances:

- Acquisition of shares/ stocks/ bonds/ debentures/securities issued by Government or local authority or
- Other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business

But does not include any institution whose principal business is that of:

- Industrial activity
- **agriculture activity**
- Purchase or sale of any goods (other than securities)
- Providing any services and sale/purchase/construction of immovable property.

NBFC's role in promoting inclusive growth

NBFCs play an important role in promoting inclusive growth in the country, by catering to the diverse financial needs of bank excluded customers.

They often take lead role in providing innovative financial services to Micro, Small, and Medium Enterprises (MSMEs) most suitable to their business requirements.

REGULATORS OF NBFCs

The **Department of Non-Banking Supervision (DNBS)** of RBI is entrusted with the responsibility of regulation and supervision of NBFCs under the regulatory - provisions contained under the Reserve Bank of India Act. 1934.

The focus of regulation and supervision is three-fold, viz.,

(A) DEPOSITOR PROTECTION
(B) CONSUMER PROTECTION
(C) FINANCIAL STABILITY

The RBI has also been empowered under the RBI Act 1934 to take punitive action which includes cancellation of Certificate of Registration, issue of prohibitor orders from accepting deposits, filing criminal cases or winding up petitions under provisions of Companies Act in extreme cases.

FRAMEWORK FOR SCALE BASED REGULATION FOR NON-BANKING FINANCIAL COMPANIES

Regulatory Structure for NBFCs

Regulatory structure for NBFCs comprises of four layers based on their size, activity, and perceived riskiness.

I. NBFCs in the lowest layer is known as NBFC - Base Layer (NBFC-BL).
II. NBFCs in middle layer is known as NBFC - Middle Layer (NBFC-ML)
III. NBFCs upper layer shall be known as NBFC - Upper Layer (NBFC-UL)

The Top Layer is ideally expected to be empty and will be known as NBFC - Top Layer (NBFC-TL).

(a) Base Laver

Base Layer comprises of:

(a) non-deposit taking NBFCs below the asset size of & 1000 crore and

(b) NBFCs undertaking the following activities:

I. NBFC-Peer to Peer Lending Platform (NBFC-P2P),
II. NBFC-Account Aggregator (NBFC-AA),
III. Non-Operative Financial Holding Company (NOFHC)
IV. NBFCs not availing public funds and not having any customer interface.

(b) Middle Layer

The Middle Layer consist of

(a) all deposit taking NBFCs (NBFC-Ds), irrespective of asset size,

(b) non-deposit taking NBFCs with asset size of 1000 crore and above

(c) NBFCs undertaking the following activities:

(i) Standalone Primary Dealers (SPDs),

(ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs),

(iii) Core Investment Companies (CICs),

(iv) Housing Finance Companies (HFCs) and

(v) Infrastructure Finance Companies (NBFC-IFCs).

(c) Upper Layer

- The Upper Layer comprises of those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters and scoring.

- The top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.
- Upper Layer shall be populated with NBFCs, identified by way of a parametric scoring methodology, comprising of quantitative and qualitative parameters/ supervisory judgment.

Scoring methodology for identification of an NBFC as NBC-UL shall be based on the set of NBFCs fulfilling the following criteria:

(a) Top 50 NBFCs (excluding top ten NBFCs based on asset size, which automatically fall in the Upper Layer) based on their total exposure including credit equivalent of off-balance sheet exposure.
(b) NBFCs designated as NBFC-UL in the previous year.
(c) NBFCs added to the set by supervisors using supervisory judgment.

(d) Top Layer

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.

Regulatory Changes under Scale Based Regulation (SBR)

Net Owned Fund:

NBFC-P2P, NBFC-AA (Account Aggregator), and NBFCs with no public funds and no customer interface, the NOF shall continue to be 2 crores.

NPA Classification:

The extant NPA classification norm stands changed to the overdue period of more than 90 days for all categories of NBFCs. A glide path is provided to NBFCs in Base Layer to adhere to the 90 days NPA norm as under:

NPA Norms	Timeline
>150 days overdue	By March 31, 2024
>120 days overdue	By March 31, 2025
> 90 days	By March 31, 2026

However, the glide path will not be applicable to NBFCs which are already required to follow the 90-day NPA norm.

Experience of the Board: Considering the need for professional experience in managing the affairs of NBFCs, **at least one of the directors** shall have relevant experience of having worked in a bank/ NBFC.

Ceiling on IPO Funding: There shall be a ceiling of **71 crore per borrower** for financing subscription to Initial Public Offer (IPO). NBFCs can fix more conservative limits.

Provisioning for Standard assets: The RBI has w. e. f. 01-10 2022 decided that NBFCs classified as NBFC-UL shall maintain provisions in respect of 'standard' assets at the following rates for the funded amount outstanding:

Category of Assets	Rate of Provision
Individual housing loans and loans to Small and 0.25 per cent Micro Enterprises (SMEs).	2.00 per cent

Housing loans extended at teaser rates	2.00 per cent, which will decrease to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates (if the accounts remain 'standard)
Advances to Commercial Real Estate Residential Housing (CRE - RH) Sector	0.75 per cent
Advances to Commercial Real Estate (CRE) Sector (other than CRE-RH)	1.00 per cent
Restructured advances	As stipulated in the applicable prudential norms for restructuring of advances
All other loans and advances not included above, 0.40 per cent including loans to Medium Enterprises	0.40 per cent

Regulatory Changes for Different Layers in the Regulatory Structure Capital Guidelines

(a) Internal Capital Adequacy Assessment Process (ICAAP):

- ❖ NBFCs are required to make a thorough internal assessment of the need for capital, commensurate within risks in their business.
- ❖ This internal assessment shall be on similar lines as ICAAP prescribed for commercial banks under Pillar 2.
- ❖ Internal capital assessment shall factor in credit risk, market risk, operational risk, and all other residual risks as per methodology to be determined internally.

(b) Common Equity Tier I: To enhance the quality of regulatory capital, NBFC-UL shall maintain Common Equity Tier 1 capital of at least 9 per cent of Risk Weighted Assets.

(c) Leverage: In addition to the CRAR, NBFC-UL will also be subjected to leverage requirement to ensure that their growth is supported by adequate capital, among other factors. A suitable ceiling for leverage will be prescribed subsequently for these entities as and when necessary.

(d) Differential standard asset provisioning: NBFC-UL shall be required to hold differential provisioning towards different classes of standard assets.

Prudential Guidelines

<u>Regulatory changes applicable to NBFC-ML and NBFC-UL</u>

Concentration of credit/ investment:

The extant credit concentration limits prescribed for NBFCs separately for lending and investments shall be merged into a single exposure limit of 25% for single borrower/ party and 40% for single group of borrowers/ parties.

Further, the concentration limits shall be determined with reference to the NBFC's Tier I capital instead of their Owned Fund. The revised norms are indicated in the table below:

Existing limit (as a percentage of Owned Fund)				**Revised limit (as a percentage of Tier I Capital**	
	Lending	Investment	Total		Exposure
Single borrower/ party	15	15	25	Single borrower/ party	25

Single group of borrowers/ parties	25	25	40	Single group of borrowers/ parties	40

Sensitive Sector Exposure (SSE):

Exposure to capital market (direct and indirect) and commercial real estate shall be reckoned as sensitive exposure for NBFCs. NBFCs shall fix Board-approved internal limits for SSE separately for capital market and commercial real estate exposures.

Regulatory restrictions on loans: NBFCs shall be subject to regulatory restrictions in respect of the following:

(i) Granting loans and advances to directors, their relatives and to entities where directors or their relatives have major shareholding.

(ii) Granting loans and advances to Senior Officers of the NBFC.

(ill) While appraising loan proposals involving real estate, NBFCs shall ensure that the borrowers have obtained prior permission from government / local governments / other statutory authorities for the project, wherever required.

Large Exposure Framework: It has been decided to introduce Large Exposure Framework (LEF) for NBFCs placed in the Upper Layer. Accordingly, large exposure of an NBFC to all counterparties and groups of connected counterparties will be considered for exposure ceilings.

Internal Exposure Limits: In addition to the internal limits on sensitive sector exposure in respect of capital market and commercial real estate Board of NBFC-UL shall also determine internal exposure limits on other important sectors to which credit is extended. Further, NBFC-UL shall put in place an internal Board approved limit for exposure to the NBFC sector.

Governance Guidelines

(a) Risk Management Committee: In order that the Board can focus on risk management, NBFCs shall constitute a Risk Management Committee (RMC) either at the Board or executive level. The RMC shall be responsible for evaluating the overall risks faced by the NBFC including liquidity risk and will report to the Board.

(b) Disclosures: Disclosure requirements shall be expanded, inter alia, to include types of exposure, related party transactions, loans to Directors/ Senior Officers and customer complaints.

(c) Loans to directors, senior officers, and relatives of directors - NBFC-BL shall have a Board approved policy on grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding.
Regulatory changes under BR applicable to NBFC-ML and NBFC-UL

(d) Key Managerial Personnel: Except for directorship in a subsidiary, Key Managerial Personnel shall not hold any office (including directorships) in any other NBFC-ML or NBFC-UL.

(e) Independent Director: Within the permissible limits in terms of Companies Act, 2013, an independent director shall not be on the Board of more than three NBFCs (NBFC-ML or NBFC-UL) at the same time.

NBFCs shall, in addition to the existing regulatory disclosures, disclose the following in their Annual Financial Statements, with effect from March 31, 2023:

• Corporate Governance report containing composition and category of directors, shareholding of non-executive directors, etc.

• Disclosure on modified opinion, if any, expressed by auditors, its impact on various financial items and views of management on audit qualifications.

• Divergence in asset classification and provisioning above a certain threshold to be decided by the Reserve Bank.

(g) Chief Compliance Officer: To ensure an effective compliance culture, it is necessary to have an independent compliance function and a strong compliance risk management framework in NBFCs.

(h) Compensation guidelines: To address issues arising out of excessive risk taking caused by misaligned compensation packages, it has been decided that NBFCs shall put in place a Board approved compensation policy.

(i) Other Governance matters: NBFCs shall comply with the following:

I. The Board shall delineate the role of various committees (Audit Committee, Nomination and Remuneration Committee, Risk Management Committee, or any other Committee)
II. NBFCs shall formulate a whistle blower mechanism for directors and employees to report genuine concerns.
III. The Board shall ensure good corporate governance practices in the subsidiaries of the NBFC.

(j) Qualification of Board Members: Board members shall be competent to manage the affairs of the NBFC. The composition of the Board should ensure mix of educational qualification and experience within the Board.

Review of Assessment Methodology:

The methodology for assessing the NBFC-UL shall be reviewed periodically.

Classification of Government owned NBFCs:

As per the Reserve Bank's extant guidelines, the Government owned NBFCs are still in the transition period to attain the minimum CRAR.

Regulation of NBFCs not availing public funds and not having customer interface:

NBFCs not availing public funds and not having customer interface bear a different risk profile and hence deserve a differential regulatory treatment.

FRAMEWORK FOR COMPLIANCE FUNCTION AND ROLE OF CHIEF COMPLIANCE OFFICER IN NON-BANKING FINANCIAL COMPANIES IN UPPER LAYER AND MIDDLE LAYER (NBFC-UL & NBFC-ML)

The Compliance Function is an integral part of effective governance, along with the internal control and risk management processes.

Compliance Risk

Compliance risk is the risk of legal or regulatory sanctions, material financial loss or loss of reputation an NBFC may suffer, because of its failure to comply with laws, regulations, rules and codes of conduct, etc., applicable to its activities.

Scope and Coverage of Compliance Function

Compliance Function shall ensure strict observance of all statutory and regulatory requirements for the NBFC, including standards of market conduct, managing conflict of interest, treating customers fairly and ensuring the suitability of customer service.

Responsibility of the Board and Senior Management

The Board / Board Committee shall ensure that an appropriate Compliance Policy is put in place and implemented. Further, the Board / Board Committee shall prescribe the periodicity for review of Compliance risk.

The Senior Management shall:

(i) carry out an exercise, at least once a year, to identify and assess the major Compliance risk facing the NBFC and formulate plans to manage it.
(ii) submit to the Board / Board Committee a review at the prescribed periodicity and a detailed annual review of Compliance; and
(iii) report promptly to the Board / Board Committee on any material Compliance failure while ensuring that appropriate remedial or disciplinary action is taken.

FAIR PRACTICES CODE FOR APPLICABLE NBFC

Applicable NBFCs having customer interface shall adopt the following guidelines:
Applications for loans and their processing
(1) All communications to the borrower shall be in the vernacular language or a language as understood by the borrower.
(2) Loan application forms shall include necessary information which affects the interest of the borrower, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by the borrower.

(3) Applicable NBFCs shall devise a system of giving acknowledgement for receipt of all loan applications.

Responsibilities of Compliance Function

Compliance Function shall be responsible for undertaking the following activities at the minimum:

(i) **Assist the Board and the Senior Management** in overseeing the implementation of Compliance Policy, including policies and procedures, prescriptions in Compliance Manuals, internal codes of conduct, etc.

(ii) **Play the central role in identifying the level of Compliance risk in the organisation.**

(iii) Compliance Function **shall monitor and test Compliance** by performing **sufficient and representative Compliance testing**, and the results of such Compliance testing shall be reported to the Senior Management.

(iv) Ensure **compliance of regulatory/ supervisory directions** given by RBI in both letter and spirit in a time-bound and sustainable manner.

BROAD CONTOURS OF COMPLIANCE FRAMEWORK IN NBFCs

Compliance Policy

(a) The NBFC shall lay down a Board-approved Compliance Policy clearly spelling out its Compliance philosophy, expectations on Compliance culture, structure and role of the Compliance function, the role of CCO, processes for identifying, assessing, monitoring, managing, and reporting on Compliance risk. The Policy shall be reviewed at least once a year.

(b) Broadly, the Policy shall ensure coverage of the following aspects:
(i) Measures to ensure the independence of the Compliance function and its right to freely disclose findings and views to senior management, Board / Board Committee.
(ii) Focus on various regulatory and statutory Compliance requirements.
(iii) Monitoring mechanism for the Compliance testing procedure.
(iv) Reporting requirements, including Compliance risk assessment and change in risk profile, etc. to the Senior Management and to the Board / Board Committee.

Compliance Structure
The Compliance Department shall be headed by the Chief Compliance Officer, meeting the requirements prescribed in this Circular. NBFCs are free to adopt their own organizational structure for the Compliance Function.

Compliance Programme
The annual review, to be carried out by the Senior Management, shall ensure coverage of at least the following aspects:
(i) Compliance failures, if any, during the preceding year and consequential losses and regulatory action, as also steps taken to avoid recurrence of the same.
(ii) Listing of all major regulatory guidelines issued during the preceding year and steps taken to ensure compliance.
(iii) Compliance with fair practices codes and adherence to standards set by self-regulatory bodies and accounting standards; and

Authority

The CCO and Compliance Function shall have the authority to communicate with any staff member and have access to all records or files that are necessary to enable her / him to carry out entrusted responsibilities in respect of Compliance issues. This authority shall flow from the Compliance Policy of the NBFC.

Dual Hatting

There shall not be any 'dual hatting, i.e., the CCO shall not be given any responsibility which brings elements of conflict of interest, especially any role relating to business.

Qualifications and Staffing of Compliance Function

Apart from having staff with basic qualifications and practical experience in business lines / audit & inspection functions, Compliance Function shall have adequate staff members with knowledge of statutory / regulatory prescriptions, law, accountancy, risk management, information technology, etc.

Appointment and Tenure of CCO

(a) Tenure: The CCO shall be appointed for a minimum fixed tenure of not less than 3 years. However, in exceptional cases. the Board / Board Committee may relax the minimum tenure by one year, provided appropriate succession planning is put in place.

(b) Removal: The CCO shall be transferred / removed before completion of the tenure only in exceptional circumstances, with the explicit prior approval of the Board / Board Committee, after following a well-defined and transparent internal administrative procedure.

(c) Rank: The CCO shall be a senior executive of the NBFC with a position not below two levels from the CEO.

(d) Skills: The CCO shall have a good understanding of the industry and risk management practices, knowledge of regulations, legal requirements, and have sensitivity to Supervisory expectations.

(e) Stature: The CCO shall have the ability to exercise judgment independently. She / He shall have the freedom and authority to interact with regulators / supervisors directly and ensure compliance.

(f) Conduct: CCO shall have a clean track record and unquestionable integrity.

(g) Selection Process: Selection of the candidate for the post of the CCO shall be made based on a well-defined selection process and recommendations made by a committee constituted by the Board / Board Committee for the purpose.

(h) Reporting Requirements: A prior intimation to the Senior Supervisory Manager, Department of Supervision, Reserve Bank of India, shall be provided before appointment, premature transfer, resignation, early retirement, or removal of the CCO.

(i) Reporting Line: The CCO shall have direct reporting lines to the MD & CEO and / or Board / Board Committee.

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QUESTION AND ANSWERS

Q1. NBFCs in India are companies that are registered under which of the following act?

a. **Company Sector 2013**
b. RBI act 1934
c. Banking Regulation Act 1949
d. Negotiable Instrument Act

Q2. As per the scale-based regulation for NBFCs the four layers are (a) base layer (b) middle layer (c) upper layer (d) top layer?

a. **True**
b. False

Q3. NBFCs must follow the rules govern by?

a. Central government
b. **Reserve Bank of India**
c. State Bank of India
d. Security exchange Board of India

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Q4. NBFCs are required to maintain CRR and SLR?

a. True
b. False

Q5. NOFHC stands for Non-Operative Financial Holding Company.

a. True
b. False

Q6. Base Layer comprises of non-deposit taking NBFCs below the asset size of ______.

a. 250 crores
b. 500 crores
c. 1000 crore
d. 5000 crores

Q7. NBFCs undertake which of the following activities?

a. Standalone Primary Dealers (SPDs),
b. Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs)
c. Core Investment Companies (CICs)
d. All the above

Q8. There shall be a ceiling of ________ per borrower for financing subscription to Initial Public Offer (IPO).

a. 10 crores
b. 71 crores
c. 80 crores
d. 100 crores

Q9. The RMC shall be responsible for evaluating the overall risks faced by the NBFC including liquidity risk and will report to the board of __________ .

a. **Risk Management Committee**
b. Audit Committee
c. Board committee
d. All the above

Q10. The CCO shall be appointed for a minimum fixed tenure of not less than ________ years.

a. **3**
b. 5
c. 7
d. 10