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An assessment of the RBI discussion paper on Revised Regulatory Framework for NBFCs – managing systemic risk

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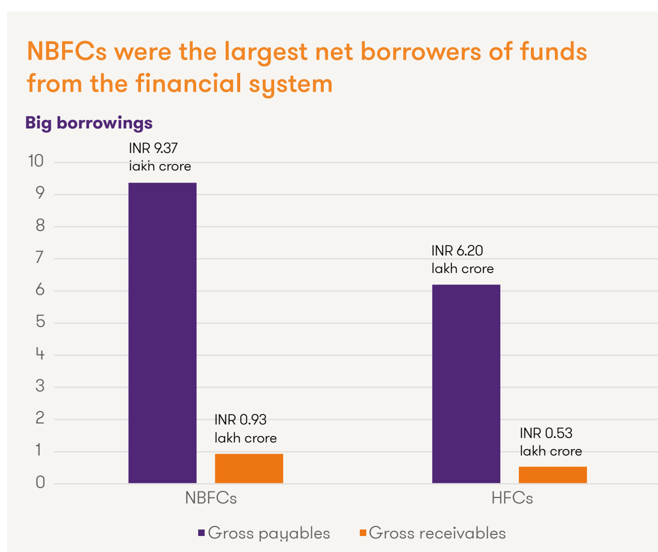
Background

The Reserve Bank of India (RBI) released its discussion paper, Discussion Paper on Revised Regulatory Framework for NBFCs – A Scale-Based Approach, on 22 January 2021. The paper provides the background of regulatory arbitrage between the banks and non-banking financial companies (NBFCs) and why it doesn't exist anymore. The premise for the regulatory arbitrage was the lower scale of operations of NBFCs vis-à-vis banks. The paper also provides some very useful statistics to demonstrate how the NBFCs have grown significantly over the years. Re-producing an extract from page 13 of the paper to elucidate the point: "NBFCs have become more and more interconnected with the financial system. NBFCs were the largest net borrowers of funds from the financial system, with gross payables of INR 9.37 lakh crore and gross receivables of INR 0.93 lakh crore as at end-September 2020. They obtained more than half of their funding from SCBs, followed by AMC-MFs (Mutual Funds) and insurance companies. HFCs were the second-largest borrowers of funds from the financial system, with gross payables of around INR 6.20 lakh crore and gross receivables of INR 0.53 lakh crore as at end-September 2020."

This will help understand the level of inter-connectedness that NBFCs have with the banks today, which poses a very high level of systemic risk. This is why the RBI has applied the principle of proportionality to come out with a scale-based regulatory framework. There are three triggers that the RBI has determined for determining the scale-based regulations for the level of regulations to be applied to the NBFC:

1. Comprehensive risk perception
2. Size of operations
3. Activity of NBFCs



The categorisation of NBFCs for applying scale-based regulation shall be:

NBFC Top Layer (NBFC-TL)	NBFC Middle Layer (NBFC-ML)
NBFC Upper Layer (NBFC-UL)	NBFC Base Layer (NBFC-BL)

The application of the first two triggers of risk perception and size of operations usually results in an NBFC-UL categorisation and the application of the last trigger on the activity of the NBFCs usually results in a ML or BL categorisation. The NBFC-TL category is ideally expected to be empty. While the RBI has not mentioned anything explicitly, it is our view that this category may be looked at for keeping an NBFC till it is converted into a Scheduled Commercial Bank (SCB). Further, the RBI has categorised Standalone Primary Dealers (SPD) in the NBFC-ML category, and it is our view that the same should be categorised under the NBFC-BL category, as the level of regulatory application for a Standalone Primary Dealers (SPD) is similar to a Bank Primary Dealer (Bank PD) with respect to their core business of primary dealers. Since the basis of classification and thereby a need for scale-based regulation, is the inherent regulatory arbitrage, the same is being suggested for SPDs as there is inherently no regulatory arbitrage.

A detailed assessment methodology of identifying NBFC-UL has been specified in the discussion paper. The Top 10 NBFCs by asset size, will be included by default in the NBFC-UL category. Further, a sample of 50 NBFCs will be selected by the supervisor to apply the assessment methodology for categorisation into NBFC-UL. The NBFC-UL categorisation will be reviewed once in four years, with an annual assessment done on all the NBFCs between September and October of the year basis the previous March-end financial data.

Some of the key components of the suggested regulatory framework in the new NBFC categories, which may warrant some discussion, are given below. While there are many changes covered in the discussion paper, and the same is detailed in Annexure 2 of the discussion paper, we are focusing on a few aspects, which, in our view, are important:

- **NBFC – BL – NPA classification** norms shall be harmonised from 180 days to 90 days.
  - It is our view, while this is prudent, the timing of this implementation would be important and it would make sense to do the classification from 1 April 2022. It may be important to bring about this change, once the stabilisation sets in the post-pandemic period.
- **NBFC – ML – Credit Concentration Norms** were prescribed for NBFCs on net owned funds, which shall be switched to Tier 1 Capital to harmonise it with the requirements of banks. The NBFCs have separate credit and investment limits and now the limits would be merged irrespective of whether the same is credit or investment. (Note: The same is also a suggestion provided for NBFC-TL category)
- **NBFC – ML – ICAAP process** to be introduced for the categories for NBFCs for more holistic management of risks within NBFCs. If supervisors are not satisfied with the results of the procedures, they can also suggest maintenance of additional capital. (Note: The same is also a suggestion provided for the NBFC-TL category, as per Annexure 2 of the discussion paper)
  - While an ICAAP framework has been suggested for these categories of NBFC-ML, the requirement seems to be too onerous, as the complexity of NBFC exists largely on the asset side of the balance sheet, while that of a bank exists on both sides of the balance sheet. In our view, while an ICAAP is always a beneficial assessment, the compliance costs may far outweigh the benefits. In our suggestion, the same could be applied to NBFC-TL category, but not to an NBFC-ML category.
- **NBFC – ML – Rotation of statutory auditors'** guidelines to be harmonised with bank statutory auditor appointment guidelines. This is a good suggestion as this will democratise the market beyond the existing few firms and bring greater diversity in professional opinion.
- **NBFC – TL – Minimum requirements of CET-1** capital as applicable for banks are proposed to be suggested for this NBFC category, to improve the quality of regulatory capital.
- **NBFC – TL – Leverage requirements** – In addition to capital to risk (weighted) asset ratio (CRAR) requirements, leverage requirements are also proposed.
- **NBFC – TL – Differential asset provisioning** is being proposed for NBFCs in line with what is proposed for banks from the current standard asset provisioning requirements.

While a scale-based regulatory framework has been suggested as per the discussion paper, it is also important that the RBI considers the implications on its supervisory bandwidth. While supervisory tech is something that the RBI is leveraging and exploring further, it must start partnering with external professionals for augmenting its bandwidth. Regulation without adequate supervision renders a regulation ineffective and augmenting supervisory bandwidth is an important attribute to be addressed. Some of the leading regulators in the world have chosen this path and the RBI may also consider it.

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- Discussion paper on Revised Regulatory Framework for NBFCs- A Scale Based Approach dated January 22, 2021.
- Author Analysis based on understanding of the Financial Services Sector

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