protiviti®
Global Business Consulting

Evaluating Shifts in the NBFC Industry: Decoding RBI Guidelines

Introduction - NBFCs under radar?

Non-Banking Financial Companies (NBFCs) have undergone remarkable expansion over the past few years, seamlessly integrating into the fabric of the Indian financial system. A report by ICRA in October 2023 anticipates a robust growth trajectory of 18-20% in the NBFC retail segment for the fiscal year 2024. This projection holds potential for further augmentation, should demand persist and business activity maintain its vigour. Consequently, the Assets Under Management (AUM) for NBFC-Retail, pegged at approximately Rs. 14 trillion as of March 2023, is poised to ascend to around Rs. 17 trillion by March 2024.

In comparison with the Banking sector, the outstanding credit of Scheduled Commercial Banks, categorized by bank group, as of March 2023 is delineated as follows: sources*

Bank Group	(Amount in ₹ Trillion)	Growth % (YoY)
Public Sector Banks	77	15%
Private Sector Banks	54	19%
Foreign Banks	5	3%
Small Finance Bank	2	34%
All Scheduled Commercial Banks	138	16%

Henceforth, the NBFC credit segment is progressively emerging as a focal point, driven by its accelerated performance and thus, concomitant rise in the significance of reconfiguring regulatory oversight for NBFCs. This phenomenon is further elucidated by the expansion of Gross Bank Credit within the banking sector directed towards NBFCs, reaching approximately Rs. 14 trillion as of September 2023, reflecting a staggering year-on-year growth of 26% since September 2022.

*dbie.rbi

The expeditious expansion of NBFCs has triggered heightened risks and vulnerabilities within the financial system. These risks emanate from the interconnected nature of NBFCs with banks and other financial institutions, their exposure to volatile asset classes, and their dependency on transitory funding sources. To mitigate these risks and uphold the financial system's stability, the Reserve Bank of India (RBI) has undertaken a series of measures aimed at fortifying the regulatory framework governing NBFCs.

Establishing the Context: Enhancements in the Regulatory Framework for NBFCs

Prominent initiatives undertaken by the Reserve Bank of India (RBI) to reinforce the regulatory structure governing NBFCs have primarily centred on categorization, capitalization, reporting protocols, and the comprehensive appraisal of NBFCs. These regulatory modifications underscore a discernible convergence between the operational dynamics and overarching framework of NBFCs and traditional banking institutions. Evidently, a substantial proportion of the regulatory alterations instituted by the RBI in recent years have been strategically designed to subject NBFCs to heightened scrutiny, thereby aligning their regulatory architecture more closely with that of established banking processes/ operations.

In conjunction with the developments, on October 19, 2023, the Reserve Bank of India (RBI) promulgated comprehensive guidelines through the **Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023**. This directive meticulously consolidates diverse directives/circulars while presenting a revamped strategy for overseeing NBFCs. Notably, this Master Direction supersedes various extant NBFC directives and circulars, encompassing pivotal guidelines such as NDSI/NSI-ND NBFC master directions. Tailored to the magnitude of an NBFC's assets, operational scale, and perceived risk, the RBI has instituted a hierarchical framework wherein escalating responsibilities are assigned to each stratum commensurate with the progression of the NBFC.

These modifications encompass a broad spectrum of NBFCs, aimed at enhancing the Reserve Bank of India's regulatory oversight across the specified thematic areas:

Categorization is primarily employed by the RBI to issue diverse regulations and determine their applicability.

Capital Requirement and Risk Monitoring are integral components of overall risk management. In this regard, the RBI has implemented measures to ensure the oversight of capital held in relation to risk-weighted assets.

Asset categorization and provisioning involve the issuance of Income Recognition and Asset Classification norms by the RBI. These norms dictate that NBFCs across various categories must adhere to the maintenance of NPAs and asset classification.

IT Security - The RBI expects controls and governance mechanisms within the information technology and security framework of NBFCs.

Outsourcing - Given the growing influence of fintechs and the rise in the co-lending model's popularity, it is essential to have comprehensive governance on the nature of outsourcing and implement controls accordingly.

Within this document, we aim to analyse the recent changes and assess the impact of the regulatory measures implemented by the RBI in this regard.

Evaluating the ramifications of the regulatory alterations

A. NBFC Categorization

Recent Changes

01 Substituted the conventional classification of Non-Banking Financial Companies (NBFCs) from Systematically Important and Non-Systematically Important to a standardized categorization comprising Base, Middle, Upper, and Top-layer NBFCs *(as per the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023)*.

02 Financial Conglomerates with multiple NBFC subsidiaries and entities will necessitate a realignment, given that NBFCs affiliated with a joint Group or established by a shared set of promoters will not be assessed independently *(outlined in the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023)*.

Impact Analysis

01 The novel regulatory measures have provided relief to numerous Non-Banking Financial Companies (NBFCs) in elucidating the various applicable regulations. This is achieved through the consolidation of diverse master directions and notifications in an overarching umbrella-regulatory-framework modified to their scale of operations.

02 While the existing regulations may not represent the definitive stride towards achieving uniformity across all categories of NBFCs, they embody a balanced approach to overseeing all NBFC categories. Additional efforts are directed towards categories such as NBFC-Peer to Peer Lending Platform, Account Aggregator, Credit Information Companies (CICs), Standalone Primary Dealers, Mortgage Guarantee Companies, and Housing Finance Companies (HFCs). This is necessitated by the need for compliance with regulations specific to these entities, in addition to the NBFC-SBR regulations.

03 The categorization at the group level, as applicable to individual entities, will impact the extent of regulations imposed on smaller or recently established NBFCs operating within existing financial conglomerates. This may also lead to consolidation of entities within group structures, since the regulatory framework will be nearly similar for them.

B. Capital Requirement and Risk Monitoring

Recent Changes

01 Perpetual debt instruments issued by Non-Deposit Taking Systemically Important Institutions (NDSIs) constituted a component of both their Tier I Capital and Tier II Capital. However, Non-Banking Financial Companies – Base Layer (NBFCs-BL) are no longer permitted to classify perpetual debt instruments as part of their Tier I Capital and Tier II Capital, as per the guidelines outlined in the Master Direction issued by the Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation Directions, 2023).

02 A pivotal revision in adhering to regulatory capital standards pertains to the Capital to Risk-Weighted Assets Ratio (CRAR). Specifically, under the Scale Based Regulation (SBR), the stipulation requiring a minimum capital ratio of 15% for Tier I and Tier II Capital in relation to their aggregate risk-weighted assets does not apply to NBFC-BL. (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023).

03 Noteworthy alterations in credit concentration norms, including limits for single borrowers and group borrowers, have been implemented for Non-Banking Financial Companies – Medium-Layer (NBFC-ML). Consequently, NBFCs with Assets Under Management (AUM) up to INR 1,000 Crores are exempt from adhering to concentration monitoring requirements in line with regulatory expectations, as specified in the Non-Banking Financial Company – Scale Based Regulation Directions, 2023.

04 The risk weight assigned to the consumer credit exposure of NBFCs, classified as retail loans (excluding housing loans, educational loans, vehicle loans, loans against gold jewellery, and microfinance/SHG loans), is set at 125%. This regulatory measure towards consumer credit and bank credit to NBFCs aims to ensure appropriate risk assessment, as per the prevailing guidelines.

05 A significant adjustment involves an increase of 25 percentage points in the risk weights Scheduled Commercial Banks (SCBs) applied to their NBFCs exposures. This adjustment applies universally in cases where the existing risk weight, determined by external rating agencies for NBFCs, falls below 100%. This regulatory measure, about consumer credit and bank credit to NBFCs, is designed to enhance prudential risk management.

Impact Analysis

01 In response to the recent regulatory changes, the RBI, in several instances, established diminished criteria for Non-Banking Financial Companies (NBFCs) categorized as Non-Deposit Taking Systemically Important (NDSIs), provided their Assets Under Management (AUM) remain below INR 1000 Crores.

02 The heightened emphasis on exposure monitoring and the imposition of elevated risk weights will necessitate thoroughly examining liquidity management considerations. Consequently, this will require augmented capital reserves thereby a reduced cashflow, potentially impacting both short-term and long-term Asset Liability Management (ALM) within the broader strategic framework.

03 Despite an overall maintenance of the status quo in capital and risk management, the Supervisory Review Process (SBR) has underscored the increased significance of monitoring activities integral to the Internal Capital Adequacy Assessment Process (ICAAP) review and the oversight of large exposures especially for NBFC – ML / UL.

C. Asset categorization and provisioning

Recent Changes

01 A glidepath has been established for Non-Banking Financial Companies (NBFCs) at the Base Layer to shift to the classification of assets as Non-Performing Assets (NPAs) after an overdue period of 90 days, departing from the previous regulatory framework of NBFCs under the Non-Deposit Taking - Non-Systemically Important (ND-NSI) category, which mandated a six-month duration (as per the Non-Banking Financial Company – Scale Based Regulation) Directions, 2023.

Impact Analysis

01 The classification of Non-Performing Assets (NPAs) has been standardized across all categories of Non-Banking Financial Companies (NBFCs), aligning with the NPA categorization practices applied to banks. This alignment aims to enhance transparency and uniformity in credit assessments conducted by lending Financial Institutions (FIs), ensuring accurate categorization as an integral part of credit bureau checks.

02 Despite the introduction of new master directions, there persists a disparity in the classification of assets as 'Sub-Standard Assets' between NBFCs categorized as Base Layer (NBFC-BL) and those categorized as Middle Layer (NBFC-ML) or above, with respective durations of 18 months and 12 months since NPA categorization. This discrepancy can potentially impact provisioning practices and continue inconsistencies in reporting within the NBFC sector.

D. IT Security

The Reserve Bank of India (RBI) has released a comprehensive Master Direction addressing Information Technology Governance, Risk, Controls, and Assurance Practices to ensure uniform IT security controls across Non-Banking Financial Companies – Middle Layer (NBFC-ML) and banks.

Recent Changes *(Key highlights of the updates include:)*

01 Governance Policy documents, approved by the Board, encompassing strategies and policies pertaining to IT, Information Assets, Business Continuity, Information Security, and Cyber Security (encompassing Incident Response and Recovery Management/Cyber Crisis Management).

02 Clearly defined roles and responsibilities for the Information Security Committee, Head of IT Function, and Chief Information Security Officer (CISO) to enhance accountability and efficiency.

03 Strengthened controls for various aspects, including the enterprise data dictionary, adoption of internationally recognized and published standards, Vulnerability Assessment and Penetration Testing (VAPT), CERT-In/IB-CART incident reporting, and regular Disaster Recovery (DR) drills.

04 Increased oversight from the Audit Committee of the Board (ACB) in Information Security (IS) audits to ensure rigorous evaluation and compliance.

Impact Analysis

01 The consistent alignment of expected IT security controls for Banks, NBFCs – ML & UL, and other REs represents another strategic move by the RBI to ensure the implementation of appropriate controls amidst the increasing digitization of processes and the heightened data security risks, particularly around customer privacy data.

02 The establishment of a governance framework and the formalisation of detailed roles and responsibilities at each layer of management and BoD have successfully materialized into an effective monitoring mechanism within NBFCs, particularly towards satisfying enhancing regulatory oversight.

03 In updating these regulations, the RBI has granted flexibility to NBFC - BL, allowing it to adhere to the previous master directions on IT governance and controls. This underscores the intention to enforce heightened controls in tandem with the growth of NBFCs while avoiding undue burdens on smaller financial institutions.

E. Outsourcing

Recent Changes ***(Key highlights of the updates include:)***

A. Master Direction on Outsourcing of Information Technology Services (applicable from 1st Oct 2023):

The provided circular centers its attention on various dimensions, including the Role of the Regulated Entity, Governance Framework, Evaluation and Engagement of Service Providers, Outsourcing Agreement, Risk Management, Monitoring and Control of Outsourced Activities, Outsourcing within a Group / Conglomerate, Cross-Border Outsourcing, Exit Strategy, Usage of Cloud Computing Services, Outsourcing of Security Operations Centre, and finally, Services not considered under Outsourcing of IT Services.

B. Draft Master Direction on Managing Risks and Code of Conduct in Outsourcing of Financial Services. Proposed fundamental changes are as follows:

Material Outsourcing: Inclusion of considerations regarding the degree of difficulty, finding alternatives, impact on the Regulated Entity's counterparties and the financial market, among other factors.

Enhancements in evaluating the Capability of the Service Provider:

i. Examination of any potential conflicts of interest.

ii. Analysis of external factors such as economic, legal, political, and social environments in the jurisdiction where the service provider operates, along with events that may impact service performance.

iii. Assessment of the service provider's ability to effectively service all customers with confidentiality when exposed to multiple Regulated Entities.

iv. Evaluation of disaster recovery arrangements and track record.

v. Examination of the degree of reliance on sub-contractors.

vi. Assessment of the adequacy of the service provider's insurance coverage.

The Outsourcing Agreement:

Emphasis on Service Level Agreements (SLA) with provisions for quality and quantity of service levels, augmented by rigorous continuous monitoring and incident reporting obligations for service providers.

Responsibilities of Direct Sales Agents (DSA)/ Direct Marketing Agents (DMA)/ Recovery Agents: Restriction on calling the borrower/ guarantor before 8:00 a.m. and after 7:00 p.m. for recovery of overdue loans by both Regulated Entities and their Recovery Agents.

Monitoring and Control of Outsourced Activities:

I. Requirement for audit reports to be presented before the Board or ACB of the Regulated Entity.

ii. Mandate for an Annual Compliance Certificate detailing outsourcing contracts, audit periodicity by internal/external auditors, major audit findings, and actions taken, submitted to respective supervisory authorities.

iii. Publicizing terminations through leading local newspapers, prominent branch displays, and website postings in cases of termination due to fraud, data leakage, breach of confidentiality or code of conduct, or blacklisting by regulator/supervisory authority.

iv. Implement an effective process to review and approve any incentive compensation embedded in service provider contracts.

Impact Analysis

01 The Reserve Bank of India (RBI) has prioritized the regulation of IT outsourcing as a critical area, given the escalating reliance of Non-Banking Financial Companies (NBFCs) on technological platforms, cloud services, and vendor-based tools for the management of customer data within their business operations. The imminent guidelines mandate a comprehensive overhaul of the overall controls governing IT outsourcing, along with implementing an enhanced monitoring mechanism.

02 The newly proposed draft guidelines on outsourcing amalgamate previously disparate regulations from various regulatory entities (REs), establishing standardized guidelines applicable to both Banks and NBFCs. This transformation elevates the management of outsourcing risks to a more extensive undertaking, necessitating the acquisition of specialized skills, policy adjustments, strengthened governance, enhanced monitoring mechanisms, and increased budgetary allocations.

"*Outsourcing is about making strategic decisions to maximize efficiency and managing costs and its success lies in finding a balance between leveraging outsourcing services and maintaining robust risk management. These recent directions provide the much needed guidance for responsible outsourcing practices. By managing risks and adhering to regulations, outsourcing can be a strong lever for driving innovation and growth in the Financial Services sector.*"

Dnyanesh Pandit
Managing Director, Financial Services Practice

Key Takeaways

The preceding section illustrates the regulator's increasing focus and altered approach to regulating NBFCs through mechanisms such as SBR and other crucial master directions about outsourcing and information technology by the RBI. With upgraded regulations in place, additional stipulations and enhancements in foresight, it is anticipated that NBFCs, especially those classified as NBFC-Middle layer and Upper layer, will undergo more active assessments and scrutiny.

The following are noteworthy indicators of what lies ahead:

- The recent implementation of the circular on Compliance Function and the Role of Chief Compliance Officer (CCO) for NBFCs has already expanded the role of the compliance department. The SBR regulations will necessitate a reorientation of compliance oversight and functional responsibilities within the organization.
- Strategic focus on regulations, including governance exercised by senior management and the board of directors, requires enhancement. The approach towards integrated risk management must include compliance as a key component, with the necessary accountability and reporting mechanisms across layers of governance forums within the organization and externally to regulators and stakeholders.
- The pace of regulatory changes and heightened expectations establish that 'Flexibility' and 'Adaptability' are no longer merely 'good-to-have' but essential virtues to meet evolving requirements. As NBFCs move towards expansion, they will face increased regulatory scale and compliance obligations, especially those mandated by SEBI regulations for NBFCs requiring to be listed within three years of identification as NBFC-UL by RBI.
- The focus on capital management, including the rate of interest, balance-sheet asset and liability management, reserves, and liquidity, will face increased scrutiny by the RBI, aligning with the regulator's approach and accountability framework for Upper layer NBFCs.
- Exposure monitoring and credit concentration assessment, particularly with the heightened focus on recording LEI numbers, identifying ultimate beneficial owners, CRILIC reporting, collateral, and shares, etc., will be crucial. RBI has established stringent norms for exposure monitoring, and these must become integral to the risk management and portfolio monitoring approach of ML and UL NBFCs.
- The emphasis on specialized service-oriented categorization and regulations is expected to become more specific for various NBFC sectors. Specific NBFCs in the ML category, such as Standalone Primary Dealers (SPDs), Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs), Core Investment Companies (CICs), Housing Finance Companies (HFCs), and Infrastructure Finance Companies (NBFC-IFCs), will experience further enhancements in their regulatory environment.
- Significant changes in the regulatory framework for information technology and outsourcing arrangements, with standard guidelines for Banks and NBFCs, indicate the RBI's intention to align NBFCs with Banks due to the substantial credit exposure of Banks in the form of credit to NBFCs.

In conclusion, while these changes may initially appear as a consolidation exercise by the RBI, there is a more profound strategic agenda envisioned through these steps. The boards of directors and management of NBFCs need to align their business and operations with the circulars' confines and reinvent themselves as a much more advanced financial entity sector than a lending-focused business's traditional mindset.

About Protiviti

Protiviti (www.protiviti.com) is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and its independent and locally owned Member Firms provide clients with consulting and managed solutions in finance, technology, operations, data, analytics, digital, governance, risk and internal audit through its network of more than 85 offices in over 25 countries.

Named to the 2023 Fortune 100 Best Companies to Work For® list, Protiviti has served more than 80 percent of Fortune 100 and nearly 80 percent of Fortune 500 companies. The firm also works with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Contact Us

Dnyanesh Pandit
Managing Director
Phone: +91 98194 46928
Email: dnyanesh.pandit@protivitiglobal.in

Rahul Zaveri
Managing Director
Phone: +91 98209 39694
Email: rahul.zaveri@protivitiglobal.in

Shravan Prabhu
Managing Director
Phone: +91 98190 24009
Email: shravan.prabhu@protivitiglobal.in

Vaibhav Koul
Managing Director
Phone: +91 98197 51715
Email: vaibhav.koul@protivitiglobal.in

Our India Offices:

Bengaluru
Umiya Business Bay - 1, 9th Floor
Cessna Business Park, Outer Ring Road
Kadubeesanahalli, Varthur Hobli
Bengaluru – 560 049
Karnataka, India
Phone: +91.80.6780.9300

Bhubaneswar
1st floor, Unit No 104, 105, 106
Utkal Signature, Chennai Kolkata
Highway Pahala, Bhubaneswar
Khordha - 752 101
Odisha, India

Chennai
10th Floor, Module No. 1007
D Block, North Side, Tidel Park
No. 4, Rajiv Gandhi, Salai
Taramani, Chennai - 600 113
Tamil Nadu, India
Phone: +91.44.6131.5151

Coimbatore
TICEL Bio Park, (1101 - 1104) 11th floor
Somaiyapalyam Village, Anna University
Campus, Maruthamalai Road, Coimbatore
North Taluk, Coimbatore - 641046
Tamil Nadu, India

Gurugram
15th Floor, Tower A,
DLF Building No. 5, DLF Phase III
DLF Cyber City, Gurugram – 122 002
Haryana, India
Phone: +91.124.661.8600

Hyderabad
Q City, 4th Floor, Block B, Survey
No. 109, 110 & 111/2 Nanakramguda
Village Serilingampally Mandal, R.R.
District, Hyderabad – 500 032
Telangana, India
Phone: +91.40.6658.8700

Kolkata
PS Srijan Corporate Park, Unit No. 1001
10th & 16th Floor, Tower - 1, Plot No. 2
Block - EP & GP Sector-V, Bidhannagar
Salt Lake Electronics Complex
Kolkata –700 091
West Bengal, India
Phone: +91.33.6657.1501

Mumbai
1st Floor, Godrej Coliseum
A & B Wing
Somaiya Hospital Road
Sion (East) Mumbai – 400 022
Maharashtra, India
Phone: +91.22.6626.3333

Noida
Windsor Grand, 16th Floor
1C, Sector - 126 Noida
Gautam Buddha Nagar- 201313
Uttar Pradesh, India
Phone: +91.120.697.2700

protiviti®