RBI’s Regulatory Framework for NBFCs

Why in news?

The RBI has proposed a tighter regulatory framework for non-banking financial companies (NBFCs), in its discussion paper on revised regulatory framework for NBFCs.

What are the key provisions?

- **Classification** - The RBI has said the regulatory and supervisory framework of NBFCs should be based on a four-layered structure:
    i. NBFCs in lower layer will be known as NBFC-Base Layer (NBFC-BL).
    ii. NBFCs in middle layer will be known as NBFC-Middle Layer (NBFC-ML).
    iii. NBFCs in the Upper Layer will be known as NBFC-Upper Layer (NBFC-UL).
    iv. There is also a Top Layer, ideally supposed to be empty.
- Each of these will invite a new regulatory superstructure.
- **Regulation** - Once an NBFC is identified as NBFC-UL, it will be subject to enhanced regulatory requirement.
- This will apply at least for four years from its last appearance in the category, even where it does not meet the parametric criteria in the subsequent year.
- In other words, if an identified NBFC-UL does not meet the criteria for classification for 4 consecutive years, it will move out of the enhanced regulatory framework.

How does the classification work?

- **Base Layer** - If the framework is visualised as a pyramid, the bottom of the pyramid will be the base layer.
- This is where least regulatory intervention is warranted.
- It can consist of NBFCs, currently classified as non-systemically important NBFCs (NBFC-ND), NBFCP2P lending platforms, NBFCAA, NOFHC and Type I NBFCs.

- **Middle Layer** - Going up, the next layer can consist of NBFCs currently classified as –
    - systemically important NBFCs (NBFC-ND-SI), deposit taking NBFCs (NBFC-D), housing finance companies, IFCs, IDFs, SPDs and core investment companies
- The regulatory regime for this layer will be stricter compared to the base layer.
- Adverse regulatory arbitrage vis-à-vis banks can be addressed for NBFCs falling in this layer in order to reduce systemic risk spill-overs, where required.
- **Upper Layer** - Going further, the next layer can consist of NBFCs which are identified as systemically significant.
- This layer will be populated by NBFCs which have large potential of systemic spill-over of risks and have the ability to impact financial stability.
- There is no parallel for this layer at present, as this will be a new layer for regulation.
- The regulatory framework for NBFCs falling in this layer will be bank-like, but with suitable and appropriate modifications.
- **Top Layer** - If certain NBFCs in the upper layer are seen to pose extreme risks as per supervisory judgement, they can be put to higher and customized regulatory/supervisory requirements.
- These NBFCs will occupy the top of the upper layer as a distinct set.
- Ideally, this top layer of the pyramid will remain empty unless supervisors take a view on specific NBFCs.

What is the rationale?

- The NBFC sector has seen tremendous growth in recent years.
- The size of NBFC balance sheets is now more than a quarter of that of banks' balance sheets, from just about 12% in 2010.
- In absolute terms, their balance sheets have more than doubled, from Rs 20.72 lakh crore in 2015 to Rs 49.22 lakh crore in 2020.
- This growth is a reflection of how lighter regulations have given them the flexibility to meet a range of financing needs.
    - It offered for needs ranging from home loans to micro-finance and large infrastructure projects.
- However, this also manifested into a systemic risk.
- The risk was apparent when one of the largest infrastructure investment-focused NBFC players, IL&FS, unravelled in 2018.
    - Its payment defaults catalysed a crisis for the entire sector.
    - The collateral damage meant NBFCs could not raise funds easily.
    - NBFCs faced liquidity pressures that escalated to solvency concerns in

some instances.

- In view of the recent stress in the sector, it has become imperative to re-examine the suitability of the regulatory approach.
- The regulatory framework for NBFCs thus needs to be reoriented to keep pace with changing realities in the financial sector.
- If implemented, the present changes could be the biggest overhaul of the regulatory framework for NBFCs in over two decades.

Source: The Indian Express, The Hindu