NBFC-UL Identification: RBI's Proposed Overhaul Towards Simplicity and Regulatory Neutrality

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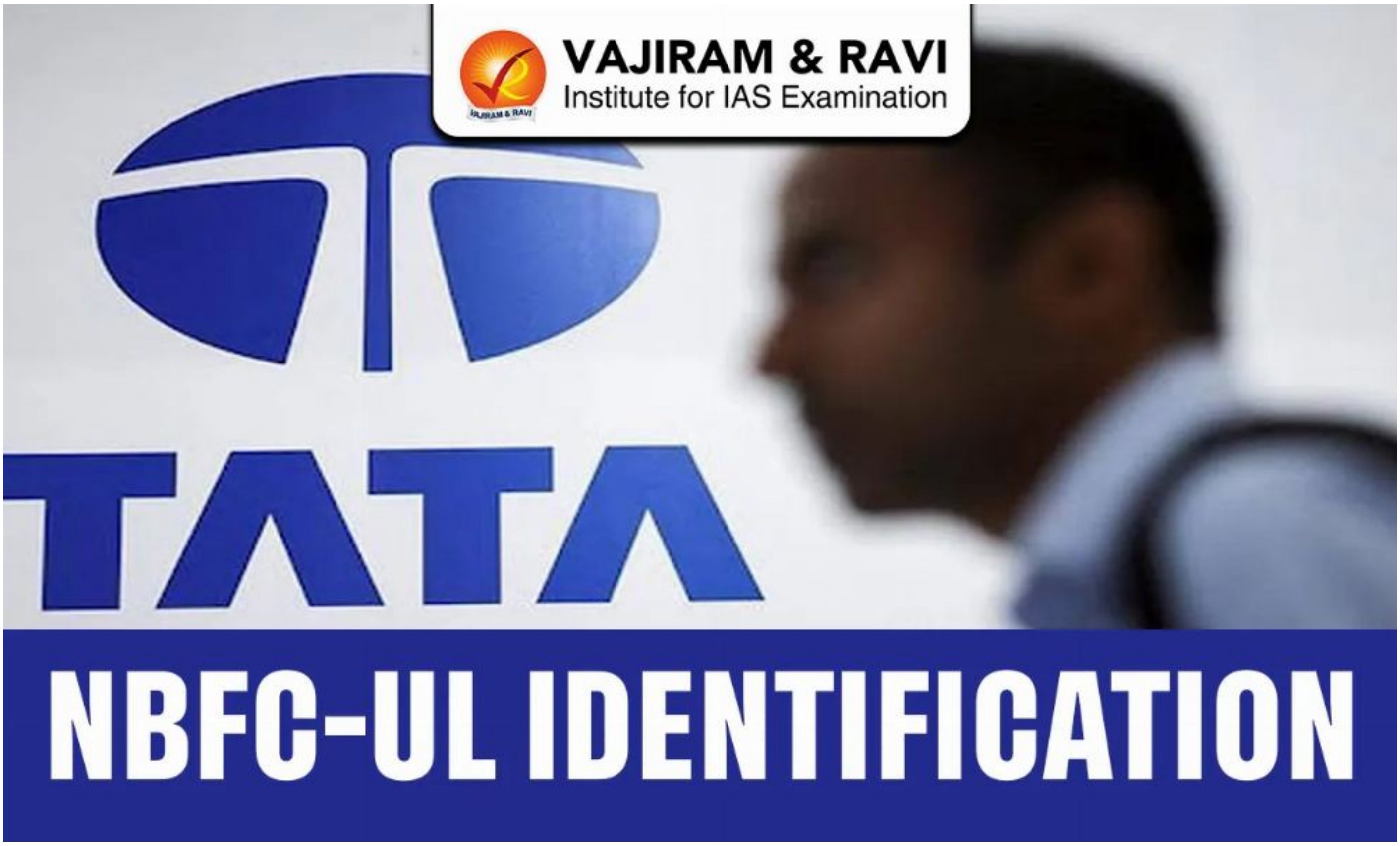

NBFC-UL Identification Latest News

- The Reserve Bank of India (RBI) has released draft amendment directions to revise the methodology for identifying Non-Banking Financial Companies – Upper Layer (NBFC-UL) under the Scale Based Regulatory (**SBR**) **Framework**.
- The move aims to enhance transparency, simplicity, and regulatory parity, while also inviting public consultation.

NBFCs and Their Identification

- **NBFCs:**
  - NBFCs are financial institutions providing banking-like services (loans, investments) without holding a full banking license, regulated by the RBI.
  - Under the SBR framework, they are **categorized into four** layers based on size and risk –

        - **Base Layer (NBFC-BL):** Small, non-deposit-taking NBFCs with fewer systemic risks.
        - **Middle Layer (NBFC-ML):** All deposit-taking NBFCs (NBFC-ND-SI) and non-deposit taking ones above a certain threshold.
        - **Upper Layer (NBFC-UL):** Systemically significant, high-risk NBFCs.
        - **Top Layer (NBFC-TL):** A "blank" layer meant for specific Upper Layer entities that the RBI identifies as posing extreme risk.
    - **NBFC-UL:** These comprises entities that pose significant systemic risks due to their size, complexity, and interconnectedness.
- **Key aspects of NBFC-UL include:**
    - **Identification**: Includes the top ten NBFCs by asset size and others identified through a scoring methodology.
    - **Examples**: Major players like Bajaj Finance, Shriram Finance, Tata Capital, Aditya Birla Finance, and LIC Housing Finance.
    - **Regulation**: Subject to enhanced regulatory provisions, including mandatory listing within 3 years, stricter governance (e.g., higher capital buffers, liquidity ratios), and intensive supervision.
    - **Duration**: Once classified as UL, they must comply with these norms for at least five years, even if their parameters dip.

Existing Framework – Two-Pronged Approach

- Under the current SBR Framework, NBFC-UL entities are identified using –
    - Top 10 NBFCs by asset size, and
    - Parametric scoring methodology (based on risk factors such as leverage, interconnectedness, etc.)
- This approach has been criticized for being complex and less transparent.

Proposed Changes in Draft Directions

- **Shift to asset size-based criteria:**
    - RBI proposes a single, objective threshold – NBFCs with asset size ≥ ₹1,00,000 crore will qualify as NBFC-UL. This replaces the dual methodology with a clear and absolute benchmark.
    - **Significance**: Enhances predictability, reduces ambiguity, and improves ease of compliance.
- **Inclusion of government-owned NBFCs:**
    - Currently, Government-owned NBFCs are placed in Base Layer (NBFC-BL) or Middle Layer (NBFC-ML).
    - Proposed reforms include Government-owned NBFCs in the Upper Layer based on size.
    - **Principle**: Ownership-neutral regulation — treating public and private entities equally.
- **State government guarantees as credit risk transfer tool:**
    - NBFC-UL entities may now use State government guarantees as a credit risk transfer instrument without any cap, subject to conditions.
    - **Implication**: Greater flexibility in risk management and credit expansion.

Corporate Dimension and Expert Opinion

- **Tata Sons episode:**

    - Tata Sons was earlier identified among NBFC-UL entities. To avoid mandatory listing requirements, it surrendered its NBFC licence.
- **Internal tussle:**
    - Shapoorji Pallonji Group (18% stake) – supports listing to unlock value
    - Tata Trusts (66% stake) – opposes listing
    - Revised norms may clarify such regulatory ambiguities in future.
- **Expert opinion – ICRA Ltd highlights:**
    - Asset-size criterion will improve clarity and transparency.
    - Inclusion of Government NBFCs will create a harmonised regulatory framework.
    - Likely increase in number of NBFC-UL entities beyond the current 15.

Key Challenges

- **Regulatory burden:** More entities entering NBFC-UL means stricter regulations (capital adequacy, governance norms), and increased compliance costs.
- **Threshold rigidity:** Sole reliance on asset size may ignore risk heterogeneity, and overlook qualitative factors like interconnectedness.
- **Impact on government NBFCs:** Inclusion may limit operational flexibility, increase compliance pressure on public sector entities.
- **Corporate governance conflicts:** Cases like Tata Sons highlight ownership conflicts, regulatory implications on corporate restructuring.

Way Forward

- **Balanced criteria**: Combine asset size with risk-based indicators to avoid oversimplification.
- **Phased implementation**: Gradual transition for newly included NBFC-UL entities, especially Government-owned ones.
- **Strengthening supervision**: Enhance RBI's supervisory capacity to monitor a larger pool of systemically important NBFCs.
- **Clear guidelines on listing requirements**: Avoid regulatory arbitrage (e.g., surrendering NBFC licence to bypass listing norms).
- **Stakeholder consultation**: Incorporate feedback from industry, experts, and public before final notification.

Conclusion

- The RBI's proposed reforms mark a significant shift towards simplification, transparency, and regulatory neutrality in NBFC supervision.
- While the move strengthens the macroprudential framework and aligns with evolving financial sector dynamics, **careful calibration** is needed to balance ease of regulation with risk sensitivity.
- If implemented prudently, it can enhance the **stability and resilience** of India's shadow banking sector, a critical pillar of financial intermediation.

Source: TH