A Dvara Research Position Paper

Regulatory and Supervisory Approaches for NBFCs

Deepti George, Dwijaraj Bhattacharya, Madhu Srinivas, Sowmini Prasad[1]

Abstract

Non-Banking Finance Companies (NBFCs) play a critical role in the credit ecosystem by acting as last-mile financiers for the unbanked and underserved segments of the Indian economy. The NBFC sector is also significantly large, contributing over 20% of the credit to the real sector. Thus, their continued growth and orderly development are crucial to ensure both complete financial inclusion and systemic stability. However, it appears that at the heart of the current regulatory approach, is a view that NBFCs are competitors to banks rather than their complements. This has led to a scenario where NBFCs are subject to prudential regulations, which are, in some cases, more stringent than those in place for banks and disproportionate to the risks posed by them. Even among NBFCs, the regulatory framework has significant inconsistencies which create regulatory arbitrage between different types of BFCs. Finally, for regulation to be effective, it needs to be complemented by a robust supervisory mechanism and resolution process, both of which are presently inadequate. In this position paper, we fill in these gaps by articulating our holistic vision for the role of NBFCs in the credit ecosystem and the corresponding regulatory, supervisory and resolution frameworks that should apply to them. We envisage NBFCs as credit intermediaries that are not money-creators, operating in the periphery of the banking system and often taking on credit risks that banks are unable to. Correspondingly, we lay out a scale based regulatory framework based on the asset size of the NBFC, and beyond a threshold of asset size, based on its risk-profile and systemic significance. In this framework, the smallest category of NBFCs must not have any minimum capital regulations. However, all NBFCs, irrespective of size or risk-profile, would have to follow uniform conduct regulations and have reporting requirements on their credit activities to enable RBI to monitor the credit market. Complementing this regulatory framework, we also propose a scale-based approach for off-site supervision of NBFCs. Similarly, we lay out a set of principles to identify systemically significant NBFCs. We propose that NBFCs identified as systemically significant be subjected to additional supervisory oversight by the RBI that is closer to that undertaken by the RBI for banks. The systemically significant NBFCs that cross an additional threshold of size and risk must be required to maintain much higher capital requirements to account for contagion risk concerns. Such NBFCs must also be allowed to convert to either full-service or wholesale banks. We conclude the paper by elaborating on the need for a robust resolution mechanism for NBFCs and how we can implement such a framework.

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[1]Authors work with Dvara Research, India. Corresponding author's email ID: deepti.george@dvara.com

A. What Role Do NBFCs Play in the Banking System?

Non-Banking Finance Companies (NBFCs) are a major source of funding for the Indian economy, contributing over 20% of the credit to the real sector. As of July 2020, there were approximately 9500 NBFCs, with 64 having deposit-taking abilities (D-NBFCs) and 292 non-deposit taking NBFCs with assets over Rs. 500 crores (cr)[2] (SI-ND-NBFC). As of March 2020, the total assets of the NBFC sector amounted to Rs. 33.89 lakh cr[3]. Further, over the last six years, excluding 2020, the NBFCs' assets have grown at a higher pace than that of Scheduled Commercial Banks (SCBs)[4], while at the same time, their asset quality has remained significantly better than SCBs[5]. There is an acknowledgement from the Reserve Bank of India (RBI) that NBFCs act as *niche* and *last-mile* financiers[6] and play a critical role in India's credit ecosystem. In this paper, we discuss how NBFCs can be regulated and supervised to enhance efficiency for the overall financial system, while minimising systemic and consumer protection risks, and thus the overall efficacy of credit delivery in India.

The need for NBFCs is deeply rooted in the need to develop a stable and low-risk banking system for India

Since India's independence, its banking sector has been called upon to bear the mantle of nation-building by being the supplier of credit to power its real economy and its growth aspirations. Banks, therefore, have carried the burden of financing priority sectors and infrastructure, as well as significant parts of the corporate sector till the capital markets were created. Most recently, the banking sector has also been given the responsibility of financing India's Micro Small & Medium Enterprise (MSME) sector too. Despite much progress, the current status of the banking system in being able to service these sectors leaves much to be desired, and its size remains small relative to the needs of the country's economy. The policy attempts to push credit at these sectors required banks to lend to them mechanically and directly at subsidised rates, through interest subventions, for instance, and have made bank balance sheets riskier. Further, instead of responding to signals from the real sector and carrying out careful needs and risk analyses, mechanical lending at low rates by banks using badly designed financial products and with poor selectivity has adversely impacted the growth and job creation potential of entire sectors.

While the problem's existence has been evident for many years now, the timing is right for reimagining India's strategy so far for a nation-wide rapid, sustained, and sustainable expansion of credit, not just for the corporate or infrastructure sectors but also for households and small and medium-sized businesses. Particularly for the latter, there is a need for providers who are able to solve the following issues that make banks ill-equipped for the task:

[2] See Chart VI.1 of *Report on Trend and Progress of Banking in India,* RBI, Dec 2020

[3] See Table VI.2 of *Report on Trend and Progress of Banking in India*, RBI, Dec 2020

[4] See Chart VI.2 (b) of *Report on Trend and Progress of Banking in India,* RBI, Dec 2020

[5] Table-20 of *Statistical Tables Relating to Banks in India* (STRBI), on Database Of Indian Economy (DBIE) and Chart VI.25 of *Report on Trend and Progress of Banking in India,* RBI, Dec 2020

[6] Paragraph 1, p. 113 *Report on Trend and Progress of Banking in India,* RBI, Dec 2020

a. A deep understanding of the real-sector risks that these borrowers are exposed to

b. An ability to design and offer financial products which, for example, can automatically reduce financial leverage when conditions turn adverse

c. An ability to offer these products such that the underlying cost-structures are sustainable

Banks often operate across multiple product segments, geographies, and categories of borrowers, and therefore, have limited abilities to specialise. Even if such specialisation is attempted, these come with higher cost structures, which, if priced into the loan, could become too expensive for the end-borrower. Regulations also prevent banks from directly managing some risks, such as embedded commodity price risks of their agriculture credit portfolios. Therefore, even though banks are under pressure to lend directly to these sectors, it is becoming increasingly evident that they are not well equipped to deliver on this goal.

A large cohort of focused non-bank lenders, mostly NBFCs, operating in the periphery of the banking system and engaging in credit activities are better positioned to solve the issues described above. Many of them are able to both understand and manage the risks associated with lending to private concerns in sectors or customer segments that they choose to specialise in. Indeed, many such entities that came into existence got created by real-sector corporates who had specialised expertise in their business and therefore were able to offer financing for the unique needs and characteristics of their existing customer base[7].

NBFCs are, therefore, credit intermediaries who offer ways to expand access to credit in an orderly manner. With their superior information about the underlying borrower, NBFCs reduce information asymmetries about the borrower and help mitigate the moral hazard and adverse selection problems where banks are not well-positioned to originate such credit risks directly. Since they do not have permissions to access demand deposits, they must a) face much lower entry barriers to operate and specialise in their chosen asset classes, and b) face much lower exit barriers to wind up business compared to banks.

NBFCs must be able to fail and shut down with minimal systemic impact so that they can take on risks that banks are unable to. This implies that they will need to be non-deposit taking and have a size below a set threshold, above which they must necessarily convert into a bank, allowing for greater regulatory and supervisory oversight.

Must NBFCs be considered as competitors or complements to banks?

This is an important question to answer. One articulation that NBFCs are competitors to banks is provided by RBI in 2006[8] where it states that "*Banks and NBFCs compete for some similar kinds of business on the asset side. NBFCs offer products/services which include leasing and hire-purchase, corporate loans, investment in non-convertible*

[7]Take the case of the largest NBFCs such as Mahindra & Mahindra Financial Services Ltd which for the first 10 years of its operations was financing only Mahindra & Mahindra utility vehicles.

[8]See DBOD. No. FSD. 5046 / 24.01.028/ 2006-07, accessible at: https://www.rbi.org.in/Scripts/BS_NBFCNotificationView.aspx?Id=3181#:~:text=(ii)%20Capital%20Adequacy%20Ratio%20for,shall%20continue%20to%20be%20applicable

debentures, IPO funding, margin funding, small ticket loans, venture capital, etc ..... Since both the banks and NBFCs are seen to be competing for increasingly similar types of some business, especially on the assets side, and since their regulatory and cost-incentive structures are not identical it is necessary to establish certain checks and balances to ensure that the banks' depositors are not indirectly exposed to the risks of a different cost-incentive structure."

More recently, the RBI has articulated the complementarity aspect. In a speech, in 2015, Shri. R. Gandhi stated that "*NBFCs can be advantageous due to their ability to lower transaction costs, quick decision-making capabilities, customer orientation and prompt provision of services. In terms of products and services offered, the NBFCs complement the banks."*

NBFCs are not in the business of collecting customer-deposits, unlike banks that carry out two distinct functions on a single balance sheet, namely taking demand deposit liabilities and making loans. Banks fund the loans they make by issuing deposits (or promises-to-pay in the official unit of account) that are treated by the wider community not only as credit, but also as money. They have, in effect, immediate purchasing power[9]. Banks, unlike all other intermediaries in the financial ecosystem, have two permissions, which, when made available together, make them distinct as 'money creators'. As articulated by Werner 2014[10]; these are, one, permission to classify their accounts payable liabilities arising from bank loan contracts as a different type of liability called 'customer deposits' (without drawing down balances elsewhere); and two, exemptions from Client Money Rules which frees them from having to segregate client money. NBFCs do not have the first permission and so are akin to any other corporate that lends, i.e., their accounts payable liabilities are met by drawing down on their cash balances sitting in a bank account and by crediting of the borrower's bank account. If banks had not enjoyed the first permission, and if their depositors decide to transfer their bank deposits to non-bank entities, they would have had to borrow from non-banks[11].

Hence, the competition argument cannot be established as banks and NBFCs are not the same kinds of credit intermediaries, and NBFCs, including D-NBFCs[12], are not money/-credit creators. Therefore, NBFCs serve the role of being complements to banks rather than competitors. However, where competition is seen, this must be welcomed as it only serves to improve the competitiveness of the banking system rather than reduce its role in economic development. There are many customer segments and asset classes where NBFCs have demonstrated better performance than banks through better non-performing asset (NPA) numbers and hence profitability.

[9]The 'money creation' view of banking, as articulated in the prompt for a roundtable on Banking: Intermediation or Money Creation. https://justmoney.org/roundtable-1-prompt/. This view was also endorsed by the Bank of England in its Q1 2014 Bulletin, titled *Money Creation in the Modern Economy*, by Michael McLeay, Amar Radia and Ryland Thomas of the Bank's Monetary Analysis Directorate. Accessible at https://www.bankofengland.co.uk/quarterly-bulletin/2014/q1/money-creation-in-the-modern-economy

[10]See *How do banks create money, and why can other firms not do the same? An explanation for the coexistence of lending and deposit-taking.* Richard A. Werner, International Review of Financial Analysis, Volume 36, 2014, Pages 71-77, ISSN 1057-5219, https://doi.org/10.1016/j.irfa.2014.10.013

[11]*Banking: Intermediation or Money Creation: Endorsing the Money-creation View.* M. Lavoie, University of Ottawa, January 08, 2020, https://justmoney.org/endorsing-the-money-creation-view/

[12]D-NBFCs too, like ND-NBFCs lend by drawing down their cash balances.

In reality, NBFCs today work with lower cost structures[13] and higher borrowing costs (given they do not have access to retail deposits) to make their credit offerings. In a scenario where a large bank and an NBFC have equal amounts of information on a potential borrower (an increasingly likely scenario with the digitisation of information trails), the former should lend to a low credit risk customer given the necessarily low risk-profile they need to maintain, while the latter should lend to a higher risk customer (whom the bank would have no way of working with in order to bring down the probability of default (PD) and loss given default (LGD), given their standardised offerings). Many NBFCs, given their knowledge of chosen real-sector businesses, are able to offer more meaningful contracts and collect repayments better from the higher risk borrower. In a scenario where NBFCs were treated more as corporates and less as banks, NBFCs would be able to use their business-model flexibility to their advantage to lend to riskier actors, while ensuring that NPAs remain low and pricing affordable (where there is adequate competition to bring down pricing). This would imply that the PD can be reduced by tweaking the manner in which the contract is set up and how the lender interacts with the borrower post disbursement. But such underwriting abilities are not exclusive to NBFCs alone. Banks can choose to incorporate some of these elements into their own underwriting processes or specialise in a limited set of asset classes. Hence, the distinction between banks and NBFCs would disappear, making them competitors of each other on the lending side. If so, such competition needs to be encouraged rather than stymied.

We conclude that it is well-established that NBFCs are complementary to banks when it comes to credit provision, and where competition may exist, as they do in many asset classes, it must be welcomed.

Laying out an ideal to aspire to

The RBI has the responsibility to '*operate the credit system of the country to its advantage*' as stated in the preamble of the RBI Act, 1934. To provide universal access to credit and to ensure systemic stability, it has to consider the question of how to develop credit markets such that credit becomes available across the entire risk-spectrum in a way that risk ordinality is achieved (where borrowers with comparable risk-profiles and loan sizes are priced in an identical manner no matter which segment they represent) and such a system works efficiently (resources and capital get allocated to the most efficient and bad actors are weeded out as quickly as possible).

The RBI must therefore shift away from its current stance of considering NBFCs as competitors to banks and move towards a stance where it sees banks and NBFCs performing complementary functions in underwriting and originating risks across the risk-return spectrum. To exemplify, while both banks and NBFCs may originate personal loans and corporate loans, banks, given their access to retail demand deposits and permissions to engage in money creation, must not engage in lending to riskier borrowers or undertake high-risk activities while NBFCs can. While NBFCs are free to originate low-risk loans just like banks, the fact that they do imply that despite comp-

[13]Such as operating costs and provisioning expenses. See *Cost of Delivering Rural Credit in India.* A. Sahasranaman and D. George. Note 1, Notes on the Indian Financial System, Dvara Research 2013. Accessible at https://www.dvara.com/research/wp-content/uploads/2013/04/Cost-of-Delivering-Rural-Credit-in-India.pdf

-etitive advantages of banks over NBFCs, particularly with respect to very low-cost deposits, NBFCs are able to make offerings that customers find more attractive than that made by banks operating in the same segments. Therefore, NBFCs must be seen as contributing to improving the competitiveness of banks themselves on their risk-adjusted performance while also improving their abilities to build their books with low-risk assets[14].

Hence, in an ideal scenario, where banks must form the low-risk core of the financial system, the riskier periphery will comprise of intermediaries such as NBFCs and Alternate Investment Funds (AIFs) that intermediate wholesale funds in order to lend to riskier segments, whether they be retail or wholesale borrowers. The strong core also allows the periphery to become riskier without increasing systemic risk. As the credit delivery system gets closer to the frontiers of SME finance, micro-lending, new unbanked geographies, and agricultural finance, well-managed banks can build strong and stable partnerships with multiple types of risk originators including NBFCs and use their larger sizes to act as risk-aggregators, lowering unexpected losses through diversification, and careful structuring and management of their own, much larger, balance sheets.

However, this raises the question of how banks can remain low risk if they are to lend to risky NBFCs that form the periphery. Once significant strides are made towards the idea of having banks with low-risk profiles, this would drive the demand for low-risk assets by banks. This would, in turn, give rise to mainstreaming of activities by third-party entities that can bring down the riskiness of assets originated. For instance, entities that can act as guarantors to NBFC debt or loans reduce the overall risk assumed by banks while taking exposures to such debt or loans. In the case of loans, the originating NBFC will carry the losses incurred on these loans up to a set limit, and these guarantee-providing entities will step in to provide second loss default guarantee (SLDG) for a portion of the same portfolio, at a level above what the originator has provided as first loss default guarantee (FLDG) and till a pre-specified limit. By doing so, the overall credit rating of the loan portfolio/facility can improve even if the originator has credit ratings lower than this. This is not new, and such third-party guarantors have provided SLDGs and other forms of credit enhancements by participating in securitisation transactions of loan pools and pooled bond issuances of NBFCs, by investing in the junior tranches of securitisation transactions and by providing guarantees for bank loans to NBFCs. The entities giving guarantee could include other banks, NBFCs and All-India Financial Institutions (AIFIs) like Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD). A key bottleneck in enabling such risk-management activities in the banking system is the need for creating demand for low-risk paper by the banking system. This can be enabled only through a concerted attempt by the RBI and the Government of India to bring down the risk-profile of the banks in the country, particularly the larger and the more systemically important ones.

[14]See *Fixing India's Banks: Making Banking Boring Again.* N. Mor and D.George, January 7, 2021, BloombergQuint, for an opinion piece on the subject. Accessible at: https://www.bloombergquint.com/opinion/fixing-indias-banks-making-banking-boring-again

B. Must RBI Regulate NBFCs?

NBFCs are a subset of corporates who engage in the business of credit intermediation, i.e., they borrow from the financial system (banks and capital markets) and lend to real-sector entities (individuals, households, enterprises) for the most part. Corporates borrow and lend as part of their business, and they, therefore, become debtors and creditors, respectively. NBFCs too do the same, with the only difference being that such activities form more than 50% of their net income and that their financial assets form more than 50% of their total assets (popularly known as the 50:50 rule of the RBI). But such distinction is merely for identification, and any holding company can technically breach this limit without having to be classified as an NBFC. That NBFCs have a high leverage (debt to equity) is also not unique to them, as there are non-financial industries such as the airline industry that carry similarly high or even higher leverage on their balance sheets. It is therefore important to articulate why the RBI wishes to regulate NBFCs while other corporates who engage in similar activities do not need to be regulated.

RBI must articulate why it considers it necessary to regulate NBFCs

RBI has articulated its regulatory interventions based on whether the NBFC has access to public funds[15] (which includes bank loans), and whether it has a customer interface. This implies that the RBI sees three distinctions between NBFCs and other corporates, namely, that they can perpetuate contagion effects on the rest of the system upon the entity's failure and, in doing so, place not only retail depositor monies at risk but also negatively affect other parts of the economy, and that they could cause retail customer level harms such as through over-lending. We question whether these distinctions are valid.

1. **The need to protect bank funds**: One of the older arguments posed by the RBI in the pre-crisis world was that, NBFCs draw a large portion of their liabilities from the banking system and that bank funds may get used for very risky activities like investing in capital markets[16]. Banks' exposure to NBFCs have grown from almost 30% in March 2018 to 36% as of September 2020[17]. However, this dependence on bank funds is not unique to NBFCs. In steel and power sectors, for instance, banks' exposures to the largest corporates hover between 40% and 62%[18]. If a large steel company fails, it has repercussions for all major banks in India today. Take the

[15]'Public funds' shall include funds raised either directly or indirectly through public deposits, commercial paper, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue. See *RBI decides to simplify and rationalise the process of registration of new NBFCs*, RBI, June 17, 2016. Accessible at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=37253

[16]For instance, the report of the RBI Internal Group on issues relating to 'level playing field', regulatory convergence and regulatory arbitrage in the financial sector 2006 states that *"it would be essential to limit the permissible bank financing for the permitted activities to ensure that the bank funds do not facilitate their taking very large capital market exposures as it may jeopardize the safety of bank funds"*.

[17]Chart IV.13 b *Trends and Progress of Banking in India*, RBI Dec 2020 and Chart IV.6 *Trends and Progress of Banking in India*, RBI Dec 2019

[18]The borrowings from banks and financial institutions as a % of total borrowings are: 61.4% (SAIL), 49.8% (Tata Steel), 54.6% (JSW) in steel sector, and 46.1% (Power Grid Corporation), 43.7% (NTPC) in power sector.

case of Bhushan Power and Steel[19]. Hence, RBI's articulation of regulating NB--FCs simply because they may put funds of their lender-banks at risk is not valid.

2. **Customer protection concerns in financial services:** When NBFCs have even one retail borrower as their customer, the regulator must worry about whether the borrower is being subjected to unfair treatment or whether her rights as a financial customer are being violated due to her interactions with the NBFC[20]. The regulator must ensure that the customer experiences the same level of institutional conduct from her bank and her NBFC for her credit needs. The risk-profile of the customer should be immaterial to how the bank or the NBFC must treat her[21]. This is a valid concern, even if the RBI does not bring under its purview corporates who lend to retail borrowers but who do not meet the 50:50 threshold test.

3. **Contagion risks for the financial system**: Depending on the degree of interconnectedness with other parts of the financial system, the failure of a large NBFC could result in contagion to the rest of the NBFC- and banking sectors as well as to other parts that perform the role of intermediation, such as insurance and mutual fund sectors. The resulting shocks to the credit supply markets could halt activities in the real economy and negatively impact GDP growth, which may then require the RBI and the government to step in with drastic measures such as extending Lender of Last Resort (LOLR) facilities to NBFCs[22]. Indeed, the need for identifying and more strictly regulating Systemically Important Financial Institutions (SIFI) got introduced in the aftermath of the global financial crisis.

Therefore, most NBFCs are not different from any other large corporates that borrow from the banking system and carry highly leveraged balance sheets (for instance, the airline industry). This leaves us to conclude that there is no real reason to subject NBFCs to micro-prudential regulations with the objective of attaining firm-level solvency. Therefore, any regulation (and supervision) need pertain only to customer protection concerns[23]. The Financial Sector Legislative Reforms Commission (FSLRC) had come to a similar conclusion that *"the class of NBFCs that do not accept deposits from public will not be regulated by the banking regulator"*[24]. It also concluded that *"with a view to systemic risk oversight, this Working Group recognises that credit linkages between banking*

[19] https://economictimes.indiatimes.com/industry/indl-goods/svs/steel/at-bhushan-tata-takeover-is-banks-delight/articleshow/63438033.cms?from=mdr

[20] Indeed, the RBI requires non-deposit taking NBFCs with assets less than Rs.500 cr having customer interface to be subjected to conduct of business regulations including FPC, KYC etc

[21] On this front, one could argue whether credit and other financial services is any different from say an FMCG good and that shouldn't it be enough for the RBI to regulate credit like how FMCG goods are regulated under the Consumer Protection Act. Financial products are different from physical products in that unlike physical products, financial products lack visibility and, unlike many services, they reveal their real outcomes at a point in time beyond the time of purchase. Clients thus have limited ability to assess upfront, the quality of a product.

[22] This was considered by the RBI according to *RBI ready to be lender of last resort for NBFCs, but it's not needed as of now, says Acharya*, BloombergQuint, December 5, 2018. Accessible at: https://www.bloombergquint.com/global-economics/rbi-ready-to-be-lender-of-last-resort-for-nbfcs-but-its-not-needed-as-of-now-says-acharya

[23] Indeed, the RBI has taken this stance and requires NBFCs with customer interface to be subjected to conduct of business regulations including FPC, KYC etc

[24] 19.10.3 (5), pg. 183, *Report of the FSLRC, Vol. I: Analysis and Recommendations,* 2013. Accessible at: https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf

and non-bank finance should be subject to appropriate regulatory oversight from the viewpoints of both micro-prudential regulation and systemic risk regulation".

We recognise that there are certain theoretical and practical considerations that suggest that NBFCs must indeed be subject to micro-prudential regulations. Theory on the financial structure of firms indicates that raising the level of capital increases the ability of firms, in this case, NBFCs, to absorb losses and thus reduce episodes of failure[25]. However, in the absence of regulation, the level of equity capital for NBFCs would be entirely dependent on the strength of the market disciplining mechanisms. As the FSLRC argues, the realities of information asymmetry, coordination problems and market power weaken the market disciplining mechanisms[26] and thus warrant the need for micro-prudential regulation. There also exist other challenges like inadequate contract enforcement, the absence of resolution mechanisms for very large systemically significant NBFCs[27], and the inadequate abilities of banks to do effective credit monitoring[28]. It is therefore not desirable to entirely depend on market discipline[29] and exempt NBFCs, even those completely financed by regulated financial institutions and other wholesale capital providers, from prudential regulations by the RBI.

Until these issues are resolved comprehensively, the applicability of prudential requirements may be needed, and the RBI needs to clarify this against the ideal that it envisages for the banking system in which it must consider banks as originators and holders of low-risk assets. It must also articulate a pathway that it will embark on to reach this ideal (as described in Section A). Some of these issues arise from limitations within the RBI, and these require the RBI to work towards overcoming them. As RBI progresses on these fronts, it is also imperative that it revisits the need for prudential interventions in the NBFC sector and progressively phase out (rather than introduce further) these requirements as it deems appropriate.

[25] *A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence.* Dewatripont, M., & Tirole, J. The Quarterly Journal of Economics, 109(4), 1027-1054. 1994

[26] See Chapter 6.1, *Report of the FSLRC, Vol. I: Analysis and Recommendations,* 2013. Accessible at https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf

[27] NBFCs were recently included under the *Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority Rules*, 2019 (FSP Rules), IBC, but they also find place within the FRDI Bill. See Section C.5 of this note for a discussion.

[28] See *Why we need banks... and getting Indian banking right*, N. Mor and M.Srinivas, December 29, 2020, BloombergQuint, for an opinion piece on the subject. Accessible at: https://www.bloombergquint. com/opinion/why-we-need-banks-and-getting-indian-banking-right

[29] Market discipline, as clarified by FSLRC to mean the process by which informed consumers identify and avoid dealing with unacceptably risky financial service providers.

C. Reimagining India's Approach to NBFCs

This section is divided into five parts. Section C.1 provides a limited critique of RBI's current approach to the regulation of NBFCs, C.2 lays out a scale-based regulatory framework for a modern NBFC sector, including that for systemically significant NBFCs (SS-NBFC), C.3 provides a scale-based supervisory framework for the same, C.4 proposes a risk-based framework for identification of SS-NBFCs, and C.5 discusses how to resolve NBFCs.

C.1 A Critique Of RBI's Approach to Regulation of NBFCs

1. Deposit-taking permissions hinder any reforming of RBI's approach to non-deposit taking NBFCs

NBFCs are corporates that pass the 50:50 test of the RBI. A smaller subset of NBFCs among these have permissions to accept retail term deposits. Corporates are not permitted to accept public deposits under the Companies Act 2013, and a carve-out has been made for NBFCs and housing finance companies (HFC). Although these NBFCs cannot accept deposits on demand (which would make them akin to banks without LOLR and deposit insurance) and given that they engage in concentrated credit risk origination, it is unclear why RBI must permit such NBFCs to continue, and what purpose such a regulatory carve-out is expected to serve. Since other forms of accessing retail liabilities such as privately placed and listed non-convertible debentures (NCD) do not require regulation under RBI and are governed by other regulators and because deposit-taking is otherwise generally prohibited under the Companies Act 2013[30], there does not seem any reason why D-NBFCs must be treated differently (from other entities accessing public monies such as through listed debt) in order to be allowed to access retail deposits.

The RBI has been applying progressively more stringent regulations over D-NBFCs since they stopped issuing fresh D-NBFC registrations in 1997. However, the time has come for RBI to question whether NBFCs must be permitted to continue accepting retail term deposits, in line with a strategy it must lay out for modernisation of India's banking sector. On the issue of NBFCs, the FLSRC's Working Group too recommends that deposit-taking NBFCs must obtain a license to operate as a bank and be made to fall within the regulatory purview of the banking regulator.

The RBI must consider offering the following options to D-NBFCs to remove any undue advantage that D-NBFCs enjoy over banks, ND-NBFCs and non-financial corporates in raising funds from the retail public.

- All deposit-taking NBFCs must stop accepting fresh retail deposits and convert to ND-NBFCs in a phased manner or be required to convert to full-service banks. For

[30]Exceptions are D-NBFCs, HFCs, Nidhi Companies. The MCA has applied a similar approach to regulating Nidhi companies (ratio of net owned funds to deposits to not exceed 1:20) as a depositor-protection measure. Nidhi Companies cannot raise debt through any other means other than deposits from their members, nor can they lend to anyone who is not a member.

the latter, in case such conversion has issues with corporate ownership and self-dealing, the RBI can consider granting them wholesale bank[31] licenses as envisaged by the RBI Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households (Chair: Dr. Nachiket Mor).

- Till such time the D-NBFC continues to accept term deposits from the retail public, the RBI must require such NBFCs to comply with disclosures that are at least as stringent as that required by the Securities and Exchange Board of India (SEBI) and RBI on NBFCs that issue listed debt[32]. This is so that the degree of transparency available to retail investors of listed debt becomes available to retail depositors in any non-bank institution, and any artificial distinctions in regulatory disclosures of term deposits and listed debentures arising from the fact that deposits are not securities can be removed.
  - SEBI's disclosure requirements go beyond just annual report and financial statements and include disclosures like Memorandum of Association, utilisation of issue proceeds, material events as and when they happen[33].
  - SEBI requires companies with listed debt to publish their financial results on a quarterly basis[34]. These disclosure items are missing in RBI's public disclosure regime for D-NBFCs[35]. Thus, for instance, depositors might not know the end use of their deposit funds, but investors in listed NCDs at least receive a statement on the utilisation of their funds in the offer document.
  - SEBI specifies the mechanism through which information is to reach the investors — through the stock exchange or direct dissemination to the security holders[36]. This articulation is missing in the RBI regime, i.e., there is no explicit mandate by RBI that D-NBFCs should ensure the proper dissemination of information to their depositors.

RBI's approach to regulating and supervising ND-NBFCs must be distinct and separate from its approach for D-NBFCs till such time D-NBFCs are permitted to continue accepting retail deposits. Such an approach must consider NBFCs for what they really are — non-banking corporate entities that borrow 'wholesale', i.e., through bank loans and raise debt through private placements and from public investors through the listed

[31] A wholesale bank licensee as recommended by the Mor Committee, will have permissions to borrow wholesale, including through demand deposits of say minimum Rs.5 cr, and freedoms to lend both wholesale and retail. See also *Is it time to introduce wholesale banks in India?*. D.George and M.Srinivas, Livemint, 25 October 2018. Accessible at: https://www.livemint.com/Opinion/CRtbv6vPwppPpmXsM6VKrK/Opinion--Is-it-time-to-introduce-wholesale-banks-in-India.html

[32] The comparison of term deposits here is with listed debt rather than privately placed debt because in the latter, private placement can be made only to a maximum of 200 persons in aggregate in a financial year (compared to public deposits that are solicited from the public). Also, term deposits have no tradability compared to listed debt and so their holders cannot liquidate their positions as fast if there are early warning signals on deteriorating financial position of the NBFC.

[33] Schedule 1 of SEBI *Issue and Listing of Debt Securities Regulations*, 2008 and Chapter 2 of SEBI *Listing Obligations and Disclosure Requirements* Regulations, 2015

[34] Section 33 of SEBI *Listing Obligations and Disclosure Requirements* Regulations, 2015

[35] *Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company Directions*, RBI, 2016

[36] SEBI *Listing Obligations and Disclosure Requirements* Regulations, 2015

route and lend either 'wholesale' or 'retail'[37] (where the borrower is an individual or unsophisticated entity).

That such NBFCs borrow from banks must purely be based on their abilities to convince banks of their creditworthiness, and this is to be decided by each bank's abilities to underwrite such credit risks with or without support from credit rating agencies. This is articulated clearly in the report of the RBI Internal Group on issues relating to 'level playing field', regulatory convergence and regulatory arbitrage in the financial sector 2006[38], where it is stated that *"it is the perception that the lenders in the category of banks, term lending institutions, corporate bodies and others having proper appraisal techniques will be taking adequate precaution for protection of their interests while taking exposure on these entities"*. This position is also reflected in the report of the RBI Working Group on the Issues and Concerns in the NBFC sector 2011 (Chair: Usha Thorat)[39], where it says, "*it is not the intention of the regulator to protect wholesale lenders and investors who are expected to exercise prudence while lending to NBFCs"*. In the event an NBFC fails, the loss must be borne by the bank who has lent to it, and the resolution of the NBFC must be swift so that capital and labour can move freely from poorly performing firms to better ones. In other words, RBI's approach to regulation and supervision of ND-NBFCs must allow for creative destruction.

2. Sharpening the definition of public funds and its applicability

RBI requires NBFCs (with asset size above Rs.500 cr) that access public funds to be subjected to prudential regulations. The current definition of public funds includes "*funds raised either directly or indirectly through public deposits, commercial paper, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue in the case of CICs*". Therefore, this definition of public funds is very expansive in that any NBFC raising any form of debt would be construed to accept public funds[40]. Such framing implies that almost all NBFCs would be considered to accept public funds whereas in reality, other than 'public deposits', all other sources of funds are wholesale in nature[41] (except in the case of listed debt instruments where SEBI's Issue and Listing of Debt Securities regulations (ILDS) and Listing Obligations and Disclosure Requirements (LODR) apply and these can be accessed by retail investors).

Till such time D-NBFCs are permitted to exist, the RBI must reframe the definition of public funds to ensure that such framing becomes applicable only to D-NBFCs since they are the only subset of NBFCs accessing public funds in the form of retail deposits.

[37]For a full discussion on an approach to frame 'retail' and 'wholesale' in financial services, see *Universal Conduct Obligations for Financial Services Providers Serving Retail Customers* . Deepti George, Dvara Research, 2019. Accessible at: https://www.dvara.com/research/wp-content/uploads/2019/05/Universal-Conduct-Obligations-for-Financial-Services-Providers-Serving-Retail-Customers.pdf

[38]Accessible at: https://rbi.org.in/scripts/PublicationDraftReports.aspx?ID=449

[39]Accessible at: https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=647

[40]Non-financial corporates too can raise funds through all the routes covered under the 'public funds' definition. To raise term deposits from the public, they need to comply with deposit acceptance rules under the Companies Act 2013

[41]It is unclear why in the case of wholesale 'public funds' providers, there is a need (articulated by the RBI) to protect them from risks they are expected to be mindful of before participating.

The remaining NBFC universe rely only on wholesale sources of funding for their liabilities (just like non-financial corporates and Alternative Investment Funds) and hence must not be subjected to the current definition of public funds.

Application of capital and leverage ratio prescriptions on Non-Deposit taking NBFCs

The RBI currently uses the 'public fund' framing to regulate any NBFC accessing loans from the banking sector. NBFCs with asset size beyond a prescribed threshold[42] accessing 'public funds' are subject to the following micro-prudential prescriptions. Taking a cue from the RBI, market participants, such as credit rating agencies and wholesale lenders like banks, place similar or higher requirements on both non-SI NBFCs and SI-NBFCs[43].

- Minimum regulatory capital adequacy requirements for credit risk, under the Basel I framing

Currently, any NBFC raising liabilities from the market is subject to the RBI's minimum capital adequacy requirements due to the manner in which 'public funds' has been defined. RBI's minimum regulatory capital prescriptions are in the range of 12-15% depending on the NBFC type, and are much higher than that prescribed for banks. This results in inefficiencies in capital deployment because of the regulatory 'pancaking' of capital. That is, the bank which lends to the NBFC, and additionally, unlike in the case of any other corporate borrower of the bank, the NBFC which lends to the end borrower, are both required to allocate capital against the same underlying risk. These raise the cost of loans to the end-borrower without any added impact on overall systemic risk levels as a bank lending to the same end-borrower does not have to keep aside the extra capital. Such minimum capital cushions on NBFCs serve only to decrease the availability of risk capital. The levels of economic capital NBFCs must hold for the risks they originate must be left to the markets to decide (in this case, the NBFC's wholesale lenders, including banks), and the RBI must aspire to such an ideal end-state. Markets and credit rating agencies take a cue from RBI's signalling of what it considers as a minimum and require NBFCs to hold much higher levels of economic capital, rather than arriving at this decision based on the riskiness of each NBFC's assets and performance alone[44]. This is reflected in the system level capital adequacy of NBFCs. As of March 2020, the system level Capital to Risk-Weighted Assets Ratio (CRAR) stood at 19.1%, much higher than the regulatory

[42] Currently Rs.500 cr asset size

[43] For instance, See ICRA's *Rating Methodology for Non-Banking Finance Companies*, Sep 2019, accessible at: https://www.icraresearch.in/Home/GetMethodologyPdf/652; and CARE's *Rating Methodology for Non-Banking Finance Companies*, Sep 2019, accessible at: https://www.careratings.com/upload/NewsFiles/GetRated/Rating%20Methodology-%20NBFC_Sept2019.pdf

[44] Rating rationales for even well-capitalised NBFCs include language requiring the NBFC to increase their CRAR to improve their ratings. Take the case of microfinance - Despite low NPAs, rating agencies have pushed for NBFC-MFIs to hold capital levels that are much higher than that prescribed by RBI. For instance, CRISIL's rating rationale for NCDs of Annapurna Finance Pvt Ltd, an NBFC-MFI states "*Given the idiosyncratic risks inherent in the sector, the company intends to maintain its adjusted gearing at 5.5-6 times and tier I CAR at above 20% - on a steady state basis, which is in line with CRISIL's expectation.*" Accessible at https://www.crisil.com/mnt/winshare/Ratings/RatingList/RatingDocs/Annapurna_Finance_Private_Limited_August_21_2020_RR.html https://www.careratings.com/upload/NewsFiles/GetRated/Rating%20Methodology-%20NBFC_Sept2019.pdf

prescription of 15%[45]. The system level Tier-I capital was maintained at 16%, again much higher than the regulatory requirement of 10%[46].

In the ideal end state that RBI must aspire for, each bank is free to estimate the unexpected loss (UL) from its exposure to each NBFC and is able to set aside capital to ensure that UL will exceed this level of capital with only a very low fixed probability. Indian banks that have permissions to use the Internal Ratings Based (IRB) approach for Basel compliance are already doing this, and RBI's endeavour must be to sharpen each bank's internal capability in this regard. Since the NBFCs are only transmitting the money created by banks, the capital each bank sets aside must depend on the bank's estimation of the respective NBFC's UL, irrespective of which type the NBFC belongs to, and the NBFC must not be required to keep any additional capital on its own through the enforcement of a regulatory prescription. One concern articulated by the RBI is that since money is fungible, it is possible for NBFCs to use bank funds for very risky activities while using their own funds for less-risky lending[47]. This concern is misplaced as banks with prudent underwriting are likely to separately assess the obligor rating and the loan/ facility rating and take a considered decision on whether to lend to the NBFC. The RBI must strive to improve, through its supervisory processes, prudence in decision-making by banks, rather than require NBFCs to hold high levels of capital (much beyond what is required to cushion their UL, as estimated by the lender banks). The bank is free to require their borrower NBFCs to hold economic capital, but this is a bilateral arrangement, and this may be more or less than the current regulatory capital adequacy prescriptions.

- Maximum leverage ratio of 7 —

This is currently applicable on ND-NBFCs with asset size lesser than Rs.500 cr and is defined as total outside liabilities / owned funds. The leverage ratio serves as a non-risk-based backstop on NBFC size vis-a-vis their equity cushion. This prescription on NBFCs has a similar effect as the minimum regulatory capital adequacy ratios in that it prevents the more efficient NBFCs from leveraging their equity beyond 7[48]. Given that these are non-systemically important NBFCs accessing only wholesale funds, the leverage ratio of these NBFCs should be decided by the market instead of being prescribed by the regulator. In comparison, banks have a minimum leverage requirement of 3.5%[49].

- Liquidity Coverage ratio —

RBI's current approach towards liquidity regulations of NBFCs is adequate and is in line with our model regulatory framework, as articulated in Section C.2 of this note.

[45] Chart IV.30 *Trends and Progress of Banking in India*, RBI Dec 2020

[46] Section 2.11 *Trends and Progress of Banking in India*, RBI Dec 2020

[47] 3.1.6 (b), Report of the RBI *Internal Group on issues relating to 'level playing field', regulatory convergence and regulatory arbitrage in the financial sector* 2006.

[48] Defined as net owned funds/outside liabilities.

[49] Defined as net owned funds/total assets (non-risk weighted). If one were to apply the leverage definition for NBFCs on banks, banks can leverage upto 28 times.

3. RBI's approach to Activity based regulation needs further sharpening

According to the FSLRC, micro-prudential regulation refers to "*the regulation that governs safety and soundness of certain financial service providers. The rationale, scope and extent of micro-prudential regulation are primarily motivated by consumer protection concerns*". It advocates for micro-prudential regulation of financial firms to be based only on the financial function performed by the firm[50] and thus, be institution neutral. However, this principle has not been followed in the regulation of NBFCs. The following instances exemplify this:

- Both NBFC-MFIs and non-deposit taking NBFC-ICCs (investment and credit companies) perform the same financial function[51] of giving retail credit while accessing wholesale funding. To this extent, the prudential regulations applicable to both sets of firms need to be similar. However, we find that there are differences in the prudential regulations applicable to both sets of firms[52].

- The definition of public funds is such that non-deposit-taking NBFCs, whose entire liabilities consist of only bank finance and other wholesale liabilities, are regulated on par with deposit-taking NBFCs. This is inconsistent with the principle that entities should be regulated only based on the financial functions performed by them, since D-NBFCs, in addition to giving credit, also accept public deposits and are thus qualitatively different from ND-NBFCs (See Section C.1).

- Certain categories of NBFCs have stricter capital adequacy regulations than others. For instance, non-SI NBFC-MFIs and Gold Loan NBFCs are required to maintain at least 15% Tier I & II capital adequacy ratios, as compared to other non-SI NBFCs who do not have this requirement. The RBI Working Group on the Issues and Concerns in the NBFC Sector (Chair: Usha Thorat, 2011) acknowledges this use of capital regulations as a substitute for lighter-touch regulations in other areas[53].

- Product-specific regulations such as qualifying assets regulations for NBFC-MFIs, interest rate-caps on loans (base rate + 8%) for qualifying under PSL[54], and so on, have enabled the orderly development of certain business models and sectors in the economy. However, these have inadvertently also restricted freedoms of institutions to innovate in deciding how they want to serve the under-served or low-income customers through their credit activities, even if these regulations were meant to limit exposure of customers to a specific product type in order to 'protect' them. Similar is the carve-out for microfinance institutions whose end-customer is free to borrow from banks or other NBFCs with less stringent

[50] See Chapter 2.1, *Report of the FSLRC, Vol. I: Analysis and Recommendations*, 2013

[51] Despite one giving unsecured loans.

[52] For instance, NBFC-ICCs are required to maintain a minimum Tier I capital ratio of 10% whereas NBFC-MFIs are required to maintain a minimum Tier I capital ratio of 7.5%. it is unclear why this distinction is needed. See *Non-Banking Financial Company — Systemically Important Non-Deposit taking and Deposit taking Company Directions*, 2016

[53] "*The CRAR for NBFCs is higher at 15 per cent compared to 9 percent for banks taking into account their size, concentration risk and lighter touch regulation in other areas.*" Report of the RBI *Working Group on the Issues and Concerns in the NBFC Sector* (Chair: Usha Thorat, 2011). Accessible at: https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=647

[54] The revised PSL guidelines have left open the exact quantum of cap over the base rate/MCLR. In the interim, market participants are using the cap of 8% over base rate as the norm.

lending restrictions. While such regulations are aimed at facilitating financial inclusion, these end up creating a product-specific restriction, making the product inadequate for the borrower, and placing restrictions on the provider on how it can choose to serve the borrower.

- There exists a variety of binding and non-binding codes such as the RBI's Fair Practice Code for NBFCs with a special carve-out for NBFC-MFIs[55], the Code of Bank's Commitment to Customers[56], and the Code of Bank's Commitment to Micro and Small Enterprises put out by the Banking Codes and Standards Board of India (BCSBI), and the Code for Banking Practice put out by the Indian Banks' Association (IBA)[57]. This results in differential regulatory treatment in terms of conduct requirements across RBI-regulated credit providers, for instance, NBFC-MFIs versus all other NBFCs and banks for credit suitability requirements[58] or NBFC-MFIs versus other NBFCs with regard to the two-loan restriction. Such regulations take away obligations on providers to ensure they are acting in the customers' interests and stifle innovation in areas where exclusion is prevalent due to cost and risk considerations that cannot be overcome by traditional business models. This inadvertently keeps certain classes of customers away from accessing and fully benefiting from innovative products, and they are left to transact only in 'basic' cookie-cutter products that NBFCs can offer.

- In the case of P2P-NBFCs and AA-NBFCs, credit risks do not enter their books, hence no capital adequacy prescriptions have been made by the RBI. RBI has, however, prescribed a leverage ratio of 2 on P2P-NBFCs. This does not capture the scale and scope of intermediation performed by them. P2P-NBFCs, are, for the most part, pure-play loan marketplaces. In the absence of a volume-based financial resources requirement[59], the applicability of the leverage ratio is ill-placed.

In an important first step, RBI has articulated that it has harmonised NBFC categories to improve its abilities to undertake activity-based regulation and supervision and to

[55]Accessible at: https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7089&Mode=0

[56]Accessible at: http://www.bcsbi.org.in/Pdf/CBCC2014.pdf

[57]Accessible at: https://www.iba.org.in/customercare/iba-code.html

[58]MFIN, the SRO for NBFC-MFIs, has articulated clearly, a requirement of 'Suitability (avoiding multiple/over-lending)' in its *Code for Responsible Lending*, accessible at: https://mfinindia.org/assets/upload_image/publications/IndustryStandards/Code%20for%20Responsible%20Lending_Aug%2020.pdf. To comply with this requirement, "*provider must assess customer's financial situation (income and expenses), credit requirement, repayment capacity and indebtedness based on information from the customer, Credit Information Report (CIR) and/or field level intelligence before disbursing a loan*". The Master Circular — Fair Practices Code applicable to other NBFCs has no requirement around credit affordability, suitability or repayment capacity analysis. Accessible at: https://rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9823. The BCSBI *Code of Bank's Commitment to Customers*, Jan 2018, accessible at http://www.bcsbi.org.in/Pdf/CBCC2018.pdf, states that "*We will base our lending decisions on a careful and prudent assessment of your financial position and capacity to repay*".

[59]UK's Financial Conduct Authority, for instance, placed prudential standards based on the total value of the firm's loaned funds outstanding instead of the total amount of cumulative loans that the firm may have provided during the lifetime. More details are discussed in *Response to RBI's Consultation Paper on Peer To Peer Lending*. L. George, Dvara Research, June 17, 2016. Accessible at: https://www.dvara.com/blog/2016/06/17/response-to-the-reserve-bank-of-indias-consultation-paper-on-peer-to-peer-lending/

ensure NBFCs have flexibility in their business models[60]. However, much remains to be done.

C.2 A Regulatory Framework for a Modern NBFC Sector

In an ideal setting, any NBFC which is entirely financed by wholesale liabilities should not be subject to micro-prudential regulations since they are not intermediating monies of unsophisticated retail participants in the economy. However, if any such NBFC contributes significantly to systemic risk[61], they must be subjected to systemic risk regulation/macro-prudential regulation. When such a systemically significant NBFC has become too large, it should be required to bring down its overall risk-profile through a combination of shifting towards conservative underwriting and by holding much higher levels of economic capital/risk weighted capital, of say 24% (See more in Table 1). Such capital requirements must be applied on a consolidated basis at the group level. If it does not wish to be subjected to such capital requirements, it must be required to convert to a bank[62], be it a full-service bank or a wholesale bank, as envisaged by the RBI Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households (Chair: Dr. Nachiket Mor). This would enable RBI to better regulate the activities of systemically significant NBFCs and reduce their contribution to systemic risk by providing access to facilities like LOLR. The conversion to a bank is not automatic, and the NBFC will have to satisfy the relevant qualifying criteria. If the NBFC does not wish to convert to a bank or be subject to the stricter capital regulations, it must reduce its balance sheet size to less than Rs.50,000 cr.

We recognise that the above scenario of not regulating NBFCs that are not systemically significant depends entirely on the market disciplining by equity and debt suppliers for the effective market conduct of NBFCs that are not posing a systemic risk issue. Given the realities of information asymmetry, weaknesses of market disciplining mechanisms, coordination problems and market power[63], it is not desirable to entirely depend on market discipline and thus exempt NBFCs, even those completely financed by regulated financial institutions and other wholesale capital providers, from prudential regulation[64].

While the type of regulations applicable to an NBFC should be based on the financial functions performed by it, the level of regulation should be based on the risk-profile of the NBFC. Thus, RBI should come up with a set of risk-based parameters, for instance - size, leverage, interconnectedness, and consistently apply these parameters across all NBFCs

[60] VI.57, RBI Annual Report, 2018-19

[61] The FLSRC recommends the IMF-FSD-BIS definition of systemic risk: "*risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy*". Chapter 9, *Report of the FSLRC, Vol. I: Analysis and Recommendations,* March 2013. Accessible at: https://dea.gov.in/sites/default/files/fslrc_ report_vol1_1.pdf

[62] *NBFC Regulation- Looking ahead.* Speech by Shri M. Rajeshwar Rao, Deputy Governor, RBI, Novem-ber 6, 2020 - at the 'National E-Summit on Non-Banking Finance Companies' organized by ASSOCHAM. Accessible at: https://m.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1101

[63] See section B of this document.

[64] NBFCs in fact score better than banks in this regard today due to the applicability of IndAS on them (those with net worth > Rs.250 cr).

and arrive at a consolidated score which could then determine the level of regulation applicable to it. This would currently be too onerous an exercise.

As a simpler intermediate solution (until an ideal as stated in Section A becomes possible), we propose in Table 1 below a scale-based regulatory framework that the RBI can consider for further examination.

Table 1: Proposed Scale Based Regulatory Framework

Regulation	**ND-NBFC Small (< Rs. 5000cr)**	**ND-NBFC Medium (> Rs.5000cr < Rs. 50000cr)**	**Medium ND-NBFC identified as SS-NBFC (through risk-based framework in Section C.4) and all D-NBFCs**	**ND-NBFC Large (SS-NBFCs >Rs.50000 cr) who choose not to convert to a bank**	**Universal Banks**
Micro-prudential Regulations[65]					
Entry level capital	Rs. 20 cr				Rs. 500 cr
Minimum CRAR[66]	NA	9% for credit risk under Basel I	15% for credit, market, and ops risk under Basel III	24% for credit, market, and ops risk under Basel III	9% for credit, market, and ops risk under Basel III
Tier I as % of Tier I and II[67]	NA	NA	>=50%	>=50%	Min Tier I — 7%
Risk Weights[68]	NA	Differential risk weights of Basel II	Differential risk weights of Basel II	Differential risk weights of Basel II	Differential risk weights of Basel III
Maximum Leverage (outside liabilities/ equity)[69]	NA	NA	7 times	7 times	Minimum of 4% for DSIBs and 3.5% for other banks (Equity/asset size)
Credit Concentration[70]	NA	As a % of the eligible capital base	As a % of the eligible capital base	As a % of the eligible capital base	As a % of the eligible capital base
Liquidity[71]	NA	Extant LCR guidelines for NBFCs	Extant LCR guidelines for NBFCs	Extant LCR guidelines for NBFCs	LCR and NSFR apply

[65] Not applicable on P2P-NBFCs and Account Aggregator-NBFCs as they do not hold credit risks on their books.

[66] Section 4.2.2, *Master Circular on Basel III Capital Regulations*, RBI, 2015

[67] Section 4.2.2 *Master Circular on Basel III Capital Regulations*, RBI, 2015

[68] *Master Circular on Basel III Capital Regulations*, RBI, 2015

[69] *Basel III Capital Regulations- Implementation of Leverage Ratio*, RBI, 2019

[70] Section 13.6 *Master Circular on Basel III Capital Regulations*, RBI, 2015

[71] *Basel III Framework on Liquidity Standards — Net Stable Funding Ratio (NSFR) — Final Guidelines*, RBI, 2018 and *Basel III Framework on Liquidity Standards — Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards*, RBI, 2014

Capital Conservation Buffer[72]	NA	NA	NA	NA	CCB applies
ICAAP[73]	NA	NA	Yearly	Yearly	Yearly
IT system with minimum functionalities[74]	Mandatory for all NBFCs and Banks				
Universal Institutional Conduct rules for activities undertaken	Rules in relation to credit provision uniformly applicable on all NBFCs and Banks				

In this regulatory framework, we propose a tiered regulation of ND-NBFCs based on asset size, with the stringency of regulations increasing with the size of the NBFC. Also, for ND-NBFCs having asset size between Rs. 5000 cr and Rs. 50,000 cr, we propose an identification framework to estimate the systemic significance of these NBFCs (hence identified as SS-NBFCs in Section C.4) and apply regulations whose stringency is between Medium and Large NBFCs. All D-NBFCs that continue to exist are to be classified as systemically significant and regulated akin to SS-NBFCs. The underlying principle here is that as the size and systemic significance of ND-NBFCs increase, the contagion risk due to them becomes significant, and their failure would result in the substantial loss of capital for other members in the financial system. To that extent, SS-NBFCs need to have additional levels of minimum capital adequacy, as reflected in the proposed framework. The framework for identification of SS-NBFCs is discussed in greater detail in Section C.4. However, once the RBI identifies the SS-NBFCs, it must subject them to risk-based regulatory and supervisory judgements in a similar vein as would be applicable to Domestic-Systemically Important Banks (D-SIB).

We also recognise that D-NBFCs, till such time they are phased out, should be regulated as SS-NBFCs due to the retail deposit-taking functions performed by them and the inabilities of retail depositors to enforce market disciplining on them (this is in addition to placing public disclosure requirements that are at least at par with those required by SEBI on listed debt issuers). ND-NBFCs with asset size greater than Rs.50,000 cr, should ideally be converted into a full-service or a wholesale bank. Those NBFCs which do not want to convert must be subject to prudential regulations similar to those applicable to banks. Due to their systemic importance, the regulations applicable to these NBFCs have been made like banks to enable their transition to full-service or wholesale banks in a seamless manner. However, till such time they remain as Large NBFCs and do not convert to a bank, they must be required to keep a much higher minimum CRAR commensurate with the high contagion risks they can unleash.

C.3 A Supervisory Framework for a Modern NBFC Sector

The first Core Principle of the Basel Core Principles for Banking Supervision sets out the promotion of safety and soundness of banks and the banking system as the primary

[72]Section 15, *Master Circular on Basel III Capital Regulations*, RBI, 2015

[73]Section 10, *Master Circular on Basel III Capital Regulations*, RBI, 2015

[74]RBI should prescribe minimum functionalities that the IT systems must possess and NBFCs must be free to decide what systems and what modules would work best for their requirements. RBI must not mandate the type of system per say (for instance, whether it should be a loan management system or a core banking system)

objective for banking supervision. Jurisdictions may assign other responsibilities to the banking supervisor, provided they do not conflict with this primary objective. It should not be an objective of banking supervision to prevent bank failures. However, supervision should aim to reduce the probability and impact of a bank failure, including by working with resolution authorities, so that when a failure occurs, it is resolved in an orderly manner[75]. Supervisors should assess the risk-profile of banks, in terms of the risks they run, the efficacy of their risk management and the risks they pose to the banking and financial systems. This risk-based process targets supervisory resources where they can be utilised to the best effect, focusing on outcomes as well as processes, moving beyond a passive assessment of compliance with rules.

Therefore, it should be the RBI's endeavour to measure the probability of failure and the impact of failure as a first step to arrive at the risk-profile of each banking entity, following which to actively engage with the bank to ensure it is taking on risks and has adequate capital commensurate with its risk-profile.

Since NBFCs are not banks and are not engaged in the act of money creation and are corporates which meet the 50:50 criterion laid out by the RBI, applying the above lens to NBFC-supervision would be ill-placed. However, as the size, complexity and inter-connectedness of the NBFC increases, it starts posing risks that are similar to that posed by banks of comparable size, complexity and inter-connectedness, thereby warranting the RBI to consider their risks to systemic stability. Unlike in the case of banks, the impact of failure risk of such an NBFC will be transmitted only to its lenders and investors who are wholesale rather than retail[76] (the D-NBFC being the exception and requiring a different approach).

The degree of supervision must be commensurate with the risks that a financial sector entity faces, i.e., the regulator must carry out risk-based supervision. The RBI has begun by taking important steps to follow such a regime, whereby smaller entities (with limited exposure to different risks, and thus limited systemic impact from their failure) are required to adhere to less exhaustive off-site reporting and on-site inspections/interventions.

However, while it is important to ensure that smaller entities which do not pose a systemic risk are required to only adhere to limited supervisory reporting and on-site inspections, it is necessary to ensure that they report adequate data for the RBI to be able to monitor the health of the credit markets, including potential over-heating in different asset classes and geographies, and over-indebtedness of borrower segments. Thus, very small NBFCs with insignificant linkages to the broader financial systems may be exempted from reporting any data, barring details of their capital position, credit concentration and other details of the portfolio that allows the RBI to oversee the health of the credit markets.

[75] *BCBS Core Principles for Effective Banking Supervision*, September 2012. Accessible at https: //www.bis.org/publ/bcbs230.pdf

[76] While it is possible for a retail investor to be directly subscribed to debt papers issued by the NBFC, such cases are rare.

On the other hand, large, complex, and highly interconnected NBFCs, often larger than banks that have significant reporting requirements[77], must be required to report timelier (and more frequent), granular, and wide-ranging data for the purpose of off-site reporting. Thus, as the risk-profile of an institution increases, there must be an increase in the supervisory returns sought from such an entity. An exhaustive discussion on all data that the RBI must capture, along with its frequency, at various levels of risk, is beyond the scope of this note. However, a stylised, non-exhaustive outline of such an approach is described in Table 2, comprising of four broad categories or profiles, n amely, capital adequacy, asset/liability, operations and credit activities of the NBFC.

While Table 2 captures our proposal on scale-based off-site supervision of NBFCs by the RBI, it includes a requirement on SS-NBFCs and Large NBFCs to submit its annual Internal Capital Adequacy Assessment Process (ICAAP) to the RBI, just as in the case for banks. The RBI can undertake its Supervisory Review and Evaluation Process (SREP) for these NBFCs just as it would for banks.

Table 2: Supervisory Continuum: Scale-Based Approach to Off-Site Supervision of NBFCs

<table>
<tr><th rowspan="2">Type of Data</th><th rowspan="2">Reporting Requirements</th><th colspan="5">Reporting Frequency for:</th></tr>
<tr><th>ND-NBFC Small (< Rs.5000cr)</th><th>ND-NBFC Medium (> Rs. 5000cr, < Rs. 50000cr)</th><th>Medium or Large ND-NBFCs identified as SS-NBFC (through risk-based framework in Section C.4) and all D-NBFCs</th><th>ND-NBFC Large (SS-NBFCs >Rs. 50000cr) who choose not to convert to bank</th><th>Banks (Extant Requirement)</th></tr>
<tr><td rowspan="6">A. Capital Adequacy Profile</td><td>CRAR</td><td>Yearly</td><td rowspan="3">Quarterly</td><td rowspan="3">Quarterly</td><td rowspan="3">Monthly</td><td>Quarterly</td></tr>
<tr><td>Tier I</td><td>Yearly</td><td>Quarterly</td></tr>
<tr><td>Risk Weighted Assets</td><td>Yearly</td><td>Quarterly</td></tr>
<tr><td>Basel III Disclosures (Public Disclosures)</td><td>Not Applicable</td><td>Yearly</td><td>Half-Yearly</td><td>Quarterly</td><td>Quarterly and Yearly</td></tr>
<tr><td>Details of Shareholders</td><td>Yearly, in addition to MCA Filing</td><td>Half-Yearly</td><td>Quarterly</td><td>Quarterly</td><td>Variable (Quarterly-Yearly)</td></tr>
<tr><td>ICAAP</td><td>NA</td><td>NA</td><td>Yearly</td><td>Yearly</td><td>Yearly</td></tr>
</table>

[77] Several NBFCs, like, Mahindra and Mahindra Finance, have loans & advances exceeding Rs. 72.8 thousand cr. This is greater than the loans and advances extended by any small finance bank or foreign bank (barring Standard Chartered and HSBC), 63% of private sector banks, and one public sector bank.

<table>
<tr><td rowspan="6">B. Asset/ Liability Profile</td><td>Asset concentration — Advances to top 20 borrowers</td><td rowspan="6">Half-Yearly</td><td>Quarterly</td><td rowspan="6">Quarterly</td><td rowspan="6">Monthly</td><td>Quarterly</td></tr>
<tr><td>Liability Concentration — Top 20 lenders (split by instrument)</td><td>Quarterly</td><td>Not Applicable</td></tr>
<tr><td>NPAs, Movement of NPAs, and similar Data</td><td>Quarterly</td><td>Quarterly</td></tr>
<tr><td>Maturity Pattern of Assets</td><td>Quarterly</td><td>Variable (Fortnightly-Quarterly)</td></tr>
<tr><td>Maturity Pattern of Liabilities</td><td>Quarterly</td><td>Variable (Fortnightly-Quarterly)</td></tr>
<tr><td>Liquidity Coverage and Interest Rate Sensitivity</td><td>Half-Yearly</td><td>Variable (Fortnightly-Quarterly)</td></tr>
<tr><td rowspan="4">C. Operations Profile</td><td>Branch level details (Name and address of the branch, contact details, etc.)</td><td colspan="4">Half-Yearly (with updates within 7 days in case of a change)</td><td>Quarterly</td></tr>
<tr><td>Details of Securitisation Transactions/DAs</td><td>Half-Yearly</td><td>Quarterly</td><td>Monthly</td><td>Monthly</td><td>Quarterly</td></tr>
<tr><td>Details of New Issuances (Debt/Equity)</td><td>Within 30 days of Transaction</td><td>Within 30 days of Transaction</td><td>Within 7 days of Transaction</td><td>Within 7 days of Transaction</td><td>Within 7 days of Transaction</td></tr>
<tr><td>Complaints to internal redressal team/ombuds, etc.</td><td>Quarterly</td><td colspan="3">Monthly</td><td>Variable (Monthly-Quarterly, depending on instrument, type of institution, etc.)</td></tr>
<tr><td rowspan="6">D. Credit Activities Profile</td><td>Assets in each geography</td><td rowspan="6">Quarterly</td><td rowspan="6" colspan="3">Monthly</td><td>Quarterly</td></tr>
<tr><td>Assets in each asset class</td><td>Quarterly</td></tr>
<tr><td>Fresh Disbursement</td><td rowspan="4">Not Available</td></tr>
<tr><td>Debt serviceability of borrowers</td></tr>
<tr><td>Instances of Multiple Lending</td></tr>
<tr><td>Insolvency and bankruptcy cases</td></tr>
</table>

While ND-NBFCs should be subjected to a differential, risk-based, supervisory paradigm, D-NBFCs must undergo more stringent supervision in the transition period during which they remain as D-NBFCs as discussed in Section C.1, since they can access retail deposits. Thus, to discharge the mandate of depositor protection, the RBI must regulate and supervise D-NBFCs akin to SS-NBFCs, with additional reporting requirements that capture the details of the deposit base and public disclosure requirements at least to the levels applicable for listed debt under SEBI. P2P-NBFCs need to report to the RBI on its operations profile and credit activities profile but can be exempted from reporting on its capital adequacy and asset-liability profiles.

Several of the indicators discussed above, such as those on ALM profile, liquidity coverage, interest rate sensitivity, etc., are already being captured by the RBI for all SI-ND-NBFCs and D-NBFCs with asset size greater than Rs. 100 cr or public deposits greater than Rs. 20 cr[78]. Thus, the proposed reporting requirements can be operationalised with minimal incremental efforts. However, many basic data/indicators are not being sought from NBFCs presently, including data on fresh disbursement, sectoral and geographical deployment of newly disbursed credit, and so on. It would therefore be prudent to add the proposed minimum reporting on credit activities to become applicable for all NBFCs so that the RBI can begin to monitor credit flows into regions and segments in the economy in a comprehensive manner[79] even if prudential requirements may not be applicable on a subset of these NBFCs.

Thus, in the envisaged supervisory approach, the RBI would have to assess the risk-profile of each entity and place it in the supervisory continuum it has to devise for itself. Doing so will enable the RBI to supervise entities based on their risk-profile and to better monitor overall credit markets. The framework for identification of SS-NBFCs is discussed in greater detail in Section C.4. However, once the RBI identifies the SS-NBFCs, it must subject them to risk-based regulatory and supervisory judgements in a similar vein as would be applicable to D-SIBs. In the next section, we discuss how insights obtained from such a supervisory process, and through other means such as through market intelligence, can be deployed to assess overall risks in the system and entities that are systemically important and significant.

C.4 Identifying Systemically Significant NBFCs

The financial system has grown in complexity and interconnectedness over the years. The financial crisis of 2007 was a stark reminder, that due to this increase in complexity and interconnectedness, the failure of a single entity might cause the entire financial system in a jurisdiction, and even beyond it, to experience substantial losses that hadn't been foreseen or handled before. It is therefore pivotal for the RBI and the Financial Stability and Development Council (FSDC) to be able to identify institutions that pose a systemic risk. Though NBFCs differ significantly from banks in that they do not *create* money, they are often dominant lenders in specific segments, which is measured in terms of market

[78] Based on the reporting requirements prescribed under returns titled, NBS-ALM 1, NBS-ALM 2, NBS-ALM 3, ALM-Yrly, accessible at: https://www.rbi.org.in/Scripts/BS_Listofreturns.aspx

[79] See *Detecting Over-indebtedness while Monitoring Credit Markets*, D.Bhattacharya, A.Neelam, D.George. Dvara Research, January 28, 2021. Accessible at https://www.dvara.com/research/wp-content/uploads/2021/01/Detecting-Over-Indebtedness-while-Monitoring-Credit-Markets-in-India.pdf

concentration, i.e., if an entity has a significant share in the market of a given asset class. For instance, due to this market dominance of the largest housing finance companies in the housing finance market, it is highly likely that if one of these institutions were to fail, it would cause a significant fracture of the market for housing loans since the markets take their pricing cues from these dominant entities. This could result in an erosion of risk ordinality of pricing for the end-borrower, the upholding of which is an objective of the RBI. The adverse impacts on other parts of the financial system would include liquidity and asset-liability mismatches for regulated entities with direct or indirect exposure to the NBFC and the consequent shocks to credit flows to other parts of the real economy.

However, not all NBFCs will have such an impact; a large but very well-diversified NBFC may not be a dominant provider in any given asset class, and thus a market fracture may not occur due to the failure of such an NBFC. However, depending on its interlinkages with the rest of the financial system, its complexity, and other factors, the NBFC's failure may impact the financial system adversely, and through it the real economy. On the other hand, an NBFC with insignificant assets compared to the banking system will seldom cause any disruption and loss upon failure. Thus, to identify which institutions pose a systemic risk, financial sector entities, whether they be banks[80], NBFCs[81], or other[82] entities, may be assessed across three parameters to determine if they are systemically important (SI):

1. Importance to the Financial System: A bank or non-banking entity is classified as an SI in case they are important to the health of the financial system, i.e., in case the entity fails, it will inadvertently and *adversely* affect other unrelated entities in the financial system. Thus, the *size* and *interconnectedness* (i.e., the assets, exposures, and liabilities, contingent or otherwise) of the entity within the financial sector becomes a key determinant to ascertain whether such an entity is systemically important.

2. Importance to the Real Economy: An entity is classified as an SI in case they have very limited *substitutability*. This substitutability is generally determined by the institution's assets under management, activity in payments systems, etc.

3. Complexities in Resolution: As the complexity of a bank or non-banking entity increases, the potential for its resolution diminishes. The difficulty associated with the resolution increases the time needed for resolving such an entity, and therefore adversely impacts the entire financial system. Thus, the more complex an entity is, the more SI it becomes.

Thus, regulators have been adopting several indicators to decide whether an entity should be classified as SI or not. These composite scales, developed differently for banks and non-banking entities, combine various factors, like *interconnectedness*, *size*, *substitutability* and *complexity* of an institution. For the determination of globally important institutions,

[80]See: *Global systemically important banks: updated assessment methodology and the higher loss ab-sorbency requirement,* BCBS, 2013; accessible at: https://www.bis.org/publ/bcbs255.pdf

[81]See: *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions-Proposed High-Level Framework and Specific Methodologies,* FSB, IOSCO 2015; accessible at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD479.pdf

[82]*ibid*

their cross-jurisdictional exposures are also considered. Table 3 summarises the approach proposed by the Basel Committee on Banking Supervision (BCBS) and adopted by various banking regulators for banks and non-banking entities.

Table 3: Details of Themes Captured (and weights) for determination of an entity's systemic importance

Theme	**Banks**		**Non-Banks**	
	BCBS[83]	**RBI**[84]	**European Banking Authority**[85]	**Financial Stability Oversight Council (FSOC)**[86]
Interconnectedness	Yes (20%)	Yes (20%)	Yes (25%)	Yes (Unknown)
Size of Firm	Yes (20%)	Yes (40%)	Yes (25%)	Yes (Unknown)
Substitutability	Yes (20%)	Yes (20%)	Yes (25%)	Yes (Unknown)
Complexity	Yes (20%)	Yes (13.3%)	Yes (8.3%)	Yes (Unknown)
International Exposures	Yes (20%)	Yes (6.7%)	Yes (16.7%)	Yes (Unknown)
Leverage	No	No	No	Yes (Unknown)
Liquidity and Maturity Mismatch	No	No	No	Yes (Unknown)
Financial Inclusion Activities	No	No	No	Yes (Unknown)
Concentration and Diversification	No	No	No	Yes (Unknown)

As may be evident from the table, regulators employ similar themes to ascertain the systemic importance of an entity. However, there are substantial differences in the weights assigned to each parameter. For instance, in the case of India, the size of the firm is a key determinant in its systemically important status, whereas in other jurisdictions, the impact of 'size of the firm' is not dominant. Similarly, the complexity of the firm is given a higher weightage in all cases barring the approach adopted by the European Banking Authority (EBA).

These indicators proposed under the various frameworks, as discussed above, capture major sources of risk to an entity and its transmissibility across the system. However, in isolation, they are inadequate to measure the expected systemic impact, if the risk absorption capacity of various counterparties connected to these entities is not assessed.

[83] See: *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* BCBS, 2013; accessible at: https://www.bis.org/publ/bcbs255.pdf

[84] See: *Framework for Dealing with Domestic Systemically Important Banks* (D-SIBs), RBI, 2014; accessible at: https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2861

[85] See: *Revised guidelines on the further specification of the indicators of global systemic importance and their disclosure* (EBA/GL/2016/01); accessible at: https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1388592/f3472fbf-64a3-48eb-9676-28ac942c3d5e/Guidelines%20on%20G-SIl%20identification.pdf

[86] See: *Federal Register/ Vol.77, No. 70/Wednesday, April 11, 2012 /Rules and Regulations;* accessible at: https://home.treasury.gov/system/files/261/Authority%20to%20Require%20Supervision%20and%20Regulation%20of%20Certain%20Nonbank%20Financial%20Companies.pdf

Thus, before discussing the various indicators that the RBI may deploy to identify *systemically significant* NBFCs (SS-NBFCs)[87], it is important to note that the RBI already assesses the risk-profile of banks (representing a sizeable proportion of NBFC counterparties) and has oversight over their loss-absorption capacity. However, whether the RBI carries out any robust analysis with the data is unknown, since the data, methodology and results are seldom released in the public domain[88]. It is therefore important that-

1. The RBI must capture more exhaustive data regarding the banking counterparties of NBFCs (as mentioned in Table 4), and

2. The RBI must seek (and analyse) these data from banks with exposure to the NBFC sector to ensure that the true level of systemic risk, and loss accruing from the materialisation of such risk is captured.

Apart from the data on counterparties, there are several other parameters that the RBI must capture to gain insight into the level of systemic risk NBFCs pose, thereby allowing a more meaningful designation of NBFCs as *systemically significant.* Traditional indicators like size, interconnectedness, complexity, etc., as discussed above, must be deployed. Conversely, several indicators that are applicable for banks, like their activity in payments systems, assets under custody, etc., are not applicable for the NBFCs and thus must not be considered.

Table 4: Risk-Based Framework for Identification of SS-NBFCs

Theme	**Indicator Proposed by Dvara Research**	**Currently Proposed/Employed by:**				
		BCBS (for G-SIBs)[89]	**RBI (for D-SIBs)**[90]	**FSOC (for regulating non-bank finance companies)**[91]	**PRA (all non-bank credit institutions)**[92]	**EBA (for globally important non-bank credit institutions)**[93]
Size & Leverage	Domestic On-Balance Sheet Assets	✓	✓	✓	✓	✓
	Domestic Off-Balance Sheet Exposures	✓	✓	✓	✓	✓

[87] To avoid confusion, the phrase *systemically important* is replaced with *systemically significant*, since presently the RBI already designates all NBFCs with assets over Rs. 500 Cr. as *systemically important.*

[88] An only notable exception is the case of the network analysis diagrams of net payables and receivables reported in the RBI's Financial Stability Reports (FSR). See Charts 2.22 and 2.27 of the *Financial Stability Report* (Issue No. 22), RBI, Jan 2021. Accessible at: https://rbidocs.rbi.org.in/rdocs//PublicationReport/Pdfs/FSR_F06B552BF8B144B80B4AEFEDEB3D62218.PDF

[89] *ibid.*

[90] *ibid.*

[91] *ibid.*

[92] See *The PRA's approach to identifying other systemically important institutions (O-SIIs),* Bank of England, 2016. Accessible at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2016/the-pras-approach-to-identifying-other-systemically-important-institutions-sop.pdf?la=en&hash=334D802D739D37465300117938E8220AB47C7B67

[93] *ibid.*

	Global On-Balance Sheet Assets	✓	✓	✓	✓	✓
	Global Off-Balance Sheet Exposures	✓	✓	✓	✓	✓
	Risk-Weighted Assets	✗	✗	✓	✗	✗
	CRAR	✗	✗	✓	✗	✗
	Leverage	✗	✗	✓	✗	✗
Liquidity and Maturity Mismatch	Liquidity Coverage (across different time horizons)	✗	✗	✓	✗	✗
	Callable debt as a fraction of total debt	✗	✗	✓	✗	✗
	Asset-backed funding versus other funding	✗	✗	✓	✗	✗
	Asset-liability duration and gap analysis	✗	✗	✓	✗	✗
	Short-term debt as a percentage of total debt	✗	✗	✓	✗	✗
	Short-term debt as a percentage of total assets	✗	✗	✓	✗	✗
Interconnectedness	Intra financial system assets	✓	✓	✓	✓	✓
	Intra financial system liabilities (split by type of liability)	✓	✓	✓	✓	✓
	Securities outstanding (split by type)	✓	✓	✓	✓	✓
	line of credit from financial institutions (including undrawn committed lines)	✗	✗	✓	✗	✗
	OTC derivatives with FIs as counterparties	✗	✗	✓	✗	✗
	Total Debt Outstanding	✗	✗	✓	✗	✗
	Number, Size, Nature of Relationship, and Strength of Counterparties (Banks & Insurers)[94]	✗	✗	Partially	✗	✗
Substitutability	Segment and geography wise concentration of assets (to measure market dominance[95])	✗	✗	✓	✗	✗
	Assets Being Serviced[96]	✗	✗	✗	✗	✗

[94]Banks and insurers are especially considered since the institutions, unlike an Asset Management Company (AMC) offering mutual funds, are not bankruptcy remote.

[95]Market dominance of an NBFC may be measured by computing saturation measures, like the Herfindahl—Hirschman Index (HHI) across sectors (or asset classes, as the case may be) and geographies.

[96]Most Frameworks, including the FSOC framework consider 'assets under custody' while measuring the substitutability of an institution. However, given the contexts of NBFCs in India, we propose the usage of the indicator 'assets being serviced'.

	Number of banks for which the NBFC is a BC (segment and geography wise)	✗	✗	✗	✗	✗
Complexity	The notional amount of OTC derivatives	✓	✓	✗	✗	✓
	Number of JVs/Subsidiaries/Group Companies in the financial sector and exposures thereto	✗	✗	Partially	✗	✗
	Trading and available-for-sale securities	✓	✓	✓	✗	✗

The list of indicators proposed in the table draws from international best practices. But given that the approach adopted by the US FSOC is the most exhaustive and comprehensive, we have adopted several indicators that are exclusive to FSOC into the table. Thus, it may be said that the framework proposed by the FSOC is used as a base framework, over which appropriate changes that were deemed necessary for the Indian context were made. To exemplify, only the US FSOC focuses on the number, size, nature of relationships, and strength of counterparties of the NBFC. This indicator is expected to be pivotal in estimating whether counterparties (mostly banks) are capable of absorbing risks that the failure of a systemically significant NBFC may transmit.

Further, given the unique context of India, several indicators are added to the framework to ensure that the regulator has complete thematic visibility. To exemplify, while assessing the substitutability of an NBFC, it is imperative to account for the products and services that it offers indirectly, through business correspondent relationships, apart from products and services it offers directly. Similarly, the complexity o f the institution is often determined by how many subsidiaries, Joint Ventures, group companies, etc., it has, and this is not being captured by many of the international approaches. Also, instead of *Assets Under Custody,* which, as discussed, is not applicable in the case of NBFCs, *Assets Being Serviced* by NBFCs are considered, since in India, even after securitisation or direct assignment, the originating entity remains the servicing entity (till such time standalone servicer arrangements become prevalent, for instance in the case of securitised loans).

Further, to truly capture the levels of systemic risk each entity poses, it is important to not only look at the risk-profile of the institution at a given time, but also its change over time, and rate of change. Thus, it is inadequate to simply rank NBFCs based on each indicator, and the RBI must adopt appropriate ratios, time derivative indicators, etc., while arriving at the final s core. If the final score exceeds the empirically determined threshold of *systemic significance*, the RBI must designate such NBFCs to be SS-NBFC. Hence, to operationalise these indicators completely, there is a need to derive appropriate weights for each indicator.

As discussed earlier, the present methodologies used internationally, assign arbitrary but uniform weights to each category, which is then sub-divided uniformly across the cate-gories' component indicators. Since most jurisdictions seem to follow this approach for assigning weights, the RBI may follow the uniform weights app-

-roach, instead of assigning differential weights, but, in an deal world, an empirical study of various institutions that have failed over the years may be conducted to derive appropriate weights for each indicator. Finally, it is also possible for the RBI to use both approaches simultaneously, whereunder if any NBFC is designated as SS-NBFC under either of the approaches (uni-form weights to each theme, or statistically derived weights from past failures), the NBFC may be designated as SS-NBFC.

A threshold may be set beyond which all NBFCs are adjudicated for their systemic significance. Ideally, such a threshold should be decided through rigorous statistical exercises, however, due to the lack of availability of data in the public domain, such an exercise is prohibitive, and it is proposed that all NBFCs that have assets over Rs. 5,000 cr (Medium NBFC) are assessed for systemic significance. This threshold, i nstead of selecting a sample of, say top 20, or 50 NBFCs, would minimise arbitrariness[97], since the difference b etween t he 20th largest and 21st largest NBFC may b e insignificant. Further, it must also be noted that the RBI is well-positioned to assess the emergent 102 NBFCs[98] since most of the indicators discussed above are already being captured by the RBI[99], robustly[100]. In case certain indicators are not being captured, even then, due to the annual nature of the exercise, compliance cost by NBFCs will be minimal, and with appropriate analytical frameworks in place, the exercise is also not expected to be time consuming or expensive for the RBI. Finally, once this data on all Medium NBFCs becomes available to the RBI, its oversight of the entire NBFC sector will improve significantly. B ased on the insights, the RBI will be better positioned to revise the threshold for identification of an NBFC as SS, as well as the threshold beyond which an NBFC should be assessed under the framework proposed above.

When all NBFCs having assets over Rs. 5,000 cr are assessed annually through supervisory returns, and with a uniform methodology that minimises discretionary inputs, it is expected that the RBI would be able to more robustly identify NBFCs that pose systemic risks. Targeted regulations thereafter would be pivotal to ensure that value at risk for the financial system is minimised from such failure. These are discussed in Section C.2 of this note. However, it must not be the RBI's endeavour to ensure that no NBFC

[97]In the case of RBI's methodology for identifying D-SIBs, paragraph 14 of the *Framework for Dealing with Domestic Systemically Important Banks (D-SIBs),* RBI, 2014, reads *"The banks will be selected for computation of systemic importance based on the analysis of their size (based on Basel III Leverage Ratio Exposure Measure) as a percentage of GDP. Banks having a size beyond 2% of GDP will be selected in the sample"*. Accessible at: https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2861

[98]Presently, there are 102 NBFCs in India with assets over Rs. 5,000 cr. See figure titled 'Number of NBFCs' in p.13 of *Discussion Paper on Revised Regulatory Framework for NBFCS-A Scale-Based Approach,* RBI, 2021. Accessible at: https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/DP220121630D1F9A2A51415B98D92B8CF4A54185.PDF

[99]Based on the study of the reporting formats for NBFCs as prescribed by the RBI.
100See: Paragraph VI.101, of the RBI Annual Report 2019-20 which reads *"A new XBRL software has been developed to improve data quality through in-form and cross-form validations, provisions for auto calculation of sub-totals and totals to obviate human error in reporting, and the generation of variance reports to check data consistency across time as well as between returns. All returns for NBFCs have been revised and rationalised from the present 21 to 19 in order to deepen and widen the information being obtained. The Department also developed on-going surveillance frameworks which extensively use data available under off-site supervision. The frequent usage of such data (Use Test) will help in improving data quality further."*

(or bank) would ever fail, and it would therefore be necessary to design an appropriate resolution mechanism if an NBFC were to fail. This is discussed in the next section.

C.5 Resolution of NBFCs

Depending on their size, interconnectedness and activity, the failure of an NBFC will be disruptive for their counterparties, their customers and the economy. Prudential regulation only lowers their probability of failure, but it does not eliminate it completely. To ensure minimal disruptions to the system in the event of a failure, we require a robust resolution mechanism to resolve failing NBFCs. Currently, the resolution of NBFCs is done according to the Insolvency and Bankruptcy Code (IBC)[101]. This applies to all NBFCs with asset size above Rs. 500 Cr. This is adequate for non-SS-NBFCs and non-Large NBFCs. However, D-NBFCs, Large NBFCs and SS-NBFCs would need to be resolved differently.

Given that D-NBFCs accept public deposits, and do not have deposit insurance, their failure would put retail depositors at great risk. SS-NBFCs and Large NBFCs would have significant interconnectedness leading to high contagion risk. Also, unlike real sector firms, the assets of financial firms lose value quickly once resolution proceedings begin[102]. Thus, to effectively protect the interests of retail depositors and to minimise systemic risk, the resolution of these firms need to be quick and must happen while the firm is not yet fully insolvent. The FSLRC had proposed a similar rationale in its recommendation for a resolution framework for financial firms[103]. In this, a Resolution Corporation (RC), would monitor all financial firms and rate them according to their risk of failure. When the risk of failure of a firm crosses a threshold, the RC takes over the firm in coordination with the concerned regulator and tries to resolve the firm as quickly and efficiently as possible. These NBFCs, namely Large NBFCs and SS-NBFCs, would need to be resolved under this framework and not under the IBC. The Financial Resolution and Deposit Insurance (FRDI) bill is based on the resolution framework proposed by the FSLRC and can act as a comprehensive legislative solution for the resolution of such NBFCs.

[101]The government had notified the FSP Rules to provide a generic framework for insolvency and liquidation proceedings of systemically important Financial Service Providers (FSPs) other than banks.

[102]Chapter 7, *Vol. I: Report of the FSLRC, Vol I: Analysis and Recommendations,* 2013, mentions that, internationally, the net worth of financial firms becomes negative if resolution gets delayed.

[103]Chapter 7, *Vol. I: Report of the FSLRC, Vol I: Analysis and Recommendations,* 2013