BASILSTONE
CONSULTING PRIVATE LIMITED

atharv

October 2021

www.basilstone.com | connect@basilstone.com

Basilstone Consulting is pleased to present to you the **October 2021** issue of atharv, covering regulatory insights as well as discussion papers. This issue covers the following areas:

I. Regulatory updates & its expected impact

1.1. Securities & Exchange Board of India

1.1.1. Modalities for Filing a Placement Memorandum through a Merchant Banker

AIF's can launch a scheme subject to filing a placement memorandum with SEBI through a SEBI registered Merchant Banker and the merchant banker will be required to independently exercise due diligence of all the disclosures in the placement memorandum and render a due diligence certificate in the prescribed format. Such certificate is required to be submitted at the time of registration or prior to launch of new scheme. Details of merchant banker have to be disclosed in the memorandum. Further, AIFs are required to intimate SEBI regarding any changes in terms of placement memorandum on a consolidated basis, within one month of the end of each financial year. Such intimation has to be submitted through a Merchant Banker, along with the due diligence certificate provided by the Merchant Banker. The Merchant Banker appointed for filing of placement memorandum shall not be an associate of the AIF, its sponsor, manager or trustee.

Impact: This amendment shall ensure independent verification of the placement memorandum, including veracity and disclosure of information made therein by SEBI regulated entity thereby increasing the authenticity and reliance placed by the investors.

1.1.2. Guiding Principles for bringing Uniformity in Benchmarking of Mutual Funds

There would be two-tiered structure for benchmarking of schemes for certain categories of schemes. The first tier benchmark shall be reflective of the category of the scheme, and the second tier benchmark should be demonstrative of the investment style / strategy of the Fund Manager within the category. All the benchmarks followed should necessarily be Total Return Indices.

Impact: This shall result in standardization and uniformity in the Benchmarks of Mutual Fund Schemes and shall help investors in better decision making.

1.1.3. Maintenance of Current Accounts in Multiple Banks by Stock Brokers

Stock Brokers can maintain current accounts in appropriate number of banks (subject to the maximum limit prescribed by Stock Exchanges/SEBI from time to time) for holding the client funds (i.e., Client Account), for settlement purposes (i.e., Settlement Account) and any other accounts mandated by Stock Exchanges such as Exchange Dues Account subject to the condition that brokers are using these accounts for their defined purposes.

Impact: This shall facilitate seamless settlement of funds and increased convenience for the customers.

1.1.4. Minimum percentage of trades carried out by Mutual Funds through RFQ Platform

Mutual Funds presently are required to undertake atleast 10% of their total secondary market trades in Corporate Bonds through RFQ platform of stock exchanges. Further, Mutual Funds will now undertake minimum 25% of their total secondary market trades by value (excluding Inter Scheme Transfer trades) in Corporate Bonds by placing/seeking quotes through one-to-many mode on the Request for Quote (RFQ) platform of stock exchanges and on a monthly basis, Mutual Funds shall now undertake minimum 10% of their total secondary market trades by value (excluding Inter Scheme Transfer trades) in Commercial Papers by placing/seeking quotes through one-to-many mode on the Request for Quote (RFQ) platform of stock exchanges.

Impact: This shall improve liquidity on exchange platforms and also contribute to the development of the Corporate Bond Market in India.

1.1.5. Informal Guidance on SEBI(Portfolio Managers) Regulations, 2020 – Ask Wealth Advisors Private Limited

SEBI is empowered to regulate the issue and transfer of securities of those companies incorporated in India, which are listed or intended to get listed on a recognized stock exchange in India. Further, SEBI has clarified that extant legal framework for Portfolio Managers does not envisage investment in/advice on offshore shares and securities which are neither listed nor intended to get listed in the recognized stock exchange.

1.2. Reserve Bank of India

1.2.1. Draft Master Direction on Prudential Regulation for AIFI's

RBI has decided to implement the Basel III capital framework for the AIFIs as detailed out in the draft Directions and comments are invited on the same by 30 November 2021. These Directions shall be applicable to the four All India Financial Institutions (AIFIs) viz., EXIM Bank, NABARD, NHB, and SIDBI. Further, the limits for investments by AIFIs in subsidiaries, financial services companies and non-financial services companies have been introduced in detail in the draft Direction.

Impact: The draft Directions aim to consolidate suitable modifications to the existing instructions on Exposure Norms, Classification, Valuation and Operation of Investment Portfolio Norms and Resource Raising Norms issued to the AIFIs.

1.2.2. Regulatory Sandbox – Announcement of Theme for Fourth Cohort and Review of Enabling Framework

Based on the experience gained from the First and Second Cohorts and the feedback from stakeholders, the 'Enabling Framework for Regulatory Sandbox' has been updated to include 'On Tap' application facility for themes of closed cohorts. Accordingly, the theme 'Retail Payments' is now open for application.

Impact: This 'On Tap' facility is expected to help in continuous innovation and engagement with innovators and proactively respond to the dynamics of rapidly evolving FinTech scenario.

1.3. International Financial Services Authority

1.3.1. International Financial Services Centre Authority (Registration of Insurance Business) Regulations, 2021

These regulations aim to put in place the registration and operations of insurer and re-insurer in an International Financial Services Centre under the regulatory purview of International Financial Services Centre Authority Act, 2019.

1.3.2. International Financial Services Centres Authority (Insurance Intermediary) Regulations, 2021

These regulations aim to put in place the process of registration and operations of insurance intermediaries in an International Financial Services Centre under the regulatory purview of The International Financial Services Centres Authority Act, 2019.

1.3.3. International Financial Services Centres Authority (Capital Market Intermediaries) Regulations, 2021

These regulations aim to govern capital market intermediaries intending to register and conduct Capital Market activities in the International Financial Services Centre.

The following categories of intermediaries shall be required to obtain registration from Authority prior to commencement of operations in IFSC:

i. Broker Dealers
ii. Clearing Members
iii. Depository Participants
iv. Investment Bankers
v. Portfolio Managers
vi. Investment Advisers
vii. Custodians
viii. Any other categories of Intermediaries as may be specified by the authorities from time to time.

Further, following categories of intermediaries may obtain a certification of registration from authority for providing financial services in IFSC:

i. Credit Rating Agencies
ii. Debenture Trustees

iii. Account Aggregators and

iv. Any other category of intermediaries as may be specified by the Authority from time to time

Further, A Banking Unit shall be permitted to function as a banker to an issue in an IFSC, without any additional registration requirement, subject to compliance with the regulatory provisions that may be specified by the Authority from time to time

1.3.4. OTC Derivatives at IFSC

Amendment has been prescribed amending the eligibility criteria wherein market makers have been replaced with

i. Offshore Derivative Instruments (ODI) which includes Banking Units holding a Foreign Portfolio Investor (Certificate) under the provisions of the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations,2019 dated September 23,2019 (as amended) and

ii. Other OTC Derivatives which include All Banking Units.

Further, Offshore Derivative Instruments (ODI) at IFSC on Indian Government Bonds (IGB) and State Development Loans (SDL) have been included in the definition of permissible instruments and shall be issued in compliance with the provisions of the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations,2019 dated September 23,2019 (as amended) including reporting of data on ODIs to the Securities and Exchange Board of India.

2. Discussion Paper

2.1. Scale Based Regulation (SBR) – A Revised Framework for NBFCs

Introduction:
RBI initially released the "discussion paper on revised regulatory framework for NBFCs – A scale-based approach" on 22nd January 2021. The objective of the discussion paper was to revisit the broad principles which underpin the current regulatory framework and examine the need to develop a scale-based approach to regulation from a 'systemic significance' vantage point and recommend appropriate regulatory measures in support of a strong and resilient financial system.

The fundamental premise underlying the NBFC regulatory framework is 'less rigorous' regulation. It enables NBFCs to have operational flexibility and develop sectoral and geographical expertise, resulting in variety of financial services and ease of access. The extant regulatory arbitrage in favour of NBFCs is a deliberate policy choice. Arbitrage induced by 'less rigorous' regulation is built on the premise that the NBFCs' scale of operations is expected to be significantly low in comparison to banks and it may, therefore, not pose any significant systemic risk. However, NBFC sector has seen tremendous growth in recent years.

The flexibility of operations of NBFCs has enabled it to assume a scale that would potentially impact systemic stability. The events unfolding in the latter half of 2018 also brought in new learnings. It may be noted that one of the largest Core Investment Companies (CIC) defaulted on its payment obligations towards market liabilities and a series of defaults followed. The liquidity stress arising out of this event impacted the fund-raising ability of NBFCs, both big and small. There were concerns that the liquidity stress could translate in to solvency concerns in some instances. On account of this, RBI has initiated a complete overhaul process of the regulation and supervision of NBFCs. The discussion paper was a step in that direction. Now it has been decided to put in place a revised regulatory framework for NBFCs and the guidelines are effective from October 1, 2022 (except for certain compliance requirements relating to funding of initial public offerings (IPOs) which would be effective from 1 April 2022).

Key Changes

a. **Classification of Layers of NBFC based on Asset size and activity**
Under the SBR Framework, the RBI has introduced four scale-based layers for regulating NBFCs (base layer, middle layer, upper layer, and top layer). Going forward, all NBFCs will be bucketed and regulated under one of these layers. The table below sets out the composition of NBFCs under each of these layers, and the related conditions imposed by the RBI.

Scale Based layer	Composition & Related Conditions
Base Layer (NBFC-BL)	• Non-deposit accepting NBFCs (including NBFC-ICC, NBFCMFI, NBFC-Factor and NBFC-MGC) with asset size of less than INR 1,000 crores • NBFC-P2P • NBFC-AA • NOFHC

	• NBFCs not availing public funds and not having any customer interface. Of these NBFCs, only non-deposit accepting NBFCs can be shifted to the other layers
Middle layer (NBFC – ML)	• NBFC-D • Non-deposit accepting NBFCs (including NBFC-ICC, NBFCMFI, NBFC-Factor and NBFC-MGC) with asset size of more than INR 1,000 crores • Housing Finance Companies (HFC) • Core Investment Companies (CIC) • Non-Banking Finance Company -Infrastructure Finance Company (NBFC-IFC) • Infrastructure Debt Finance Non-Banking Finance Company (IDF-NBFC) • Standalone Primary Dealers (SPD) All of these NBFCs can be shifted to the upper layer (except IDF-NBFCs and SPDs, which will always remain in the middle layer)
Upper Layer (NBFC-UL)	• These include NBFCs which are specifically identified by the RBI for being subject to enhanced regulatory requirements • Top 10 NBFCs based on their asset size will always fall in the upper layer • Detailed scoring methodology prescribed for identification of NBFCs based on quantitative parameters (such as size, leverage, interconnectedness, and complexity) and qualitative parameters (such as quality of liabilities on its balance sheet, group structure, and segment penetration) • Selected NBFCs will be intimated by the RBI and must adopt a policy approved by the board of directors (Board) for enhanced regulatory framework within three months, and must implement such framework within 24 months • Once categorised in the upper layer, NBFCs must mandatorily remain in the upper layer for a period of five years, irrespective of whether they meet the scoring criteria or not.
Top Layer (NBFC- TL)	• RBI to identify and shift NBFCs from upper layer to top layer if it is of the opinion that such NBFCs carry substantial potential systemic risk • RBI to specifically communicate higher capital requirements for such NBFCs at the time of their categorisation into the top layer • Such NBFCs will be subject to enhanced and intensive supervisory engagement by the RBI

	• RBI may not categorise any entity in the top layer if it does not perceive any systemic risk with respect to NBFCs in the upper layer

On and from 1 October 2022, all references to NBFC-ND under existing regulations would be construed as NBFC-BL, and all references to NBFC-ND-SI and NBFC-D would mean NBFC-ML or NBFC-UL, as the case may be. The RBI has clarified that NBFC-ND-SIs whose asset size is more than the previous threshold of INR 500 crores, but less than the new threshold of INR 1,000 crores would fall under the NBFC-BL category.

Any regulatory stipulation applicable to a lower layer under the new NBFC categorisation will automatically apply to a higher layer, unless otherwise notified by the RBI.

b. Net Owned Fund

Regulatory minimum Net Owned Fund (NOF) for NBFC-ICC, NBFC MFI and NBFC-Factors shall be increased to ₹10 crore and a glide path has been provided for transition to Rs 10 Crore.

NBFC's	Current NOF	By 31 March 2025	By 31 March 2027
NBFC-ICC	Rs 2 Crore	Rs 5 Crore	Rs 10 Crore
NBFC-MFI	Rs 5 Crore (2 Crore in NE Region)	Rs 7 Crore (Rs 5 crore in NE Region)	Rs 10 Crore
NBFC-Factors	Rs 5 crore	Rs 7 Crore	Rs 10 Crore

However, for NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF shall continue to be ₹2 crore. It is clarified that there is no change in the existing regulatory minimum NOF for NBFCs - IDF, IFC, MGCs, HFC, and SPD.

c. NPA Classification

The extant NPA classification norm has been changed to the overdue period of more than 90 days for all categories of NBFCs and a glide path is provided to NBFCs in Base Layer to adhere to the 90 days NPA norm as under –

NPA Norms	Timeline
>150 days overdue	By March 31, 2024
>120 days overdue	By March 31, 2025
>90 days	By March 31, 2026

d. Ceiling on IPO Funding

There shall be a ceiling of ₹1 crore per borrower for financing subscription to Initial Public Offer (IPO). NBFCs can fix more conservative limits.

Key Changes to Capital and Prudential norms

a. Internal Capital Adequacy Assessment Process (ICAAP)

NBFCs in the middle and upper layers are required to undertake a thorough internal capital assessment taking into account various risks associated with their business. The ICAAP will be on similar lines prescribed for banks

b. Additional requirements for upper layer.

In order to improve the quality of regulatory capital, the RBI has prescribed that NBFCs falling in the upper layer must maintain common equity tier 1 capital (which would typically consist of the paid-up capital, free reserves and balances in the profit & loss account) of at least 9% of its risk weighted assets. Such NBFCs will also be required to comply with leverage ceilings and differential standard asset provisioning requirements to be prescribed by the RBI in due course.

c. Credit concentration norms.

The RBI has prescribed a single credit concentration limit (as against separate limits for lending and investments) for NBFCs in the middle and upper layers. Such limit must now be determined with reference to the tier 1 capital of the NBFC (as against owned funds). Such NBFCs must ensure that their exposure to a single party and a single borrower group does not exceed 25% and 40% of their tier 1 capital respectively.

d. Large exposure framework

The RBI also proposes to notify a separate large exposure framework for NBFCs in the upper layer. This will take into account large exposures of such NBFCs to all counterparties (as well as business groups of connected counterparties). The RBI will detail out the definition of large exposure, the relevant exposure limits, and the related reporting requirements in due course.

e. Limits for sensitive sector exposures

The RBI has prescribed that exposure of NBFCs in the middle and upper layers to capital market and commercial real estate would be considered as sensitive sector exposures, requiring such NBFCs (other than HFCs) to set internal limits as per Board approved policy for such exposures. Such NBFCs are also required to separately fix sub-limits (within the overall limits for real estate exposure) for financing land acquisition.

f. Real estate financing

The RBI has prescribed that NBFCs in the middle and upper layers must ensure that borrowers have obtained prior permission from all government and statutory authorities, as required for the relevant real estate project. While NBFCs may sanction loans pending compliance of this requirement, they can undertake disbursement of such loans only after the borrower has obtained requisite approvals from the relevant authorities

Key Changes to Corporate Governance Norms

1. **Requirement for NBFC/Banking Experience in managing affairs of NBFC**
   At least one of the directors shall have relevant experience of having worked in a bank/ NBFC. Also for NBFC-UL, there should be a mix of educational qualification and experience within the Board. Specific expertise of Board members will be a prerequisite depending on the type of business pursued by the NBFC.

2. **Constitution of Risk Management Committee**
   NBFCs shall constitute a Risk Management Committee (RMC) either at the Board or executive level and be responsible for evaluating the overall risks faced by the NBFC including liquidity risk and will report to the Board.

3. **Increased Disclosures**
   Increased Disclosure requirements for Types of exposure, related party transactions, loans to Directors/ Senior Officers and customer complaints. NBFCs in the middle and upper layers will be subject to additional disclosure requirements from 31 March 2023, under which such NBFCs must disclose in their annual financial statements certain prescribed information including a report on corporate governance, details of breaches under financing documents, views of the management on audit qualifications, divergence in asset classification and provisioning above certain threshold, etc.

4. **Policy for Grant of Loans**
   A Board approved policy on grant of loans to directors, senior officers and relatives of directors and to entities where directors or their relatives have major shareholding.

5. **Restriction of KMP holding other offices**
   Key managerial personnel (KMPs) of NBFCs in the middle and upper layers must not hold any office in any other NBFCs in such layers (other than taking up directorship positions in subsidiaries of the NBFCs they are employed with). Such NBFCs have been provided with time until 30 September 2024 to comply with this requirement.

6. **Independent Directors**
   The RBI has prescribed that an independent director must not simultaneously hold more than three directorship positions in NBFCs falling in the middle and upper layers. Such NBFCs have until 30 September 2024 to ensure compliance. However, there is no restriction to directorship on Board of NBFC's - BL subject to provisions of Companies Act 2013. In case of removal/resignation of any independent director before completion of normal tenure.

7. **Chief Compliance Officer**
   NBFCs in the middle layer and upper layer are required to appoint a Chief Compliance Officer (CCO) would be in charge of independent compliance function and must have a Board Approved policy on roles and responsibilities of CCO.

8. **Compensation Guidelines**
   In order to minimise excessive risks taken due to misaligned compensation packages offered by NBFCs to its senior management, the RBI has prescribed that all NBFCs in the middle and upper layers must adopt a comprehensive compensation policy, which must require constitution of a remuneration committee, and must set out the principles for fixed / variable pay structures, and claw-back provisions.

9. **Adoption of Core Banking Solution**
   NBFCs with 10 and more branches are mandated to adopt Core Banking Solution. A glide path of 3 years with effect from October 01, 2022 is being provided.

10. **Whistle Blower Mechanism**
    All NBFCs in the middle and upper layers must adopt a whistle-blower mechanism for whistle blowers to report genuine concerns and mishandling within the organisation.

11. **Other Governance matters**
    The Board shall delineate the role of various committees and lay down a calendar of reviews and ensure good corporate governance practices in the subsidiaries of the NBFC.

Concluding Remarks

The revised framework hints towards the shift of RBI's regulatory approach from overall financial parameter-based regulation, to regulation of operational activities. A higher systemic importance bucket would be a boon for both the regulator, as well as the industry, which may experience a lesser compliance burden, while at the same time, assist the regulator in focusing on addressing systemic risk.

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About Basilstone

Basilstone Consulting Private Limited ('Basilstone") has been promoted to partner with the society and its businesses to achieve their true potential and help realize their vision. We work closely with our clients and enrich their growth by offering them solution driven consultancy services in the areas of strategic planning, incubation, impact analysis, idea validation, product validation, feasibility study, synergy evaluations, fund raising, restructuring, transaction advisory, representation – guiding on regulatory / non-regulatory meetings, succession planning, Inbound and outbound investment, due diligence, dealing with regulatory / statutory authorities, etc.

We, at Basilstone aim to position ourselves as the 'Go to Consultants' for **Simple Solutions & Value Creation** recognised by our clients for delivering ultimate desired results.

The Purpose of Basilstone is to provide simple solutions and create value backed by:

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In-Depth Knowledge

Invaluable Experience

Deep-Rooted Values

We clearly resonate ourselves with the ever-growing Basil, inspiring us to imbibe the quality of being natural and pure while we adapt to changing conditions and innovation. The rock-solid Stone is representative of our endurance, stability, permanence and our determination, paving the path of value creation for our clients and our firm allegiance to our principles.

Basilstone is the quintessential blend of traditional values and modern thoughts which are echoed in the experience, enthusiasm and energy of its people and translated in the services rendered to its clients.

Contact Us

connect@basilstone.com | www.basilstone.com | +91 22 4017 2050
8A-2, Chander Mukhi, Plot No. 316, Rajani Patel Marg, Nariman Point, Mumbai 400 021, MH, India