CHAPTER 9

NON-BANKING FINANCIAL COMPANIES

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Learn the definition of Non-Banking Financial Companies (NBFC) and their classification.
- Comprehend the regulations governing NBFCs in India.
- Familiarize with the requirements of the prudential accounting norms for NBFCs.

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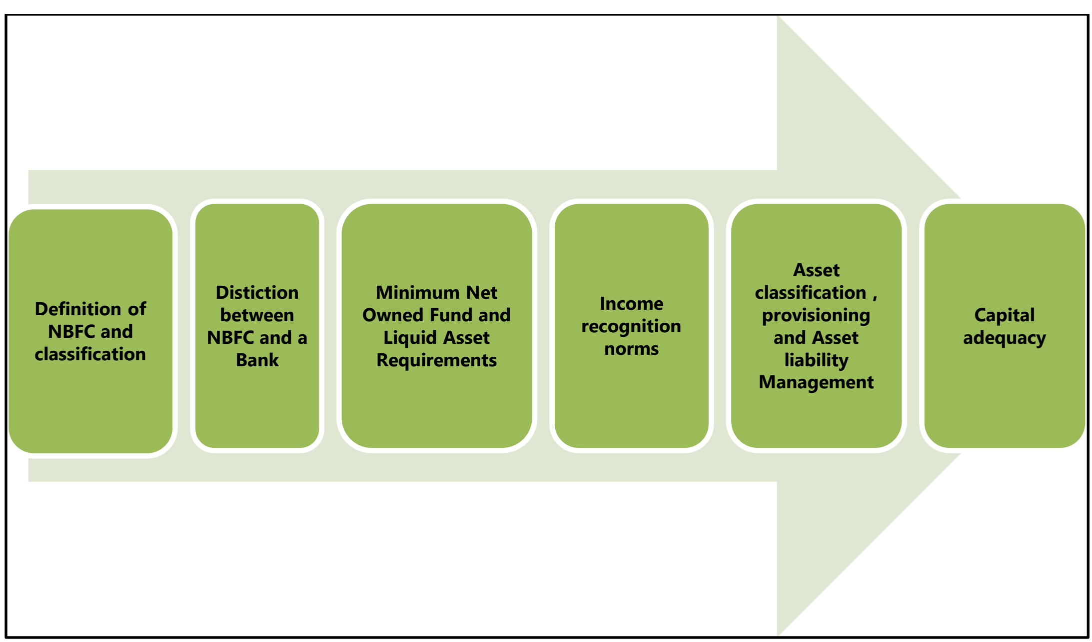

1. INTRODUCTION

Non-Banking Financial Companies (NBFC) play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognized as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress. Simplified sanction procedures, orientation towards customers, attractive rates of return on deposits, flexibility and timeliness in meeting the credit needs of specified sectors (like equipment leasing and hire purchase), are some of the factors that enhanced the attractiveness of NBFCs.

2. DEFINITION OF NBFC

A Non-Banking Financial Company (NBFC) (As per Reserve Bank of India (RBI) FAQ (Frequently Asked Questions) dated 10 January 2017)

- is a company registered under the Companies Act, 1956 or 2013;
- engaged in the business of loans and advances, acquisition of

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shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of like nature, leasing, hire-purchase, insurance business, chit business;

- but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

What does conducting financial activity as "principal business" mean?

Financial activity as principal business is when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term 'principal business' is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as 50-50 test and is applied to determine whether or not a company is into financial business.

3. REGISTRATION

In terms of Section 45-IA of the RBI Act, 1934, no NBFC shall commence or carry on business of a non-banking financial institution without-

a) obtaining a certificate of registration from the Reserve Bank of India (RBI); and

b) having Net Owned Funds (NOF) of ₹ 200 lakhs.

They can apply to the RBI in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

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However, in terms of the powers given to the RBI, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956/Sec 406 of Companies Act, 2013, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982, Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit company.

4. DISTINCTION BETWEEN AN NBFC AND A BANK

NBFCs perform functions similar to that of banks. However, there are following few differences:

S.No.	NBFC	Bank
1.	An NBFC cannot accept demand deposits.	A Bank can accept demand deposits.
2.	An NBFC is not a part of the payment and settlement system.	A Bank is a part of the payment and settlement system.
3.	An NBFC cannot issue cheques drawn on itself.	A Bank can issue cheques drawn on itself.
4.	Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available for NBFC depositors.	Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC) is available for depositors of banks.

5. CLASSIFICATION OF NBFC

A. Companies exempted from registration under RBI

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation. Following NBFCs have been exempted from the

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requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

- Housing Finance Institutions (regulated by National Housing Bank);
- Merchant Banking Companies (regulated by Securities and Exchange Board of India);
- Stock Exchanges (regulated by Securities and Exchange Board of India);
- stock-brokers/sub-brokers (regulated by Securities and Exchange Board of India);
- Nidhi Companies (regulated by Ministry of Corporate Affairs, Government of India);
- Insurance companies (regulated by Insurance Regulatory and Development Authority of India);
- Chit Companies as defined in clause (b) of section 2 of the Chit Funds Act, 1982 (Act 40 of 1982);
- Micro Finance Companies;
- Securitization and Reconstruction Companies;
- Mutual Benefit Companies;
- Mortgage Guarantee Companies;
- Core Investment Companies i.e. a non-banking financial company referred to in the Core Investment Companies (Reserve Bank) Directions, 2016, which is not a Systemically Important Core Investment Company (total assets of not less than ₹100 crs and which raises or holds public funds), as defined in sub-paragraph (xxv) of paragraph 3 of the Core Investment Companies (Reserve Bank) Directions, 2016.
- Alternative Investment Fund (AIF) Companies.

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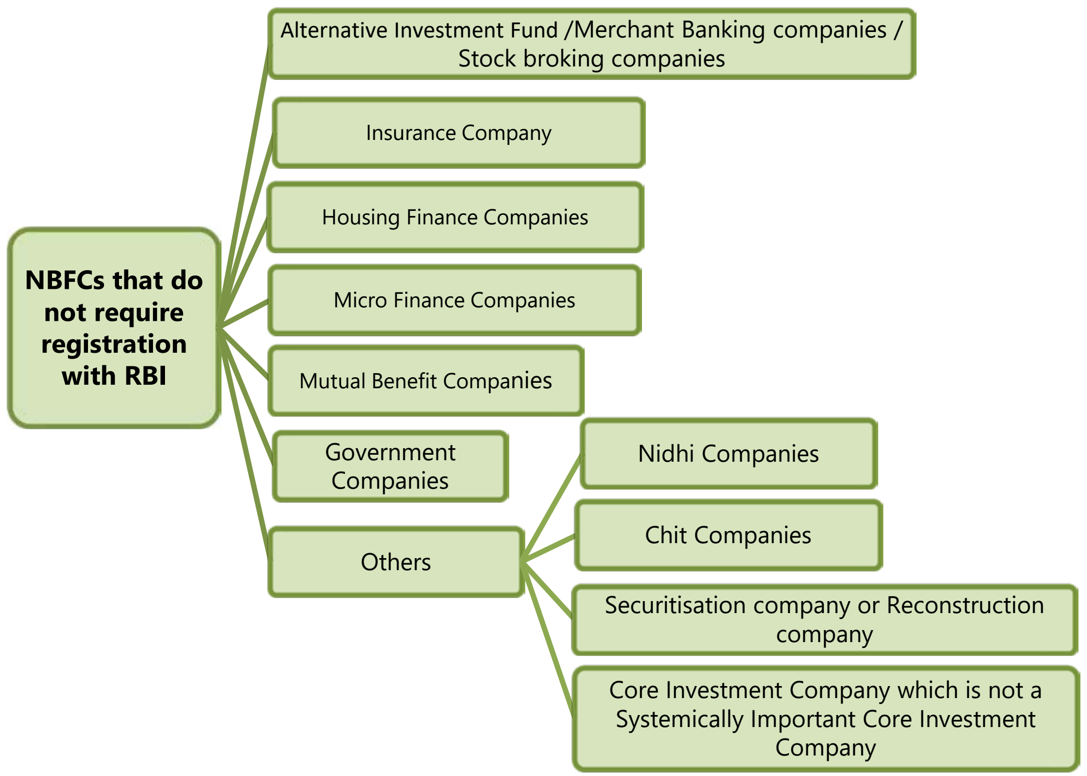
NBFCs not registered with RBI are classified under following categories:



B. Categories of NBFCs registered with RBI:

NBFCs registered with RBI are categorized as follows:

a) in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs;

b) non deposit taking NBFCs by their size into systemically important (those with asset size of ₹500 crs or more) (NBFC NDSI) and non-deposit taking non-systemically important (those with asset size of less than ₹500 crs) (NBFC NDNSI) (NBFC-NDSI and NBFC-ND); and

c) by the kind of activities they conduct.

Within the categorization mentioned in (c) above, (i.e. by the kind of activities they conduct), the different types of NBFCs are as follows:

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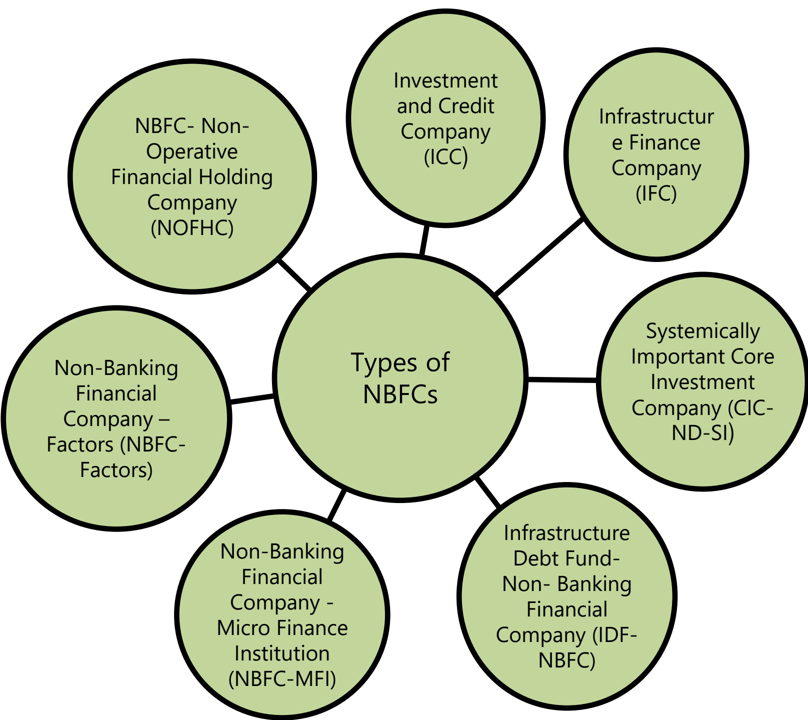

1. Investment and Credit Company (ICC)

ICC means any company which is a financial institution carrying on as its principal business - asset finance, the providing of finance whether by making loans or advances or otherwise for any activity other than its own and the acquisition of securities; and is not any other category of NBFC as defined by the RBI in any of its Master Directions.

2. Infrastructure Finance Company (IFC): An IFC is defined as **non-deposit taking NBFC** that fulfills the criteria mentioned below:

i. a minimum of 75 per cent of its total assets deployed in infrastructure loans

ii. has net owned funds of ₹ 300 crore or above;

iii. has obtained a minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA, Brickwork Ratings India Private Limited (Brickwork) or equivalent rating by any other crediting rating agency accredited by RBI;

iv. has a Capital to Risk Asset Ratio (CRAR) of 15 percent (with a minimum Tier I capital of 10 percent).

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3. Systemically Important Core Investment Company (CIC-ND-SI):

Core Investment Company (CIC):

CIC means an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions as on the date of the last audited balance sheet:

i. it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies;

ii. its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies and units of Infrastructure Investment Trust only as sponsor constitute not less than 60% of its net assets as mentioned in clause (i) above.

   Provided that the exposure of such CICs towards Infrastructure Investments Trusts shall be limited to their holdings as sponsors and shall not, at any point in time, exceed the minimum holding of units and tenor prescribed in this regard by SEBI (Infrastructure Investment Trusts) Regulations, 2014, as amended from time to time;

iii. it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or dis-investment;

iv. it does not carry on any other financial activity referred to in section 45-I(*c*) and 45-I(*f*) of the RBI Act, 1934 except

   a) investment in bank deposits, money market instruments, government securities and bonds or debentures issued by group companies;

   b) granting of loans to group companies; and

   c) issuing guarantees on behalf of group companies.

Core Investment Companies (CIC) having total assets of not less than ₹ 100 crores either individually or in aggregate along with other CICs in the group and which raise or hold public funds are called as **Systemically Important Core Investment Companies (CICs-ND-SI).**

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4. Infrastructure Debt Fund - Non- Banking Financial Company (IDF-NBFC): means a non-deposit taking NBFC that has:

(a) net owned funds of ₹ 300 crore or more; and

(b) which invests only in Public Private Partnerships (PPP) and post commencement operations date (COD) infrastructure projects which has completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

5. Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI): The Reserve Bank of India having considered it necessary in the public interest and being satisfied that for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, gave the directions for the Non-Banking Financial Company-Micro Finance Institutions (Reserve Bank) Directions, 2011.

An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company formed and registered under Section 25 of the Indian Companies Act, 1956 or Section 8 of the Companies Act, 2013) which satisfy the following criteria:

i. Minimum Net Owned Funds of ₹ 5 crore. (For NBFC-MFIs registered in the North Eastern Region of the country, the minimum NOF requirement shall stand at ₹ 2 crore).

ii. Not less than 85% of its net assets are in the nature of "qualifying assets."

For the purpose of ii above,

"Net assets" are defined as total assets other than cash and bank balances and money market instruments; and

"Qualifying asset" shall mean a loan which satisfies the following criteria:-

a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹ 1,25,000 or urban and semi-urban household income not exceeding ₹ 2,00,000;

b. loan amount does not exceed ₹ 75,000 in the first cycle and ₹ 1,25,000 in subsequent cycles;

c. total indebtedness of the borrower does not exceed ₹1,25,000;

d. tenure of the loan not to be less than 24 months for loan amount in excess of ₹ 30,000 with prepayment without penalty;

e. loan to be extended without collateral;

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f. aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

g. loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower.

6. **Non-Banking Financial Company–Factors (NBFC-Factors):** NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

7. **Non-Operative Financial Holding Company (NOFHC)** means a non-deposit taking NBFC referred to in the "Guidelines for Licensing of New Banks in the Private Sector", issued by the RBI, which holds the shares of a banking company and the shares of all other financial services companies in its group, whether regulated by the Bank or by any other financial regulator, to the extent permissible under the applicable regulatory prescriptions.

C. Residuary non-banking company a non-banking institution, being a company, which receives any deposit under any scheme or arrangement, by whatever name called, in one lump sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any other manner and which, according to the definitions contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 or, as the case may be, the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 2016, is not - (i) an equipment leasing company; (ii)a hire purchase finance company'; (iii) an investment and credit company; (iv) a housing finance company; (v) an insurance company; (vi) a factor; (vii) a mutual benefit financial company; (viii) a miscellaneous non-banking company and (ix) a mutual benefit company. Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Asset Financing, Loan Company.

6. MINIMUM NET OWNED FUND

On registration of NBFC with the RBI, all NBFCs have to comply with certain requirements like maintenance of the minimum Net Owned Fund (NOF), creation of reserve fund, compulsory transfer of certain percentage of net profit etc.

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NOF requirement for new companies applying for grant of CoR to commence business of an NBFC is stipulated at ₹ 2 crores.

As per the definition:

Owned Fund = Aggregate of the paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, after deducting therefrom accumulated balance of loss, book value of intangible assets and other deferred revenue expenditure, if any.

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC – Book value of debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund).

Illustration 1

Calculate 'Owned Fund' of an NBFC based on the following information:

Paid up share capital: ₹ 150 lakhs

Free reserves: ₹ 250 lakhs

Compulsory convertible preference shares (CCPS): ₹ 50 lakhs

Revaluation Reserve: ₹ 95 lakhs

Solution

Owned fund calculation:

Paid up share capital: ₹ 150 lakhs

Free reserves: ₹ 250 lakhs

Compulsory convertible preference shares (CCPS): ₹ 50 lakhs

Total: ₹ 450 lakhs (owned fund)

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Illustration 2

Templeton Finance Ltd. is a non-banking finance company. It provides the following information:

	₹ in crores
Leased out assets	*800*
Investment:	
In shares of subsidiaries and group companies	*100*
In debentures of subsidiaries and group Companies	*100*
Cash and bank balances	*200*
Deferred expenditure	*200*
Paid-up equity capital	*100*
Free reserves	*500*
Loans	*400*
Deposits	*400*

You are required to compute 'Net owned Fund' of Templeton Finance Ltd. as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Solution

Statement showing computation of 'Net Owned Fund'

		₹ in crores
Paid up Equity Capital		100
Free Reserves		500
		600
Less: Deferred expenditure		(200)
	A	400
Investments		
In shares of subsidiaries and group companies		100
In debentures of subsidiaries and group companies		100
	B	200
10% of A		40
Excess of Investment over 10% of A (200-40)	C	160
Net Owned Fund [(A) - (C)] (400-160)		240

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7. LIQUID ASSET REQUIREMENTS

In terms of Section 45-IB of the RBI Act, 1934 the minimum level of liquid asset to be maintained by NBFCs is 15 per cent of public deposits outstanding as on the last working day of the second preceding quarter. Of the 15%, NBFCs are required to invest not less than 10% in approved securities and the remaining 5% can be in unencumbered term deposits with any scheduled commercial bank. Thus, the liquid assets may consist of government securities, government guaranteed bonds and term deposits with any scheduled commercial bank.

The investment in government securities should be in dematerialised form which can be maintained in Constituents' Subsidiary General Ledger (CSGL) Account with a scheduled commercial bank (SCB) / Stock Holding Corporation of India Limited (SHICL). In case of Government guaranteed bonds the same may be kept in dematerialised form with SCB/SHCIL or in a dematerialised account with depositories [National Securities Depository Ltd. (NSDL)/Central Depository Services (India) Ltd. (CDSL)] through a depository participant registered with Securities & Exchange Board of India (SEBI). However in case there are Government bonds which are in physical form the same may be kept in safe custody of SCB/SHCIL.

NBFCs have been directed to maintain the mandated liquid asset securities in a dematerialised form with the entities stated above at a place where the registered office of the company is situated. However, if a NBFC intends to entrust the securities at a place other than the place at which its registered office is located, it may do so after obtaining in writing the permission of RBI. It may be noted that the liquid assets in approved securities will have to be maintained in dematerialised form only. The liquid assets maintained as above are to be utilised for payment of claims of depositors. However, deposit being unsecured in nature depositors do not have direct claim on liquid assets.

8. PRUDENTIAL ACCOUNTING NORMS

In order to ensure that NBFCs function on sound and healthy lines and make adequate disclosures in their financial reports, the Reserve Bank has issued prudential norms for all the Non-banking Financial Companies. The current prudential regulation mainly comprises the following elements:

a) Norms relating to Income Recognition, Asset Classification and Provisioning norms;

b) Capital to Risk Weighted Assets Ratio (CRAR); and

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c) Credit Concentration Norms

Note: [Above mentioned norms in points (b) and (c) are applicable to only NBFCs–D and NBFCs-ND-SI].

Currently, there are following two sets of Directions for prudential norms:

1. "Non-Banking Financial Company–Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016"

The provisions of "Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016", shall apply to

(i) every non-banking financial company not accepting / holding public deposits which is not systemically important;

(ii) every NBFC-Factor registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of below ₹ 500 crore;

(iii) every Non-Banking Finance Company – Micro Finance Institution (NBFC-MFI) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ₹ 500 crore;

(iv) every Non-Banking Finance Company - Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ₹ 500 crore.

2. "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016"

The provisions of "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016" shall apply to:

(i) every Systemically Important Non-Deposit taking Non-Banking Financial Company (NBFC-ND-SI) registered with the Bank under the provisions of RBI Act, 1934;

(ii) every Deposit taking Non-Banking Financial Company (NBFC-D) registered with the Bank under the provisions of RBI Act, 1934;

(iii) every NBFC-Factor registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of ₹ 500 crore and above;

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(iv) every Infrastructure Debt Fund –Non-Banking Finance Company (IDF-NBFC) registered with the Bank under the provisions of RBI Act, 1934;

(v) every Non-Banking Finance Company –Micro Finance Institutions (NBFC-MFIs) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of ₹ 500 crore and above;

(vi) every Non-Banking Finance Company - Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of ₹ 500 crore and above.

9. IMPORTANT DEFINITIONS

Break-up value means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company.

Carrying cost means book value of the assets and interest accrued thereon but not received.

Earning value means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalized at the following rate:

(a) in case of predominantly manufacturing company, eight per cent;

(b) in case of predominantly trading company, ten per cent; and

(c) in case of any other company, including non-banking financial company, twelve per cent;

Note: If an investee company is a loss making company the earning value will be taken at zero.

Fair value means the mean of the earning value and the break-up value.

Substantial interest means holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares of a company, the amount paid up on which exceeds ten per cent of the paid up capital of the company; or the capital subscribed by all the partners of a partnership firm.

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10. INCOME RECOGNITION

(1) The income recognition shall be based on recognised accounting principles.

(2) Income including interest/ discount or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

(3) In respect of hire purchase assets, where instalments are overdue for more than 3 months, income shall be recognised only when hire charges are actually received. Any such income taken to the credit of profit and loss account before the asset became non performing and remaining unrealized, shall be reversed.

(4) In respect of lease assets, where lease rentals are overdue for more than 3 months, the income shall be recognised only when lease rentals are actually received. The net lease rentals taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised shall be reversed.

11. INCOME FROM INVESTMENT

(1) Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis;

provided that the income from dividend on shares of corporate bodies shall be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the applicable NBFC's right to receive payment is established.

(2) Income from bonds and debentures of corporate bodies and from Government securities/bonds shall be taken into account on accrual basis;

provided that the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears.

(3) Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government shall be taken into account on accrual basis.

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12. ACCOUNTING FOR INVESTMENTS

1. (a) The Board of Directors of every non-banking financial company shall frame investment policy for the company and implement the same;

   (b) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the company in the investment policy;

   (c) Investments in securities shall be classified into current and long term, at the time of making each investment;

   (d) In case of inter class transfer:

      (i) There shall be no such transfer on ad-hoc basis;

      (ii) Such transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;

      (iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;

      (iv) The depreciation, if any, in each scrip shall be fully provided for and appreciation, if any, shall be ignored;

      (v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

2. Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

   (a) equity shares,

   (b) preference shares,

   (c) debentures and bonds,

   (d) Government securities including treasury bills,

   (e) units of mutual fund, and

   (f) others.

   Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each

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category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

3. Unquoted equity shares in the nature of current investments shall be valued at cost or break-up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break-up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.

4. Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.

5. Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

6. Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

7. Commercial papers shall be valued at carrying cost.

8. A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI (Others as applicable).

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

13. ASSET CLASSIFICATION

The asset classification norms as given below shall apply to every NBFC (except NBFC-MFIs):

(1) Every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realization, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes namely, -

(a) Standard assets;

(b) Sub-standard assets;

(c) Doubtful assets; and

(d) Loss assets.

(a) Standard asset means an asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business.

(b) Sub-standard asset: As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, sub-standard asset means

(a) an asset which has been classified as non-performing asset for a period not exceeding 12 months;

(b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms.

However, as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, sub-standard asset shall mean:

(a) an asset which has been classified as non-performing asset for a period not exceeding 18 months;

(b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms.

(c) Doubtful asset: As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, doubtful asset means

(a) a term loan, or

(b) a lease asset, or

(c) a hire purchase asset, or

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(d) any other asset, which remains a sub-standard asset for a period exceeding 12 months.

However, as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, "doubtful asset" shall mean

(a) a term loan, or

(b) a lease asset, or

(c) a hire purchase asset, or

(d) any other asset, which remains a sub-standard asset for a period exceeding 18 months.

(d) ***Loss asset*** means

(i) an asset which has been identified as loss asset by the NBFC or its internal or external auditor or by the Reserve Bank during the inspection of the NBFC, to the extent it is not written off by the NBFC; and

(ii) an asset which is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the up gradation.

14. NON-PERFORMING ASSET (NPA)

'Non-performing asset' means:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

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(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the above six months criteria for the assets covered under (a) to (f) is 3 months.

As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 6 months or more.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of three months or more;

As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 12 months only.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery.

15. PROVISIONING REQUIREMENTS

The provisioning requirements as given below shall apply to every NBFC (except NBFC-MFIs):

Every NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realization of the security and the erosion over time in the value of security charged, make provision against

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sub-standard assets, doubtful assets and loss assets as provided hereunder:

A. Loans, advances and other credit facilities including bills purchased and discounted

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

1. Loss Assets

The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

2. Doubtful Assets

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis.

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis: -

Period for which the asset has been considered as doubtful	***% of provision***
Upto one year	20
One to three years	30
More than three years	50

3. Sub-standard asset

A general provision of 10% of total outstanding shall be made.

4. Standard asset

A general provision at 0.40 per cent of the outstanding standard assets shall be made by NBFCs covered under Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Note: As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, every NBFC shall make provision for standard assets at 0.25 percent of the outstanding amount.

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The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet.

B. Lease and hire purchase assets

The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire purchase assets

(i) In respect of hire purchase assets, the total dues (overdue and future installments taken together) as reduced by

(a) the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and

(b) the depreciated value of the underlying asset,

shall be provided for.

Explanation:

For the purpose of this paragraph,

(a) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and

(b) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under:

(a)	Where hire charges or lease rentals are overdue upto 12 months	Nil
(b)	where hire charges or lease rentals are overdue for more than 12 months but upto 24 months	10 percent of the net book value
(c)	where hire charges or lease rentals are overdue for more than 24 months but upto 36 months	40 percent of the net book value

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(d)	where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value
(e)	where hire charges or lease rentals are overdue for more than 48 months	100 percent of the net book value

(iii) On expiry of a period of 12 months after the due date of the last installment of hire purchase/leased asset, the entire net book value shall be fully provided for.

Here, '**Net book value**' means

(a) in the case of hire purchase asset, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 13(2) of these Directions;

(b) in the case of leased asset, aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

Notes:

(1) The amount of caution money/margin money or security deposits kept by the borrower with the non-banking financial company in pursuance of the hire purchase agreement may be deducted against the provisions stipulated under clause (i) above, if not already taken into account while arriving at the equated monthly installments under the agreement. The value of any other security available in pursuance to the hire purchase agreement may be deducted only against the provisions stipulated under clause (ii) above.

(2) The amount of security deposits kept by the borrower with the non-banking financial company in pursuance to the lease agreement together with the value of any other security available in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.

(3) It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances including the depreciated book value of the leased asset under reference after adjusting the

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balance, if any, in the lease adjustment account. The fact that income on an NPA has not been recognized cannot be taken as reason for not making provision.

(4) An asset which has been renegotiated or rescheduled as referred to in paragraph (12) (3) (ii) (b) of the Directions for Prudential Norms (i.e. Part 16(b) of this chapter regarding sub-standard assets) shall be a sub-standard asset or continue to remain in the same category in which it was prior to its renegotiation or rescheduling as a doubtful asset or a loss asset as the case may be. Necessary provision is required to be made as applicable to such asset till it is upgraded.

(5) The balance sheet to be prepared by the non-banking financial company may be in accordance with the provisions contained in sub-paragraph (2) of paragraph 16 of the Directions (i.e. Part 20(b) of this Chapter).

(6) In case of NBFC-MFIs, if the advance covered by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Illustration 3

Bright Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 200 lakhs of which installments are overdue on 200 accounts for last one month (amount overdue ₹ 40 lakhs), on 24 accounts for two months (amount overdue ₹ 24 lakhs), on 10 accounts for more than 30 months (amount overdue ₹ 20 lakhs) and on 4 accounts for more than two years (amount over due ₹ 20 lakhs-already identified as sub-standard assets) and one account of ₹ 10 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹ 6 lakhs) for more than twelve months and other are identified as sub-standard asset for a period of less than twelve months.

Classify the assets of the company in line with Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

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Solution

Statement showing classification as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

		(₹ in lakhs)
Standard Assets :		
Accounts (Balancing figure)	86.00	
200 accounts overdue for a period of 1 month	40.00	
24 accounts overdue for a period of 2 months	24.00	150.00
Sub-Standard Assets:		
4 accounts identified as sub-standard asset for a period less than 12 months		14.00
Doubtful Debts:		
6 accounts identified as sub-standard for a period more than 12 months		6.00
4 accounts identified as sub-standard for a period more than 2 years		20.00
Loss Assets		
1 account identified by management as loss asset		10.00
Total overdue		200.00

Illustration 4

While closing its books of account on 31st March, a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	*16,800*
Sub-standard assets	*1,340*
Secured portions of doubtful debts:	
– *upto one year*	*320*
– *one year to three years*	*90*
– *more than three years*	*30*

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Unsecured portions of doubtful debts	*97*
Loss assets	*48*

Calculate the amount of provision, which must be made against the Advances as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016.

Solution

Calculation of provision required on advances as on 31st March, as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	***Percentage of provision***	***Provision ₹ in lakhs***
Standard assets	16,800	0.25	42.00
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			427.00

Illustration 5

Continuing with the same information given in Illustration 4, Calculate the amount of provision, which must be made against the Advances as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

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Solution

Calculation of provision required on advances as on 31st March, as per the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	Percentage of provision	Provision ₹ in lakhs
Standard assets	16,800	0.40	67.20
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			452.20

Illustration 6

Babu Bhai Financiers Ltd. is an NBFC providing Hire Purchase Solutions for acquiring consumer durables. The following information is extracted from its books for the year ended 31st March, 20X1:

Assets Funded	Interest Overdue but recognized in Profit & Loss		Net Book Value of Assets Outstanding
	Period Overdue	Interest Amount	
		(₹ In crore)	(₹ In crore)
LCD Televisions	Up to 12 Months	500.00	20,000
Washing Machines	For 24 Months	100.00	2,000
Refrigerators	For 30 Months	50.00	1,250
Air Conditioners	For 45 Months	25.00	600
Mobile Phones	For 60 Months	10.00	100

You are required to calculate the amount of provision to be made.

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Solution

On the basis of the information, in respect of hire purchase and leased assets, provision shall be made as under:

		(₹ in crore)
(a) Where hire charges are overdue upto 12 months	Nil	-
(b) Where hire charges are overdue for more than 12 months but upto 24 months	10% of the net book value 10% x 2,000	200
(c) Where hire charges are overdue for more than 24 months but upto 36 months	40 percent of the net book value 40% x 1,250	500
(d) Where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value 70% x 600	420
(e) Where hire charges or lease rentals are overdue for more than 48 months	100% of net book value (100% x 100)	100
	Total	1,220

16. ACCOUNTING YEAR

Every non-banking financial company shall prepare its balance sheet and profit and loss account as on March 31 every year. Whenever a non-banking financial company intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the Reserve Bank of India before approaching the Registrar of Companies for this purpose.

Further, even in cases where the Bank and the Registrar of Companies grant extension of time, the non-banking financial company shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date.

Every non-banking financial company shall finalize its balance sheet within a period of 3 months from the date to which it pertains.

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17. DISCLOSURE IN THE BALANCE SHEET

(a) Every NBFC shall, separately disclose in its balance sheet the provisions made as per requirements without netting them from the income or against the value of assets.

(b) The provisions shall be distinctly indicated under separate heads of accounts as

(i) provisions for bad and doubtful debts and

(ii) provisions for depreciation in investments.

(c) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC.

(d) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general Provisions and loss reserves may be written back without making adjustment against them.

(e) Every systemically important non-deposit taking non-banking financial company shall disclose the following particulars in its Balance Sheet:

i. Capital to Risk Assets Ratio (CRAR);

ii. Exposure to real estate sector, both direct and indirect; and

iii. Maturity pattern of assets and liabilities.

18. PREPARATION OF FINANCIAL STATEMENTS OF NBFCS

All NBFCs should comply with the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India, so far as these are not inconsistent with the directions of the Reserve Bank of India.

On 30th March, 2016 the Ministry of Corporate Affairs of India (MCA) issued the roadmap for implementation of Ind AS by Non-Banking Financial Companies. As per the notification:

(a) The following NBFCs shall comply with the Indian Accounting Standards (Ind AS) for accounting periods beginning on or after the 1st April, 2018, with comparatives for the periods ending on 31st March, 2018, or thereafter—

(A) NBFCs having net worth of rupees five hundred crore or more;

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(B) holding, subsidiary, joint venture or associate companies of companies covered under item (A),

(b) The following NBFCs shall comply with the Indian Accounting Standards (Ind AS) for accounting periods beginning on or after the 1st April, 2019, with comparatives for the periods ending on 31st March, 2019, or thereafter—

(A) NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchange in India or outside India and having net worth less than rupees five hundred crore;

(B) NBFCs, that are unlisted companies, having net worth of rupees two-hundred and fifty crore or more but less than rupees five hundred crore; and

(C) holding, subsidiary, joint venture or associate companies of companies covered under item (A) or item (B) of sub-clause (b),

Other NBFCs shall prepare their financial statements based on the Companies (Accounting Standards) Rules, 2006.

Further, RBI vide Notification dated 13 March 2020 has issued regulatory guidance on Ind AS which will be applicable on Ind AS implementing NBFCs for preparation of their financial statements from financial year 2019-20 onwards.

19. REQUIREMENT AS TO CAPITAL ADEQUACY

NBFCs-ND with asset size of less than ₹ 500 crore, are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

At present, all NB0FCs-D and NBFCs-ND-SI are required to have minimum CRAR of 15%. Consequently, Tier 1 capital cannot be less than 10%. For Infrastructure Finance Companies (IFCs), Tier 1 capital cannot be less than 10%. Similarly, NBFCs primarily engaged in lending against gold jewellery have to maintain a minimum0 Tier 1 capital of 12%.

The total of Tier II capital, at any point of time, shall not exceed one hundred percent of Tier I capital.

"Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans

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and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund and perpetual debt instruments issued by a non-deposit taking non-banking financial company in each year to the extent it does not exceed 15% of the aggregate Tier I Capital of such company as on March 31 of the previous accounting year;;

"Tier II capital" includes the following:

(a) preference shares other than those which are compulsorily convertible into equity;

(b) revaluation reserves at discounted rate of fifty five percent;

(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are availabl000e to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt

(f) perpetual debt instruments issued by a systemically important non-deposit taking non-banking financial company which is in excess of what qualifies for Tier I Capital

to the extent the aggregate does not exceed Tier I capital.

"*Subordinated debt*" means an instrument, which is fully paid up and is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

	Remaining Maturity of the instruments	***Rate of discount***
(a)	Upto one year	100%
(b)	More than one year but upto two years	80%
(c)	More than two years but upto three years	60%
(d)	More than three years but upto four years	40%
(e)	More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier I capital.

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Every systemically important non-deposit taking non-banking financial company shall maintain, a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than ten per cent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off balance sheet items.

On balance sheet assets - Degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

Weighted risk assets – On-Balance Sheet items	***Percentage weight***
(i) Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii) Investments	
(a) Approved securities [Except at (c) below]	0
(b) Bonds of public sector banks	20
(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100
(d) Shares of all companies and debentures/ bonds/commercial papers of all companies and units of all mutual funds	100
(e) All assets covering Public Private Partnership (PPP) and post commercial operations date (COD) infrastructure projects in existence over a year of commercial operation	50
(iii) Current assets	
(a) Stock on hire (net book value)	100
(b) Inter-corporate loans/deposits	100
(c) Loans and advances fully secured against deposits held by the company itself	0
(d) Loans to staff	0
(e) Other secured loans and advances considered good	100

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	(f) Bills purchased/discounted	100
	(g) Others (To be specified)	100
(iv)	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture & Fixtures	100
(v)	Other assets	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100
(vi)	Domestic Sovereign	
	(a) fund based claims on the Central Government	0
	(b) Direct loan / credit / overdraft exposure and investment in State Government securities	0
	(c) Central Government guaranteed claims	0
	(d) State Government guaranteed claims, which have not remained in default/ which are in default for a period not more than 90 days	20
	(e) State Government guaranteed claims, which have remained in default for a period of more than 90 days	100

Notes:

(1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.

(2) Assets which have been deducted from owned fund to arrive at net owned fund shall have a weightage of ₹ zero'.

(3) While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, non-banking financial companies may net off the amount of cash margin / caution money/security deposits (against which right to set-off is available) held as collateral against the advances out of the total outstanding exposure of the borrower.

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(4) For loans guaranteed by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) NBFC-MFIs may assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion would attract a risk-weight as per extant guidelines.

Off-Balance Sheet Items –

It has been considered necessary to expand the off-balance sheet regulatory framework to introduce greater granularity in the risk weights and credit conversion factors for different types of off balance sheet items. For this purpose, NBFCs will need to calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. The risk-weighted amount of an off-balance sheet item that gives rise to credit exposure will be calculated by means of a two-step process:

(a) the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and

(b) the resulting credit equivalent amount is multiplied by the risk weight applicable viz; zero percent for exposure to Central Government/State Governments, 20 percent for exposure to banks and 100 percent for others.

(1) Non-market-related off- balance sheet items

i. The credit equivalent amount in relation to a non-market related off-balance sheet item will be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF).

Sr. No.	***Instruments***	***Credit Conversion Factor***
i.	Financial & other guarantees	100
ii.	Share/debenture underwriting obligations	50
iii.	Partly-paid shares/debentures	100
iv.	Bills discounted/rediscounted	100
v.	Lease contracts entered into but yet to be executed	100
vi.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the NBFC.	100

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vii.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down.	100
viii.	Lending of NBFC securities or posting of securities as collateral by NBFC, including instances where these arise out of repo style transactions	100
ix.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of	
	upto one year	20
	over one year	50
x.	Similar commitments that are unconditionally cancellable at any time by the NBFC without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness'.	0
xi.	Take-out Finance in the books of taking-over institution	
	(i) Unconditional take-out finance	100
	(ii) Conditional take-out finance	50
	Note: As the counter-party exposure will determine the risk weight, it will be 100 percent in respect of all borrowers or zero percent if covered by Government guarantee.	
xii.	Commitment to provide liquidity facility for securitization of standard asset transactions	100
xiii.	Second loss credit enhancement for securitization of standard asset transactions provided by third party	100
xiv.	Other contingent liabilities (To be specified)	50

Note:

i. Cash margins/deposits shall be deducted before applying the conversion factor

ii. Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to

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maturity. Any drawn portion of a commitment forms a part of NBFC's on-balance sheet credit exposure.

For example:

A term loan of ₹ 700 cr is sanctioned for a large project which can be drawn down in stages over a three year period. The terms of sanction allow draw down in three stages – ₹ 150 cr in Stage I, ₹ 200 cr in Stage II and ₹ 350 cr in Stage III, where the borrower needs the NBFC's explicit approval for draw down under Stages II and III after completion of certain formalities. If the borrower has drawn already ₹ 50 cr under Stage I, then the undrawn portion would be computed with reference to Stage I alone i.e., it will be ₹ 100 cr. If Stage I is scheduled to be completed within one year, the credit conversion factor (CCF) will be 20 per cent and if it is more than one year then the applicable CCF will be 50 per cent'.

(2) Market Related Off-Balance Sheet Items

i. NBFCs should take into account all market related off-balance sheet items (OTC derivatives and Securities Financing Transactions such as repo / reverse repo/ CBLO etc.) while calculating the risk weighted off-balance sheet credit exposures.

ii. The credit risk on market related off-balance sheet items is the cost to an NBFC of replacing the cash flow specified by the contract in the event of counterparty default. This would depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument.

iii. Market related off-balance sheet items would include:

a. interest rate contracts - including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures;

b. foreign exchange contracts, including contracts involving gold, - includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options;

c. Credit Default Swaps; and

d. any other market related contracts specifically allowed by the Reserve Bank which give rise to credit risk.

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iv. Exemption from capital requirements is permitted for -

a. foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and

b. instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.

v. The exposures to Central Counter Parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. Collateralized Borrowing and Lending Obligations – CBLOs, Repos) outstanding against them will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralized on a daily basis, thereby providing protection for the CCP's credit risk exposures.

vi. A CCF of 100 per cent will be applied to the corporate securities posted as collaterals with CCPs and the resultant off-balance sheet exposure will be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight will be 20 per cent and for other CCPs, the risk weight will be 50 percent.

vii. The total credit exposure to counterparty in respect of derivative transactions should be calculated according to the current exposure method as explained below:

Current Exposure Method:

The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of a) current credit exposure and b) potential future credit exposure of the contract.

(a) Current credit exposure is defined as the sum of the gross positive mark-to-market value of all contracts with respect to a single counterparty (positive and negative marked-to-market values of various contracts with the same counterparty should not be netted). The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market.

(b) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant

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add-on factor indicated below according to the nature and residual maturity of the instrument.

Credit Conversion Factors for interest rate related, exchange rate related and gold related derivatives		
Credit Conversion Factors (%)		
Interest Rate Contracts	***Exchange Rate Contracts & Gold***	
One year or less	0.50	2.00
Over one year to five years	1.00	10.00
Over five years	3.00	15.00

i. For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

ii. For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1.0 per cent.

iii. No potential future credit exposure would be calculated for single currency floating / floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

iv. Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, the 'effective notional amount' must be used for determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the lending rate of the NBFC would have an effective notional amount of USD 2 million.

<u>Credit conversion factors for Credit Default Swaps (CDS):</u>

NBFCs are only permitted to buy credit protection to hedge their credit risk on corporate bonds they hold. The bonds may be held in current category or permanent category. The capital charge for these exposures will be as under:

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(i) For corporate bonds held in current category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, the credit protection will be permitted to be recognized to a maximum of 80% of the exposure hedged. Therefore, the NBFC will continue to maintain capital charge for the corporate bond to the extent of 20% of the applicable capital charge. This can be achieved by taking the exposure value at 20% of the market value of the bond and then multiplying that with the risk weight of the issuing entity. In addition to this, the bought CDS position will attract a capital charge for counterparty risk which will be calculated by applying a credit conversion factor of 100 percent and a risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

(ii) For corporate bonds held in permanent category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, NBFCs can recognize full credit protection for the underlying asset and no capital will be required to be maintained thereon. The exposure will stand fully substituted by the exposure to the protection seller and attract risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

20. ASSET-LIABILITY MANAGEMENT (ALM)

ALM is a risk management tool that helps a bank/NBFC to manage its liquidity risk and interest rate risk. This is a powerful tool that helps banks/NBFCs plan long term financial, funding, and capital strategy using present value analysis. With ALM, a bank/NBFC can model interest income and expenses for analysis and re-price assets and liabilities. ALM involves the analysis of Structural Liquidity Gap Analysis, Interest Rate Gap Analysis, Net Interest Income (NII) Analysis, Net Interest Margin (NIM) Analysis, Tolerance Analysis, Cost to Close Analysis, Duration Gap Analysis, Trend Analysis, Comparative Analysis, Present Value Analysis, Forward Analysis and Scenario Analysis The Reserve Bank of India has announced its ALM guidelines for NBFCs for effective risk management. The NBFCs covered under the system are required to submit ALM returns comprising of statements on structural liquidity, short-term dynamic liquidity and interest rate sensitivity, to the Reserve Bank of India.

Illustration 7

XYZ Limited is an NBFC registered with RBI as non-deposit accepting company. Its main activity includes issuing term loans of different tenures. One of its major customers, ABC Ltd, is engaged in the business of manufacturing. However, due to

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fall in demand and non-recovery of existing trade receivables, ABC Ltd. is facing working capital difficulties. As on 31st March, 20X1 outstanding amount in respect to ABC Ltd. is as under:

Principle amount outstanding (for more than 8 months): ₹250 lakhs

Interest and penalties on the above : ₹30 lakhs

XYZ Ltd. is following accrual system for accounting of its income. Following the same, the Company has accrued ₹30 lakhs as interest income in the Financial Statements for the year ended 31st March, 20X1.

You are required to state whether income accrual of ₹30 lakhs is in accordance with Non Banking Finance Company – Non-Systemically Important Non Deposit taking Company Directions, 2016?

Solution

As per the said directions, Non-performing asset shall mean: a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more. In the present case, dues of ABC Ltd. is outstanding for more than 6 months. Hence, ABC Ltd. will need to be classified as NPA in the books of XYZ Ltd. as on 31st March, 20X1. Once an asset becomes NPA, any income on the said asset need to be recognized on cash basis. Also, previous income accrued but not received, need to be reversed. Based on the same, XYZ Ltd. shall stop accruing further interest accrual on term loan of ABC Ltd. Also, ₹30 lakhs accrued but not realized, need to be reversed.

SUMMARY

- The term NBFC does not include any institution whose principal business is that of agriculture activity, industrial activity or sale/purchase/construction of immovable property. For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a – Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company".
- No NBFC is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.
- Functions of Non-Banking Financial Companies are similar to banks.

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However, there are a few differences:

(a) A NBFC cannot accept demand deposits;

(b) Non-Banking Financial Companies do not take part in the payment and settlement system and hence cannot issue cheques to its customers; and

(c) Deposit Insurance and Credit Guarantee Corporation (DICGC) does not insure the NBFC deposits.

- **Owned fund"** means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;
- **Net Owned Fund =** Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC – Book value of debentures, bonds, outstanding loans and advances made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund).
- **Requirement of Minimum NOF of ₹ 200 lakh**

Prudential Regulations Applicable to NBFCs-ND-SI (asset of ₹ 500 crore and above) and all NBFCs-D

Tier 1 Capital

All NBFCs-ND which have an asset size of ₹ 500 crore and above, and all NBFCs-D, shall maintain minimum Tier 1 Capital of 10%.

"Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

"Tier II capital" includes the following:

(a) preference shares other than those which are compulsorily convertible into equity;

(b) revaluation reserves at discounted rate of fifty five percent;

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(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt to the extent the aggregate does not exceed Tier I capital.

Asset Classification

In the interest of harmonization, the asset classification norms for NBFCs-ND-SI and NBFCs-D are being brought in line with that of banks, in a phased manner, as given below:

Lease Rental and Hire-Purchase Assets shall become NPA if they become overdue for 3 months.

Assets other than Lease Rental and Hire-Purchase Assets shall become NPA if they become overdue for 3 months.

For all loan and hire-purchase and lease assets, sub-standard asset would mean an asset that has been classified as NPA for a period not exceeding 12 months

For all loan and hire-purchase and lease assets, doubtful asset would mean an asset that has remained sub-standard for a period exceeding 12 months

Income Recognition

- Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis.
- However, income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the NBFC's right to receive payment is established. Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis.
- Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

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The assets are classified as:

(a) Standard assets;

(b) Sub-standard assets;

(c) Doubtful assets; and

(d) Loss assets.

Provisioning Requirements

Loss Assets

100% of the outstanding should be provided for.

Doubtful Assets

(a) 100% provision to the extent to which the advance is not covered by the realizable value of the security to which the NBFC has a valid recourse shall be made.

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realizable value of the outstanding) shall be made on the following basis:

Period for which the asset has been considered as doubtful	% of provision
Upto one year	20
One to three years	30
More than three years	50

Sub-standard asset

A general provision of 10% of total outstanding shall be made.

Standard Assets

The provision for standard assets for NBFCs-ND-SI and for all NBFCs-D is 0.40%. This provision towards standard asset need not be netted from gross advances but shown separately as 'Contingent provision against standard assets' in the Balance Sheet.

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TEST YOUR KNOWLEDGE

MCQs

1. For the purpose of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means the non-banking institution which is

   (a) Loan company or investment company.

   (b) Hire-purchase finance company or equipment leasing company.

   (c) Both (a) and (b).

2. For Sub-standard assets in the case of NBFC, a general provision of

   (a) 5% of total outstanding shall be made.

   (b) 10% of total outstanding shall be made.

   (c) 15% of total outstanding shall be made.

3. "Owned fund" excludes

   (a) paid up capital.

   (b) free reserves, balance in share premium account.

   (c) reserves created by revaluation of asset.

4. For secured portion of loans (one to three years) under doubtful category, provision will be made at

   (a) 20%

   (b) 30%

   (c) 50%.

5. For hire-purchase and lease assets, doubtful asset would mean an asset that has remained sub-standard for a period exceeding 12 months

   (a) 6 months.

   (b) 12 months.

   (c) 3 months.

6. For more than three years (unsecured) doubtful advances, provision will be made for

   (a) 10%

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(b) 40%

(c) 100%

7. For more than three years (secured) doubtful advances, provision will be made for

   (a) 50%

   (b) 40%

   (c) 10%

8. A general provision of total outstanding shall be made in case of sub-standard advances.

   (a) 50%

   (b) 40%

   (c) 10%

9. Lease Rental and Hire-Purchase instalments shall become NPA if they become overdue for

   (a) 6 months.

   (b) 12 months.

   (c) 3 months.

10. Provision towards standard assets

    (a) should be netted from gross advances.

    (b) shown separately as 'Contingent provision against standard assets' in the Balance Sheet.

    (c) Both (a) and (b).

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Theoretical Questions

Question 1

Write short notes on:

(i) "Non-Performing Assets".

(ii) Earning value (Equity share).

Practical Questions

Question 1

While closing its books of account at year end, a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	84,000
Sub-standard assets	6,700
Secured portions of doubtful debts:	
– upto one year	1,600
– one year to three years	450
– more than three years	150
Unsecured portions of doubtful debts	485
Loss assets	240

Calculate the amount of provision, which must be made against the advances as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016.

Question 2

Using the same information given in Question 1 relating to advances, calculate the amount of provision, which must be made against the advances as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

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Question 3

Peoples Financiers Ltd. is an NBFC providing Hire Purchase Solutions for acquiring consumer durables. The following information is extracted from its books as at year end:

Asset Funded	Interest Overdue but recognized in Profit & loss		Net Book Value of Assets outstanding
	Period Overdue	Interest Amount	
		(₹ in crore)	(₹ in crore)
LCD Televisions	Upto 12 months	480.00	20,123.00
Washing Machines	For 24 months	102.00	2,410.00
Refrigerators	For 30 months	50.50	1,280.00
Air Conditioners	For 45 months	26.75	647.00

You are required to calculate the amount of provision to be made.

Question 4

LK Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 400 lakhs of which installments are overdue on 400 accounts for last one month (amount overdue ₹ 80 lakhs), on 24 accounts for two months (amount overdue ₹ 48 lakhs), on 10 accounts for more than 30 months (amount overdue ₹ 40 lakhs) and on 4 accounts for more than three years (amount over due ₹ 40 lakhs-already identified as sub-standard assets) and one account of ₹ 20 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹ 12 lakhs) for more than twelve months and other are identified as sub-standard asset for a period of less than twelve months.

Classify the assets of the company in line with Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

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Question 5

While closing its books of accounts as at year end, a Non-Banking Finance Company has its advances classified as follows:

	₹ (in lakhs)
Standard assets	18,400
Sub-standard assets	1,250
Secured Portion of doubtful debts:	
Upto one year	300
One year to three years	90
More than three years	30
Unsecured portions of doubtful debts	92
Loss assets	47

Calculate the amount of provision which must be made against the Advances as per -

(i) The Non-banking Financial Company - Non-systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016; and

(ii) Non-banking Financial Company - Systemically Important Non- Deposit taking Company (Reserve Bank) Directions, 2016.

ANSWERS/ HINTS

MCQs

1. (c); **2.** (b); **3.** (c); **4.** (b); **5.** (b); **6.** (c);
7. (a); **8.** (c) **9.** (c); **10.** (b)

Theoretical Questions

Answer 1

(i) Refer para 14

(ii) Refer para 9

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Practical Questions

Answer 1

Calculation of provision required on advances as at year end, as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	***Percentage of provision***	***Provision ₹ in lakhs***
Standard assets	84,000	0.25	210.00
Sub-standard assets	6,700	10	670.00
Secured portions of doubtful debts–			
– upto one year	1,600	20	320.00
– one year to three years	450	30	135.00
– more than three years	150	50	75.00
Unsecured portions of doubtful debts	485	100	485.00
Loss assets	240	100	240.00
			2,135.00

Answer 2

Calculation of provision required on advances as at year end as per the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	***Percentage of provision***	***Provision ₹ in lakhs***
Standard assets	84,000	0.40	336.00
Sub-standard assets	6,700	10	670.00
Secured portions of doubtful debts–			
– upto one year	1,600	20	320.00
– one year to three years	450	30	135.00
– more than three years	150	50	75.00
Unsecured portions of doubtful debts	485	100	485.00
Loss assets	240	100	240.00
			2,261.00

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Answer 3

On the basis of the information given, in respect of hire purchase and leased assets, additional provision shall be made as under:

			(₹ in crore)
(a)	Where hire charges are overdue upto 12 months	Nil	-
(b)	Where hire charges are overdue for more than 12 months but upto 24 months	10% of the net book value 10% x 2,410	241
(c)	Where hire charges are overdue for more than 24 months but upto 36 months	40 percent of the net book value 40% x 1,280	512
(d)	Where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value 70% x 647	452.90
		Total	1,205.90

Answer 4

Statement showing classification as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

		(₹ in lakhs)
Standard Assets		
Accounts (Balancing figure)	172.00	
400 accounts overdue for a period for 1 month	80.00	
24 accounts overdue for a period for 2 months	48.00	300.00
Sub-Standard Assets		
4 accounts identified as sub-standard asset for a period less than 12 months		28.00
Doubtful Debts		
6 accounts identified as sub-standard for a period more than 12 months		12.00
4 accounts identified as sub-standard for a period more than 3 years		40.00
Loss Assets		
1 account identified by management as loss asset		20.00
Total overdue		400.00

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Answer 5

Calculation of provision required on advances as at year end as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	***Percentage of provision***	***Provision ₹ in lakhs***
Standard assets	18,400	0.25	46.00
Sub-standard assets	1,250	10	125.00
Secured portions of doubtful debts–			
– upto one year	300	20	60.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	92	100	92.00
Loss assets	47	100	47.00
			412.00

Calculation of provision required on advances as at year end as per the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	***Percentage of provision***	***Provision ₹ in lakhs***
Standard assets	18,400	0.40	73.60
Sub-standard assets	1,250	10	125.00
Secured portions of doubtful debts–			
– upto one year	300	20	60.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	92	100	92.00
Loss assets	47	100	47.00
			439.60

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