Year-end considerations

Financial services sector supplement

May 2023

Building a better working world

Foreword

The year 2022 was full of disruptive factors such as high inflation, Ukraine and Russia war, interest rate volatility, events in crypto market etc., due to which there has been a major impact on the BFSI (Banking, Financial services, and Insurance) sector. The year 2023 has kickstarted with a few major events, such as failure of few global financial institutions, which has increased the fear of global financial crises. In light of these events, governments, and central banks all over the world have become more vigilant, especially in the areas of governance and controls.

There have been various regulatory developments/amendments during the year to ensure that entities in the financial service sector are operating efficiently. The idea is to adopt high standards of governance in a globally competitive manner. There are several amendments around new accounting framework such as expected credit loss, scale-based regulation for NBFCs, IFRS 17 for Insurance companies, Ind AS for mutual funds etc.

It is our constant endeavor to help entities stay updated with latest developments and changes in finance function. As all entities gear-up to finalize their financial statements for the year-ended 31 March 2023, it is critical that they evaluate all key changes in accounting and regulatory space which impacts financial and corporate reporting. This publication provides critical updates and insights to help finance leaders and teams update themselves with the changes applicable for the year-end closure and ensure that the companies are well prepared for the closure with the changes.

Purpose of this publication

This publication is the financial services sector supplement of our year-end reporting considerations publication which provides an overview of the changes in accounting standards and interpretations as well as regulatory changes up to 31 January 2023 which are relevant for financial year (FY) 2022-23 and beyond. It covers key changes which are relevant to the BFSI sector and provides a glance at the regulatory and other changes that have been issued during this year, which have consequential impact on accounting, disclosures, and compliance with regulations. It does not attempt to cover all the regulatory pronouncements but covers the key changes impacting the financial year-ended 31 March 2023. This publication does not aim to provide an in-depth analysis or discussion on the changes, rather it aims to highlight the key aspects of these changes. Reference should be made to the text of the pronouncements before taking any decisions or actions.

The publication is divided into the following sections:

Section 1: Banks and NBFCs

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Section 3: Wealth and Asset Management

Hope you all find the publication useful.

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Section 1

Banks and NBFCs

A Impacting financial statements

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6. Provisioning requirement for investment in Security Receipts (SRs)

1 Reserve Bank of India (Financial Statements - Presentation and Disclosures) Directions, 2021

RBI had issued Master Direction on Financial Statements - Presentation and Disclosures vide direction dated 30 August 2021. Subsequent to this, Reserve Bank of India (RBI) has issued some clarification and has updated the master direction during FY 2022-2023. This master direction contains the format of Balance Sheet and Profit and Loss Account, notes and instructions for compilation, disclosures in notes to accounts and instructions and format for the consolidated financial statements. Apart from financial statements presentation and disclosures, this master direction also includes other instructions such as inter branch account provisioning, reconciliation of nostro accounts, maintenance of reserve fund and deferred tax liability on special reserve. Following are the key updates that were issued by the RBI during the FY 2022-23:

I Reporting of reverse repos with Reserve Bank on the bank's balance sheet

In order to bring more clarity on the presentation of reverse repo on Bank's balance sheet, RBI issued clarifications on reverse repo transactions dated 19 May 2022. As per these guidelines, banks are required to report reverse repos in their balance sheet as follows:

- All type of reverse repos with the Reserve Bank including those under Liquidity Adjustment Facility shall be presented under sub-item (ii) 'In Other Accounts' of item (II) 'Balances with Reserve Bank of India' under Schedule 6 'Cash and balances with Reserve Bank of India'.
- Reverse repos with banks and other institutions having original tenors up to and inclusive of 14 days shall be classified under item (ii) 'Money at call and short notice' under Schedule 7 'Balances with banks and money at call and short notice'.
- Reverse repos with banks and other institutions having original tenors more than 14 days shall be classified under Schedule 9 – 'Advances' under the following heads:
  - A. (ii) 'Cash credits, overdrafts and loans repayable on demand'
  - B. (i) 'Secured by tangible assets'
  - C. (I).(iii) Banks (iv) 'Others' (as the case may be)

How we see it: The main objective of the above notification is to bring clarity to the presentation of reverse repo on the Balance sheet. Prior to this notification, there was a mixed practice followed by Banks to present balance in Reverse Repo Account under Schedule 7 (Balance with Banks and Money at Call & Short Notice) or Schedule 9 (Advances).

II Disclosure of Divergence in Asset Classification and Provisioning

In terms of paragraph C.4(e) of Annexure III to the Reserve Bank of India (Financial Statements - Presentation and Disclosures) Directions, 2021, commercial banks (excluding Regional Rural Banks (RRBs)) are required to disclose details of divergence in asset classification and provisioning where such divergence assessed by the RBI exceeds certain specified thresholds. In order to strengthen compliance with income recognition, asset classification and provisioning norms, RBI has revised the specified thresholds for commercial banks and introduced similar disclosure requirements for Primary (Urban) Co-operative Banks (UCBs).

Accordingly, for the financial statements for the year ending 31 March 2023, banks shall make suitable disclosures in the manner specified in paragraph C.4(e) of Annex III to the afore-mentioned Directions, if either or both of the following conditions are satisfied:

i. the additional provisioning for non-performing assets (NPAs) assessed by the RBI exceeds 10% of the reported profit before provisions and contingencies for the reference period; and

ii. the additional Gross NPAs identified by the RBI exceed 10% of the reported incremental Gross NPAs for the reference period.

Provided further that in the case of UCBs, the threshold for reported incremental Gross NPAs specified in paragraph (ii) above shall be 15%, which shall be reduced progressively in a phased manner, after review.

The thresholds specified in above shall be revised for disclosures in annual financial statements for the year ending 31 March 2024, and onwards, as under:

Ref.	Threshold linked to	Commercial Banks (%)	UCBs (%)
(i)	Reported profit before provisions and contingencies	5	5
(ii)	Reported incremental Gross NPA	5	15*

*May be reduced subject to review

How we see it: It seems that the RBI's intention is to tighten the disclosure norms around the divergence of NPA assets. Divergence takes place when the RBI finds that a lender has under-reported (or not reported at all) bad loans in a particular year.

Earlier, the commercial banks (excluding RRBs) were required to disclose details of divergence in asset classification and provisioning where such divergence assessed by the RBI exceeds certain specified thresholds (10% of the reported profit before provisions and contingencies for the reference period and additional Gross NPAs identified by RBI exceeds 15% of the published incremental Gross NPAs).

Now, RBI mandated similar disclosure requirements for UCBs also and revised the specified thresholds for commercial banks.

III Disclosure of material items

In terms of Part A of Annexure II to the mentioned Directions, in case any item under the subhead "Miscellaneous Income" under the head "Schedule 14-Other Income" exceeds 1% of total income, particulars shall be given in the notes to accounts. Similar instructions exist in the case of subhead "Other expenditure" under the head "Schedule 16-Operating Expenses" where particulars shall be given in the notes to accounts for other expenditure exceeding 1% of the total income.

Payments bank shall disclose particulars of all the items under the Schedule 14(I)-Other Income-"Commission, Exchange and Brokerage" that exceeds 1% of the total income in the notes to accounts.

In order to ensure greater transparency, banks shall also disclose the particulars of all such items in the notes to accounts wherever any item under the Schedule 5(IV)-Other Liabilities and Provisions-"Others (including provisions)" or Schedule 11(VI)-Other Assets-"Others" exceeds 1% of the total assets. These instructions are applicable to all commercial banks. These instructions shall come into effect for disclosures in the notes to the annual financial statements for the year ending 31 March 2023 and onwards.

How we see it: The above notification is aimed at enhancing transparency in a bank's financial statements through detailed disclosures. The banks will have to ensure that the necessary data for the above-mentioned disclosure is appropriately available and presented in a manner that aids in better understanding of the financial position and performance of the banks.

2 Reserve Bank of India (Unhedged Foreign Currency Exposure) (UFCE) Directions, 2022

This circular is applicable to all commercial banks (excluding Payments Banks and RRBs) and the overseas branches / subsidiaries of banks incorporated in India. These instructions shall come into force from 01 January 2023.

To address the risk on bank's books, banks were advised to maintain incremental provisioning and capital requirements for their exposures to entities with UFCE. The process of computing incremental provisioning and capital requirements can be summarized in the following steps:

- **Step 1:** Assess the foreign currency exposure (FCE) of the entity.
- **Step 2:** Ascertain the amount of UFCE from entities' FCE, taking into account two types of hedges – natural hedge and financial hedge.
- **Step 3:** Estimate the potential loss to the entity from UFCE exposure to entity due to exchange rate movements.
- **Step 4:** Maintain incremental provisioning and capital requirements against banks' exposure to the entity based on the impact of likely / potential loss on entity's overall profitability.

Computation of Unhedged Foreign Currency Exposure:

a. Banks should ascertain the Foreign Currency Exposure (FCE) from all sources, including the foreign currency borrowings and external commercial borrowings of all entities at least on an annual basis. Banks shall compute the FCE following the relevant accounting standard applicable to the entity. Banks shall consider the items maturing or having cash flows over the period of next five years.

b. Banks should assess the UFCE of entities with FCE by obtaining information on UFCE from the concerned entity. Information on UFCE shall be obtained from entities on a quarterly basis based on statutory audit, internal audit, or self-declaration by the concerned entity. UFCE information shall be audited and certified by the statutory auditors of the entity, at least on an annual basis.

Provisioning and Capital Requirements

a. The largest annual volatility in the USD-INR exchange rates during the last 10 years should be used to determine the potential loss to an entity from UFCE. For other than the US currency UFCE, it should be converted to US dollar using current market rates for determining potential loss.

b. Susceptibility of the entity to adverse exchange rate movements should be determined by computing the ratio of the potential loss to the entity from UFCE and the entity's Earnings Before Interest and Depreciation (EBID) over the last four quarters as per the latest quarterly results certified by the statutory auditors.

   - In cases where banks are not in position to obtain information on UFCE or EBID from listed entities for the latest quarter due to restrictions on disclosure of such information prior to finalization of accounts, banks shall have the option to use data pertaining to the immediately preceding last four quarters.
   - In case of unlisted entities where the audited results of the last quarter are not available, the latest audited quarterly or annual results available shall be used. The annual EBID figure used shall at least be of the last financial year.

c. Banks shall apply incremental capital and provisioning requirements to all exposures to such entities as under:

Potential loss/ EBID (%)	Incremental provisioning requirement	Incremental capital requirement
Up to 15 %	0	0
More than 15% and up to 30%	20bps	0
More than 30% and up to 50%	40bps	0
More than 50% and up to 75%	60bps	0
More than 75 %	80 bps	25% point increase in the risk weigh *(For example: for an entity which otherwise attracts a risk weight of 50%, the applicable risk weight would become 75%)*

The incremental provisioning for UFCE shall be based on the total exposure amount which is used for computing standard asset provisioning and incremental capital requirements for UFCE shall be based on the total exposure amount which is used for computing credit risk capital requirements.

d. Banks shall calculate the incremental provisioning and capital requirements at a minimum on a quarterly basis.

e. For projects under implementation and the new entities, Banks shall calculate the incremental provisioning and capital requirements based on projected average annual EBID for the three years from the date of commencement of commercial operations. This provisioning should be subjected to a minimum floor of 20 bps of provisioning requirement.

f. In cases where the bank is not able to get sufficient data to assess UFCE and compute incremental capital and provisioning requirements except for the smaller entities covered under the alternative method provided in sub-clause (g) below, the bank shall take a conservative view and place the exposure to the entity at the last bucket which requires incremental provisioning of 80bps and a 25%-point increase in risk weight.

g. This alternative method is for smaller entities* which are not in position to provide information, banks shall apply an incremental provisioning of 10 bps over and above extant standard asset provisioning instead of computing incremental capital and provisioning requirements

Smaller entities are those entities on which total exposure of the banking system is at INR 50 crore or less.

Systems and Controls:

- Banks shall incorporate the risk of UFCE of entities in their internal credit rating system and credit risk management policies and procedures.
- Internal limits shall be stipulated for UFCE within the overall Board approved risk policy of the bank.

Consortium Lending: In the case of consortium/ multiple banking arrangements, the consortium leader/ bank having the largest exposure shall have the lead role in monitoring the UFCE of entities.

Note: Banks shall put in place a system for information sharing and dissemination in terms of circular DBOD. No.BP.BC.94/08.12.001/2008-2009 dated 08 December 2008, on 'Lending under Consortium Arrangement / Multiple Banking Arrangements', as amended from time to time.

Exemption / Relaxation: Banks shall have the option to exclude the following exposures from the calculation of UFCE:

- Exposures to entities classified as sovereign, banks, and individuals.
- Exposures classified as NPA.
- Intra-group foreign currency exposures of Multinational Corporations (MNCs) incorporated outside India.

if the bank is satisfied that such foreign currency exposures are appropriately hedged or managed robustly by the parent.

- Exposures arising from derivative transactions and / or factoring transactions with entities, provided such entities have no other exposures to banks in India.

Capital Treatment and Disclosures: The incremental provision requirement for UFCE shall be treated as a general provision for disclosures and inclusion in Tier 2 capital.

Overseas Branches/Subsidiaries: The provisions of these Directions shall be applicable to overseas branches/subsidiaries of banks subject to the following:

- With respect to the exposure to entities incorporated outside India, information on UFCE shall be obtained from such entities on a quarterly basis based on internal audit or self-declaration and the requirement of a certificate from statutory auditors on an annual basis may not be insisted upon.

In cases where a bank is not able to obtain information on UFCE from concerned entities, the treatment similar to smaller entities shall apply.

- Banks shall compute the potential loss due to UFCE by replacing INR with the domestic currency of that jurisdiction and US dollar with the foreign currency (i.e., currency other than domestic currency of that jurisdiction) in which the entity has maximum exposure.

Banks shall compute the largest annual volatility over a period of last 10 years considering: First, daily changes in the foreign exchange rates shall be computed as a log return of today's rate over the previous day's rate. Second, daily volatility shall be computed as standard deviation of these returns over a period of one year (250 observations). Third, this daily volatility shall be annualised by multiplying it by square root of 250. This computation shall be performed on a daily basis for all the days in the last 10 years. The largest annual volatility thus computed shall be used for the computation of the potential loss by multiplying it with the UFCE.

How we see it: Unhedged foreign currency exposure of any entity is an area of concern not only for the individual entity but also for the entire financial system. RBI has, from time to time, issued several guidelines to the banks on UFCE of the entities. In the current guidelines, the RBI has not just consolidated all the necessary instructions in one place but has also suggested certain key changes around the definition of entity, exemption from UFCE guidelines, incremental capital requirement and alternative method for exposure to small entities.

The RBI has provided a comprehensive set of guidelines on UFCE, which requires that the Banks make certain changes in their existing processes and systems to be compliant with the guidelines.

3 Establishment of Digital Banking Units (DBUs)

RBI issued guidelines on the establishment of Digital Banking Units (DBUs) on 07 April 2022. These guidelines are applicable to all Domestic Scheduled Commercial Banks (excluding RRBs, Payments Banks, and Local Area Banks). Scheduled Commercial Banks (excluding RRBs, Payments Banks, and Local Area Banks) with past digital banking experience are permitted to open DBUs in Tier 1 to Tier 6 centres, unless otherwise specifically restricted, without any permission from the RBI. The DBUs of the banks will be treated as Banking Outlets (BOs). Each DBU must offer certain minimum digital banking products and services. Such products should be on both liabilities and assets side of the balance sheet of the digital banking segment.

There are various compliance considerations to be taken care by these DBUs, such as offering products and operational processes that are regulatory complaint, having appropriate outsourcing arrangements, risk monitoring, put in place adequate digital mechanism for customer grievances, reporting and disclosure requirements.

Banks shall report the Digital Banking Segment as a sub-segment within the existing "Retail Banking Segment" in the format as specified under paragraph 4 of Annexure II (Part B) of the Reserve Bank of India (Financial Statements – Presentation and Disclosures) Directions, 2021. It is clarified that the digital banking products / services applicable to segments other than 'Retail Banking' need not be reported at this stage.

Performance update with respect to DBU shall be furnished in a pre-defined reporting format (being separately issued) to Department of Supervision, RBI on a monthly basis and in a consolidated form in Annual Report of the bank.

How we see it: The DBUs of the banks will be treated as banking outlets. It will enable customers to have cost effective, convenient access and enhanced digital experience of banking products and services throughout the year. The DBUs will have to adhere to various operational as well as governance requirements.

4 Regulatory Restrictions on Loans and Advances

Guidelines applicable to NBFC - Upper Layer (UL) and NBFC – Middle Layer (ML)

Loans and advances aggregating INR 5 crores and above to Directors (including the Chairman/ Managing Director) or relatives of Directors, including any firm/company in which Director or their relatives are interested as partner, manager, employer major shareholder, etc shall be approved by Board of Directors/Committee of Directors of such NBFCs.

Director or their relatives shall be deemed to be interested in a company, being the subsidiary or holding company, if he/she is a major shareholder or is in control of the respective holding or subsidiary company.

Director who is directly or indirectly concerned or interested in any proposal should disclose the nature of her interest to the Board when any such proposal is discussed and recuse from the meeting unless presence is required by the other directors for the purpose of eliciting information and the director so required to be present shall not vote on any such proposal.

Board should be reported for the proposals for credit facilities of an amount less than INR 5 crores to above mentioned borrowers.

Loans and advances to Senior Officers of the NBFC

Loans and advances sanctioned to senior officers of the NBFC shall be reported to the Board. No senior officer nor as part of committee meeting shall, while exercising powers of sanction of any credit facility, sanction any credit facility to a relative of that senior officer. Such a facility shall be sanctioned by the next higher sanctioning authority under the delegation of powers.

For both categories of above loans (including contracts), NBFCs shall obtain a declaration from the borrower giving details of the relationship of the borrower to their directors/ senior officers for loans and advances aggregating INR 5 crores and above. NBFCs shall recall the loan if it comes to their knowledge that the borrower has given a false declaration.

The above restrictions do not apply to loans or advances against:

- Government securities
- Life insurance policies
- Fixed deposits
- Stocks and shares
- Housing loans, car advances, etc., granted to an employee of the NBFC under any scheme applicable generally to employees.

Provided that NBFC's interest/lien is appropriately marked with legal enforceability.

(INR crores)

	Current Year	Previous Year
Directors and their relatives		
Entities associated with directors and their relatives		
Senior Officers and their relatives		

Following disclosure is required by NBFCs in their Annual Financial Statement:

Loans and advances to real estate sector

While appraising loan proposals involving real estate, NBFCs shall ensure that the borrowers have obtained prior permission from government/ local government/ other statutory authorities for the project, wherever required. Disbursement shall be made only after the borrower has obtained requisite clearances.

Guidelines applicable to NBFC - Base Layer (BL) - Loans to Directors, Senior Officers, and relatives of Directors

NBFCs shall have a Board approved policy which shall include a threshold beyond which loans shall be reported to the Board for grant of loans to directors, senior officers, and relatives of directors and to entities where directors or their relatives have major shareholding. Similar disclosure (as mentioned in table above) shall be provided in the annual financial statements for such loans and advances.

How we see it: The RBI circular has provided detailed guidelines on restrictions on lending in respect of NBFCs placed in different layers. NBFCs should have the necessary process in place to comply with such restrictions and ensure that necessary disclosures are made in annual financial statement.

5 Disclosures in Financial Statements: notes to accounts of NBFCs

Currently, NBFCs are required to prepare their financial statements as per the following guidelines:

- Format prescribed in Schedule III to the 2013 Act, as applicable and provides disclosures which are mandated therein. Additionally, disclosure requirements as per AS / Indian Accounting Standards (Ind AS), as applicable to be followed.
- NBFCs that are listed on a recognized stock exchange in India are also required to comply with disclosure requirements prescribed in the Securities and Exchange Board of India (SEBI) Listing Regulations.
- RBI has, from time-to-time, prescribed a set of regulatory disclosures that are to be reported by the NBFCs. Recently, through the Scale based regulations (SBR), RBI has advocated additional disclosures in the financial statements for financial periods ending 31 March 2023 and onwards. RBI also provided clarifications on these disclosure requirements through its circular dated 19 April 2022 on 'Disclosures in Financial Statements - Notes to Accounts of NBFCs'.

The additional disclosure requirements for NBFCs in accordance with the SBR framework are outlined below:

Disclosures	Remarks
Exposure to real estate sector	This is an existing disclosure requirement. This is applicable to all layers of NBFC (Systemically Important non-deposit taking NBFCs and deposit taking NBFCs (SI-NBFCs) and Housing Finance Company (HFCs)) and there is no change in the format of reporting.
Exposure to capital market	Existing disclosure requirement is amended by RBI. **Refer note 1 below**
Sectoral exposure	Existing disclosure requirement is amended by RBI. **Refer note 2 below**
Intra group exposures	Existing disclosure requirement is amended by RBI. **Refer note 3 below**
Unhedged foreign currency exposures	This is a new requirement under which NBFCs shall disclose details of its unhedged foreign currency exposures and their policies to manage currency induced risk. Currently, NBFCs provide disclosures of currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, as per the disclosure requirements of Ind AS 107 : Financial Instruments.
Related party disclosure	This is an existing disclosure and further new requirement is introduced. Refer note 4 below. Currently, NBFCs provide disclosures of with respect to related party transactions as per the requirements of Ind AS 24 : Related Party Disclosures.
Disclosure of complaints	Existing disclosure requirement is amended by RBI. **Refer note 5 below**
Corporate governance	This is a new requirement. **Refer note 6 below**. However, listed NBFCs are required to comply with the disclosure requirements, as per SEBI - Listing Obligations and Disclosure Requirements, Regulation 2015.
Breach of covenant	This is a new requirement. NBFCs shall disclose all instances of breach of covenant of loan availed or debt securities issued.
Divergence in asset classification and provisioning	This is an existing disclosure and further new requirement is introduced. Refer note 7 below
Disclosure of NBFCs – UL	This is a new requirement. As per the SBR framework issued by Reserve Bank, NBFC-UL shall be mandatorily listed within three years of identification as NBFC-UL. Upon being identified as NBFC-UL, unlisted NBFC-ULs shall draw up a Board approved roadmap for compliance with the disclosure requirements of a listed company under the SEBI (Listing Obligations and Disclosure Requirements (LODR)) Regulations, 2015.

Note 1:

Exposure to capital market: The RBI, vide its SBR disclosure guidelines, now requires NBFCs in all layers to provide the below mentioned additional details in the disclosure on 'exposure to the capital market':

- Underwriting commitments taken up by the NBFCs in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds
- Financing to stockbrokers for margin trading
- All exposures to Alternative Investment Funds:
  - Category I
  - Category II
  - Category III

Note 2:

Sectoral exposure: Currently, SI-NBFCs (i.e., NBFCs that are systemically important) and HFCs are required to disclose sector-wise NPAs for the following sectors with column - percentage of NPAs to Total Advances in that sector:

- Agriculture and allied activities
- MSME
- Corporate borrowers
- Services
- Unsecured personal loans
- Auto loans
- Other personal loans

NBFCs in all layers of the SBR framework are now required to provide disclosures of total exposure (on and off-balance sheet), gross NPAs and percentage of gross NPAs to total exposure along with comparatives of the previous year in the below mentioned sectors:

- Agriculture and allied activities
- Industry (additional sectors are required to be disclosed within industry)
- Services (additional sectors are required to be disclosed within services)
- Personal loans (additional details are required to be disclosed within personal loans)
- Others, if any.

If exposure to a specific sub-sector/industry within each sector is more than 10% of the Tier I capital of an NBFC (material subsector), then exposure to the material sub-sector is required to be disclosed separately within that sector. Exposures to other sub-sectors/industry within each sector, which is less than 10% of the Tier I capital of the NBFC, are required to be aggregated and disclosed as 'others' within each sector.

Note 3:

Intra group exposures: NBFCs shall make the following disclosures for the current year with comparatives for the previous year:

- Total amount of intra-group exposures
- Total amount of top 20 intra-group exposures
- Percentage of intra-group exposures to total exposure of the NBFC on borrowers/customers

Note 4:

Related party disclosure: Disclosure is required to be given in the following format:

(Amount in INR crores)

Particulars	Parent (*as per ownership or control*)		Subsidiaries		Associates/ Joint ventures		Key Management Personnel@		Relatives of Key Management Personnel@		Other*		Total	
	CY	PY	CY	PY	CY	PY	CY	PY	CY	PY	CY	PY	CY	PY
Borrowings#														
Deposits#														
Placements of deposits#														
Advances#														
Investments#														
Purchase of fixed/ other assets														
Sale of fixed/ other assets														
Interest paid														
Interest received														
Other*														

CY= Current Year | PY= Previous Year

@Disclosures for directors and relatives of directors should be made separately in separate columns from other KMPs and relatives of other KMPs.

#The outstanding at the year end and the maximum during the year are to be disclosed

*Specify item if the total for the item is more than 5% of total related party transactions. Related parties would include trusts and other bodies in which the NBFC can directly or indirectly (through its related parties) exert control or significant influence.

- Related party, in the context of the aforementioned disclosure, would include all related parties as per the applicable accounting standards. Further, the related party shall also include details of related parties as defined under Section 2(76) of the Companies Act, 2013.
- Key Management Personal (KMPs) at minimum shall include details of key managerial personnel as per section 2(51) of the Companies Act, 2013
- Relatives of KMPs at the minimum, shall include details of relatives as defined under section 2(77) of the Companies Act, 2013 and Rule 4 of the Companies (Specification of definitions details) Rules, 2014

Note 5:

Disclosure of complaints: The guidelines now require NBFCs in all layers of the SBR framework to include the certain additional disclosures with regard to customer complaints in a prescribed format. The disclosures are as follows:

- Instead of reporting the number of complaints redressed, NBFCs will now disclose the number of complaints disposed during the year (which includes the number of complaints rejected by the NBFC)
- Details of maintainable complaints received by the NBFC from the Office of the Ombudsman (this includes a number of complaints resolved in favor of the NBFC, number of complaints resolved after passing of awards against the NBFC, and complaints resolved through conciliation/mediation/ advisories)
- Number of awards unimplemented within the stipulated time (other than those appealed)
- Top five grounds of complaints received by the NBFCs from customers along with details regarding pending at beginning of year, received during the year, percentage increase/decrease in complaints, pending at the end of the year (including details of complaints pending for more than 30 days).

Note 6:

Corporate governance: Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Paragraph C of Schedule V - Annual Report) as amended from time to time, specifies disclosures to be made in the section on the corporate governance of the Annual Report. With respect to the corporate governance report, non-listed NBFCs should also endeavor to make full disclosure in accordance with the requirement of SEBI (LODR) Regulation, 2015. Non-listed NBFCs at the minimum should disclose the following under the corporate governance section of the annual report:

- Composition of the Board
  - Details of change in composition of the BoD during the current and previous financial year
  - Reasons for resignation given by independent director, where such resignation is before completion of his/her term
  - Relationship amongst the directors inter-se
- Committees of the Board and their composition (including the terms of reference of the committee, etc.)
- General Body Meetings (giving details of date, place and special resolutions passed at the meetings)
- Details of non-compliance with requirements of the 2013 Act (reasons for non-compliances should also be provided, including for accounting and secretarial standards)
- Details of penalties and strictures imposed on the NBFC by RBI or any other statutory authority.

Note 7:

Divergence in asset classification and provisioning: The disclosure of divergence in asset classification and provisioning is required to be provided in accordance with the format (Table 1) as given below. Disclosures of divergence would be required if either or both of the following conditions are satisfied:

- The additional provisioning requirements assessed by RBI (or National Housing Bank (NHB) in the case of Housing Finance Companies (HFC)) exceed 5% of the reported profits before tax and impairment loss on financial instruments for the reference period, or
- The additional Gross NPAs identified by RBI/ NHB exceeds 5% of the reported Gross NPAs for the reference period

Table 1

Sr.	Particulars	Amount
1	Gross NPAs as on March 31, 20XX* as reported by the NBFC	
2	Gross NPAs as on March 31, 20XX as assessed by the RBI/ NHB	
3	Divergence in Gross NPAs (2-1)	
4	Net NPAs as on March 31, 20XX as reported by the NBFC	
5	Net NPAs as on March 31, 20XX as assessed by the RBI/ NHB	
6	Divergence in Net NPAs (5-4)	
7	Provision for NPAs as on March 31, 20XX as reported by the NBFC	
8	Provision for NPAs as on March 31, 20XX as assessed by the RBI/ NHB	
9	Divergence in provisioning (8-7)	
10	Reported Profit before tax and impairment loss on financial instruments for the year ended March 31, 20XX	
11	Reported Net Profit after Tax (PAT) for the year ended March 31, 20XX	
12	Adjusted (notional) Net Profit after Tax (PAT) for the year ended March 31, 20XX after considering the divergence in provisioning	

*March 31, 20XX is the close of the reference period in respect of which divergence were assessed

How we see it: Certain information mentioned under the guidelines were already being reported by NBFCs, for example disclosure pertaining to related party, disclosures on corporate governance by listed NBFCs, etc. Apart from the information already disclosed, few information to be disclosed are new requirements. The NBFCs will have to evaluate as to how they want to disclose the information in their financial statements, but they will have to ensure that there is no duplication of information, and the details are presented in a way that it is useful for the investors and other stakeholders to comprehend. NBFCs will also need to have a process in place to collate the required information as per prescribed format. The above guidelines will be effective for annual financial statements for the year ending 31 March 2023.

6 Provisioning requirement for investment in Security Receipts (SRs)

Clause 77 of the Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 ("MD-TLE") states that Investments by lenders in SRs/ Pass Through Certificates (PTCs) / other securities issued by Asset Reconstruction Company (ARCs) shall be valued periodically by reckoning the Net Asset Value (NAV) declared by the ARC based on the recovery ratings received for such instruments.

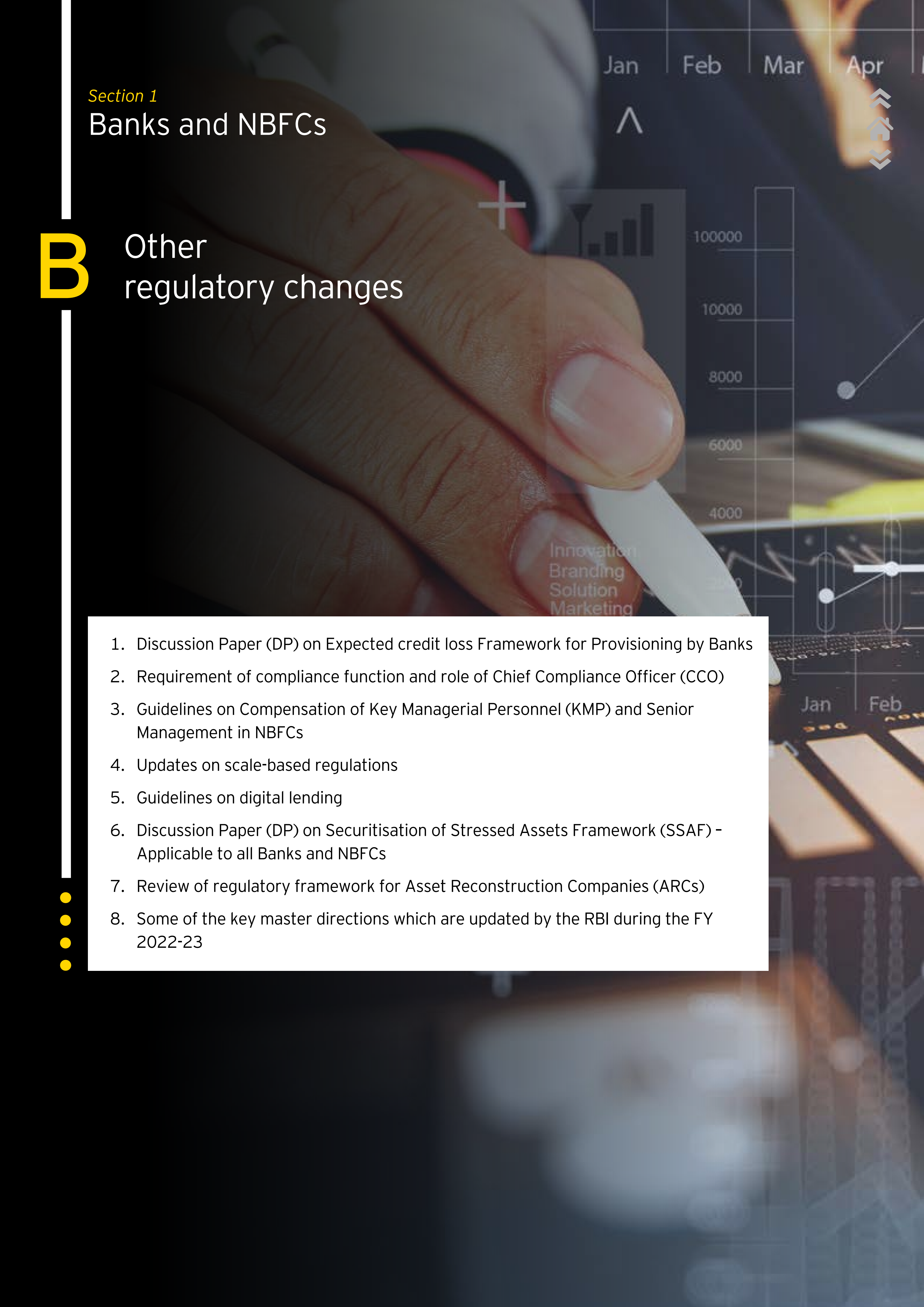
The current circular provides a glide path to the entities (RRBs) which were kept out of Circular "Guidelines on Sale of Stressed Assets by Banks" dated 01 September 2016 and ensure smooth implementation of clause 77 of the MD-TLE . The circular provides clarification on the computation of valuation of investments in SRs outstanding on the date of issuance of MD-TLE (24 September 2021):

a. The difference between the carrying value of such SRs and the valuation arrived at as on the next financial reporting date after the date of issuance of MD-TLE, in terms of clause 77 of the MD-TLE, to be provided over a five-year period starting with the financial year ending March 31, 2022, till FY 2025-26.

b. Subsequent valuations of investments in such SRs on an ongoing basis shall be as per terms of the provisions of MD-TLE.

All lending institutions shall put in place a board approved plan to ensure that the provisioning made in each of the financial years as per above clause (a) is not less than one fifth of the required provisioning on this count.

Valuation of investments in SRs made after the issuance of MD-TLE shall be as per terms of the provisions thereunder.



Section 1

Banks and NBFCs

B Other regulatory changes

1. Discussion Paper (DP) on Expected credit loss Framework for Provisioning by Banks
2. Requirement of compliance function and role of Chief Compliance Officer (CCO)
3. Guidelines on Compensation of Key Managerial Personnel (KMP) and Senior Management in NBFCs
4. Updates on scale-based regulations
5. Guidelines on digital lending
6. Discussion Paper (DP) on Securitisation of Stressed Assets Framework (SSAF) - Applicable to all Banks and NBFCs
7. Review of regulatory framework for Asset Reconstruction Companies (ARCs)
8. Some of the key master directions which are updated by the RBI during the FY 2022-23

1 Discussion Paper (DP) on Expected Credit Loss Framework for Provisioning by Banks

On 16 January 2023, RBI released the 'Discussion Paper (DP) on Introduction of Expected Credit Loss (ECL) Framework for Provisioning by Banks'. The DP proposes a framework for adoption of an expected loss framework and includes discussion questions on which a final view shall be taken based on the feedback received and after analyzing comprehensive data. The feedback/ comments/ suggestions are to be submitted to the RBI by 28 February 2023, basis which the RBI shall issue the final guidelines.

As per the extant requirements, banks follow the 'incurred loss' approach, wherein the level of provisions is contingent on the asset classification of a particular exposure. While finalizing the framework under the expected credit loss approach, RBI has considered the guidance under IFRS 9 Financial Instruments and ASC 326 - Financial Instruments – Credit Losses under the US GAAP. However, RBI has proposed to introduce the expected credit loss approach as per IFRS 9 for loss provisioning supplemented by regulatory backstops. In the DP, RBI has also proposed to adopt the principles laid out by Basel Committee on Banking supervision (BCBS).

Some key takeaways from the DP are:

- The DP proposes to apply the ECL approach to only scheduled commercial banks. RRBs and co-operative banks have currently been excluded from the application.
- The DP specifically mentions the assets on which ECL would be applicable (all loans and advances including irrevocable loan commitments (including sanctioned limits under revolving credit facilities), Lease receivables, Irrevocable financial guarantee contracts, and Investments classified as held-to-maturity or available-for-sale). It also applies to contractual guarantees, examples of contractual guarantees would be performance guarantees and bid-bond guarantees.

How we see it: The DP specifically mentions the exact scope of assets to which ECL model would be applied but is silent on other financial assets which would otherwise get scoped-in under IFRS 9.

Also, under IFRS 9 contractual guarantees are generally not covered unless they meet the definition of a financial guarantee and consequently ECL requirements are not applicable for such contractual guarantees.

Under IFRS 9, there is a policy choice (simplified approach or general approach) to measure the loss allowance for lease receivables, whereas the DP proposes that lease receivables should always be measured at an amount equal to lifetime expected credit losses.

RBI issued a Discussion Paper released on 'Review of Prudential Norms for Classification, Valuation and Operations of Investment Portfolio of Commercial Banks' (DP on Investment Portfolio) in January 2022, this paper provides guidance on measurement of Assets held for sale (AFS) securities and impairment methodology to be followed for held till maturity (HTM) securities. Further clarification may be provided by RBI regarding the applicability of impairment guidance on Investment portfolio as per DP on Investment Portfolio or as per DP on ECL, in case both DP are finalized by RBI.

- The DP specifically mentions that it is proposed to allow the use of the 'low credit-risk' practical expedient in respect of SLR eligible investments; direct claims on central government (i.e., excluding claims that arise from exposures that are guaranteed by the central government); and exposures that are guaranteed by the central government, provided that the guarantee contains suitable clauses mandating invocation within a specified period (say, 30 days) from the event of default and payment of the guarantee amount will be received within a reasonable period (say, 60 days) after the invocation.

How we see it: In the case of 'low credit risk expedient', it appears that there is a carve out proposed from the requirements of IFRS 9 to allow the use of the practical expedient only to instruments specified above.

- IFRS 9 does not define "default", but there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. 'Default' has been specifically defined in the DP as follows:
    - The counterparty is classified as a non-performing asset (NPA) under the extant guidelines of RBI.
    - The exposure to the counterparty has been restructured by the bank and such exposure continues to be in the 'monitoring period'; or
    - The bank considers that the borrower is unlikely to pay its existing debt. A non-exhaustive list of indicators of unlikeliness to pay is also included in DP.
    - Exposures that are overdue for a continuous period of 90 days.

How we see it: It appears that the definition of default is very similar to the definition provided under IFRS 9 for credit impaired assets. As per the DP the default is required to be evaluated at counter-party level and hence banks would need to make appropriate system changes to capture the default at counter-party level and also ensure that all elements mentioned in the definition of default are adequately covered.

- DP proposes specific guidelines for restructured assets which are as follows:
    - The exposures which are restructured will have to be treated as credit-impaired till satisfactory performance is demonstrated post such restructuring.
    - Restructured assets that are in the monitoring period and are performing satisfactorily will be subject to a fixed prudential floor for loss provisioning regardless of the time spent as a Stage 3 asset. Once the asset exits the monitoring period successfully and enters the remaining specified period, the asset can be classified as Stage 2.
    - Banks should test renegotiated and modified financial assets other than restructured assets for a significant increase in credit impairment by comparing the risk of default occurring at the reporting date with that at the initial recognition.

How we see it: While detailed guidelines for treatment of restructured assets is provided in the current Income Recognition and Asset Classification and Provisioning (IRACP) norms, specific guidance may be required as to what would construe as a restructured asset (as defined under IRACP norms) and a modified asset other than restructured to avoid any scope for misinterpretation.

- The DP has proposed criteria for determining significant increase in credit risk (SICR) which includes 'watch-list' accounts and financial assets for which contractual payments are 30 days past due (rebuttable presumption). A non-rebuttable backstop of 60 days past due to be assessed at counterparty level has also been proposed by the DP.
- The DP proposes that "Watch-list" or equivalent classification for stressed exposures, as reported to the Board or Board-level Committees based on Board approved policies of the banks should also be assessed as exposures where significant increase in credit risk has been evidenced since initial recognition.
- While IFRS 9 does not explicitly define the tenure of 'cooling-off period', the DP specifically mentions that an asset in Stage 3 shall not directly be brought to Stage 1 even after the irregularities are rectified and the asset shall be kept in Stage 2 for minimum six months after all the irregularities are rectified, before the same is brought to Stage 1.

How we see it: As per the extant guidelines, an NPA may be upgraded to a standard asset once all irregularities have been rectified, i.e., all arrears of principal and interest have been paid. There is no specific requirement to observe a cooling-off period for upgrading an asset.

As per the DP 'cooling-off' period will have to be observed for stage 3 assets (for restructured assets a separate cooling-off period is suggested) which may be cumbersome and entail system changes to ensure that correct staging criteria is adequately captured for the assets.

- The DP proposed that interest recognition in respect of Stage 3 assets should be based on actual receipt of cash flows and not on an accrual basis. This is a carve-out when compared to IFRS 9. As per IFRS 9 interest on stage 3 assets is accrued by applying the effective interest rate on the net carrying amount of the financial asset, i.e., carrying amount of the financial asset after adjusting for expected credit losses.
- The DP proposes that each bank will be permitted to design and implement its own models for measuring expected credit losses. Additionally, the models shall be required to undergo a process check based on standard principle/considerations. One option could be for the banks to get the models externally validated, and such reports may need to be placed before the audit committee.

How we see it: While the Banks have been submitting pro-forma Ind AS financial statements to the RBI they may have to relook/analyze their methodologies and calculations to align with the specific guidance that is mentioned in this DP. RBI may further clarify whether it requires the Banks to prepare its Pro-forma financial statements under Ind AS 109 or as per the guidance suggested in the DP.

Banks may have to hire an external consultant for model development, validation, and review. They will also have to develop detailed model documentation which adequately captures the approach, assumptions and judgement that is adopted for ECL calculation.

Banks will have to develop policies and governance framework for ECL which adequately defines the roles and responsibilities, validation process (back testing), frequency, method to assess management overlays, etc.

A data and system gap assessment may also be required to be carried out to ensure the adequate ECL methodology is in place once the final guidelines are announced by the RBI.

- One of the key proposals of the DP is that the credit loss estimates arrived at by the banks using their respective models would be subject to a prudential floor prescribed by RBI as a regulatory backstop. It is proposed that the expected credit loss (ECL) measured in respect of an asset classified as Stage 1 as well as Stage 2 or 3 will be subject to prudential floors to be calibrated based on a comprehensive data analysis, rather than merely re-prescribing extant norms. The prudential floors will be subject to a step-up prescription depending upon the time that a financial instrument spends as a Stage 2 or 3 asset. Actual specifications shall be included in the Draft Guidance. The DP chalks out key issues and options around the determination of 'specific' and 'general' provision for stage 2 assets as follows:
    - to treat the entire provisions held in respect of Stage 2 assets, including the additional provisions required to be maintained to meet the prudential floor, as **general provisions**.
    - or alternatively, to treat the estimated ECL provisions (without considering the applicable prudential floor) as **specific provisions** while permitting any additional provisions held as general provisions.
- The DP also chalks out key issues and options around the determination of 'Secured' and 'Unsecured' exposure for the purpose of arriving at the prudential floors as follows:
    - a financial asset should be treated as secured only to the extent of distressed valuation of the security cover available in respect of such asset. To ensure that the valuation correctly captures the prevailing economic conditions, such distressed valuation should be not older than twelve months; or
    - Unsecured exposure should be defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank's inspecting officers, is not more than 51% or a higher percentage to be specified, ab initio, of the outstanding exposure; or
    - Factor in the valuation of the collaterals during the calibration of the prudential floor and issue guidance for valuation of collateral to be reckoned for the computation of the loan loss provisions under the ECL model used by the banks.

How we see it: As per the extant guidelines, the collaterals such as immovable properties charged in favor of the bank should be valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

One of the options discussed in the DP requires a distressed valuation of collaterals to be carried out once in 12 months. This would entail significant time and cost from the Bank's perspective. The banks would also face severe operational and administrative challenges for the distress valuation of retail loans.

The DP is silent on the valuation techniques for the collaterals for LGD computation.

- As transition provisions, the DP provides that the difference between the accounting provisions held on adoption of ECL approach as on the effective date and the provisions computed as per the extant provisioning norms, net of tax effects, may be allowed to be added back to the Common Equity Tier 1 (CET 1) capital. This benefit shall be phased out over a maximum five year- period. Banks may also choose to spread the transition over a shorter period.

How we see it: It is expected that the provision for ECL would have a significant impact on the Bank's profitability and consequently on capital adequacy and leverage. Banks need to gear up and estimate the potential impact on their financial statements and regulatory ratios. Additional clarification/ guidance on the transitional provisions for recording the impact in the financial statements may be required. For example, whether impact needs to be given in opening reserves for the reporting period in which ECL is adopted.

- It is also proposed to prescribe a non-exhaustive list of disclosures that banks would be required to make upon the adopting ECL approach for loss provisioning.

Other considerations

Computation of loan loss provisioning as per ECL will be very crucial for the Banks. In-order to implement the ECL as per the guidance provided in the DP will require the Banks to take into consideration the following aspects.

- **Business:** Under IFRS 9, the behavior of the borrower after origination will become a very important indicator of volatility in ECL provision. Hence, it will become very important to align the key performance indicators of the business teams with the ECL provisions determined. The internal management reporting (MIS) and business metrics would require reassessment. ECL provision amount and the methodology adopted will reflect strongly on the credit risk management practices followed by the banks and pricing of loans. The current communication content to the stakeholders may also require suitable modification.
- **Data:** Significant historical data is required for the determination of ECL, such as data pertaining to past default rates across portfolios, recovery/collection related data across portfolios, etc. Banks will have to start the process of identification of data points and the systems from which it will be sourced.
- **Systems:** Risk models and data will have to be more extensively used to make the assessments and calculations required for accounting purposes, which are both a major change from the extant regulations and a key challenge.

  Significant system enhancements may be required, or banks may have to evaluate whether investment in developing a suitable IT infrastructure for ECL modelling is required.
- **Governance:** One more key aspect that Banks need to consider is that audit trail is available for the ECL provision amount to be suitably audited by the auditors. A lot of elements are involved in the ECL such as probability of default (PD), loss given default (LGD), and exposure at default (EAD), macro-economic overlay; audit trail for each of these elements would be necessary for the auditors to get comfort on the same.

  Systems and processes that the Bank will build, and associated controls will need to be appropriately streamlined to deliver reliable results that are subject to appropriate review and back testing.

  Further, as the composition of the portfolio changes, market condition changes and the ECL methodology and assumptions will have to be accordingly adapted/changed. Hence, strong governance and controls will be required.
- **Training:** Banks would have to consider training its personnel or hiring people with relevant skill sets to work on the ECL modelling, quantifying and financial reporting.

Lastly, the Bank may want to start engaging with their statutory auditors to take them through the current ECL computation and take their inputs on the methodology and assumptions used in the calculation.

The transition to ECL will be a significant milestone and is likely to result in significant time and efforts for banks and will call for major investment and involvement of senior management. Further, it is not merely a financial reporting change, as the impact could be pervasive in nature. However, the adoption of ECL framework shall strengthen the Indian Banking system with more pro-active measures required from the bank's end and timely recognition of losses.

2 Requirement of compliance function and role of Chief Compliance Officer (CCO)

Upper Layer (NBFC-UL) and Middle Layer (NBFC-ML) are required to have an independent Compliance Function and a Chief Compliance Officer (CCO). NBFC-UL and NBFC-ML should have in place Board approved policy and a Compliance function including appointment of CCO latest by 01 April 2023 and 01 October 2023, respectively.

Framework for compliance function and role of CCO

Compliance function shall ensure strict observance of all statutory and regulatory requirements for the NBFC, including standards of market conduct, managing conflict of interest, treating customers fairly and ensuring the suitability of customer service.

Responsibility of the Board and senior management

The Board / Board Committee shall ensure that an appropriate compliance policy is in place and implemented and prescribe the periodicity for review of compliance risk.

The senior management shall:

- at least once a year identify and assess the major compliance risk facing the NBFC and formulate plans to manage it.
- submit to the Board / Board Committee a review at the prescribed periodicity and a detailed annual review of compliance; and
- report promptly to the Board / Board Committee on any material compliance failure while ensuring that appropriate remedial or disciplinary action is taken.

Responsibilities of compliance function

- Assist the Board and the senior management in overseeing the implementation of compliance policy, including policies and procedures, prescriptions in compliance manuals, internal codes of conduct, etc.
- Play the central role in identifying the level of compliance risk in the organization in existing / new products and processes and appropriate risk mitigants shall be put in place. CCO shall be a member of the 'new product' committees. All new products shall be subjected to intensive monitoring for at least the first six months.
- Compliance function shall monitor and test compliance by performing sufficient and representative compliance testing and reporting such results to the senior management. Circulate periodically the instances of compliance failures among staff, along with the required preventive instructions. Staff accountability shall be examined for major compliance failures.
- Ensure compliance of regulatory/ supervisory directions given by RBI in both letter and spirit in a time-bound and sustainable manner. Unsatisfactory compliance with Risk Mitigation Plan (RMP) / Monitorable Action Plan (MAP) may invite penal action from RBI.
- Attend to compliance with directions from other regulators in cases where the activities of the entity are not limited to the regulation/supervision of RBI. Further, discomfort conveyed to the NBFC on any issue by other regulators, and action taken by any other authorities / law enforcement agencies, shall be brought to the notice of RBI.
- The compliance department may also serve as a reference point for the staff from operational departments for seeking clarifications / interpretation of various regulatory and statutory guidelines.

The CCO shall be the nodal point of contact between the NBFC and the regulators / supervisors and shall necessarily be a participant in the structured or other regular discussions held with RBI. Compliance with RBI inspection reports shall be communicated to RBI necessarily through the office of the compliance function.

In some NBFCs, if there are separate departments/ divisions looking after compliance with different statutory and other requirements. In such cases, the departments concerned shall hold the prime responsibility for their respective areas, which shall be clearly outlined. Adherence to applicable statutory provisions and regulations is the responsibility of each staff member. However, the Compliance Function would need to ensure overall oversight.

Broad contours of compliance framework in NBFCs

A. **Compliance policy:** The NBFC should have a Board-approved compliance policy mentioning its compliance philosophy, expectations on compliance culture, structure and role of the compliance function, the role of CCO, processes for identifying, assessing, monitoring, managing, and reporting on compliance risk. The policy shall be reviewed at least once a year. It should cover the following aspects:

- Measures to ensure the independence of the Compliance function and its right to freely disclose findings and views to senior management, the Board / Board Committee.
- Focus on various regulatory and statutory compliance requirements.
- Monitoring mechanism for the compliance testing procedure.
- Reporting requirements, including compliance risk assessment and change in risk profile, etc. to the senior management and to the Board / Board Committee.
- The authority of the compliance function to have access to information as specified in "authority" below.

- A mechanism for dissemination of information on regulatory prescriptions and guidelines among staff and periodic updating of operational manuals; and
- The approval process for all new processes and products by the compliance department, prior to their introduction.

B. **Compliance structure:** The compliance department shall be headed by the Chief Compliance Officer. NBFCs are free to adopt their own organizational structure for the compliance function. The function shall be independent and sufficiently resourced, its responsibilities shall be clearly specified, and its activities shall be subject to periodic and independent review.

C. **Compliance programme:** The NBFC shall carry out an annual compliance risk assessment in order to identify and assess major compliance risks faced by them and prepare a plan to manage the risks. The annual review by the senior management shall cover at least the following aspects:

- Compliance failures, if any, during the preceding year and consequential losses and regulatory action, as also steps taken to avoid recurrence of the same.
- Listing of all major regulatory guidelines issued during the preceding year and steps taken to ensure compliance.
- Compliance with fair practices codes and adherence to standards set by self-regulatory bodies and accounting standards; and
- Progress in the rectification of significant deficiencies and implementation of recommendations pointed out in various audits and RBI inspection reports.

D. **Authority:** The CCO and compliance function shall have the authority to communicate with any staff member and have access to all records or files that are necessary to enable her / him to carry out entrusted responsibilities in respect of compliance issues. This authority shall flow from the compliance policy of the NBFC.

E. **Dual hatting**

- There shall not be any 'dual hatting,' i.e., the CCO shall not be given any responsibility which brings elements of conflict of interest, especially any role relating to business.

The CCO shall not be a member of any committee which conflicts her / his role as CCO with responsibility as a member of the committee, including any committee dealing with purchases / sanctions. In case the CCO is a member of any such committee, that would only be an advisory role.

- The staff in the compliance department shall primarily focus on compliance functions. However, they could be assigned some other duties while ensuring that there is no conflict of interest.

F. **Qualifications and staffing of compliance function:** Apart from having staff with basic qualifications and practical experience in business lines / audit and inspection functions, Compliance Function shall have adequate staff members with knowledge of statutory / regulatory prescriptions, law, accountancy, risk management, information technology, etc. Appropriate succession planning shall be ensured to avoid any future skill gap.

G. **Internal audit and independent review of compliance function:** Compliance risk shall be included in the risk assessment framework of the internal audit function, and compliance function shall be subject to regular internal audit. CCO should be informed of audit findings related to compliance, which serves as a feedback mechanism for assessing the areas of compliance failures.

H. **Supervisory focus:** Examination of compliance rigor prevalent in the NBFC shall be a part of Reserve Bank's supervisory risk assessment process.

I. **Appointment and tenure of CCO**

- **Tenure:** Minimum fixed tenure should be of not less than three years. The Board / Board Committee may relax the minimum tenure by one year in exceptional cases, provided appropriate succession planning is put in place.
- **Removal:** Can be transferred / removed before completion of the tenure only in exceptional circumstances, with the explicit prior approval of the Board / Board Committee, after following a well-defined and transparent internal administrative procedure.
- **Rank:** Shall be a senior executive of the NBFC with a position not below two levels from the CEO. In NBFCs-ML, this requirement can be relaxed by one level further. The CCO can also be recruited from the market if required.
- **Skills:** Have a good understanding of the industry and risk management practices, knowledge of regulations, legal requirements, and have sensitivity to supervisory expectations.
- **Stature:** Has the ability to exercise judgment independently. She / He shall have the freedom and authority to interact with regulators / supervisors directly and ensure compliance.
- **Conduct:** CCO shall have a clean track record and unquestionable integrity.
- **Selection process:** Selection of the candidate for the post of the CCO shall be made based on a well-defined selection process and recommendations made by a committee constituted by the Board/ Board Committee for the purpose. The Board/ Board Committee shall take the final decision in the appointment of CCO.
- **Reporting Requirements:** A prior intimation to the Senior Supervisory Manager, Department of Supervision, RBI, shall be provided before

appointment, premature transfer, resignation, early retirement, or removal of the CCO. Such information shall be supported by a detailed profile of the candidate along with the 'Fit and Proper' certification by the MD and CEO of the NBFC, confirming that the person meets the prescribed supervisory requirements and rationale for changes, if any. 'Fit and Proper' criteria may be examined based on the requirements spelled out in the Circular.

- **Reporting Line:** The CCO shall have direct reporting lines to the MD & CEO and / or Board / Board Committee. In case the CCO reports to the MD and CEO, the Board / Board Committee shall meet the CCO at quarterly intervals on a one-to-one basis, without the presence of the senior management, including MD and CEO. The CCO shall not have any reporting relationship with the business verticals. Further, the performance appraisal of the CCO shall be reviewed by the Board / Board Committee.

How we see it: Compliance function and risk management framework are a critical part of the corporate governance structure. NBFC (UL) and (ML) shall put in place a Board approved policy and a Compliance Function, including the appointment of a Chief Compliance Officer (CCO), based on the framework provided in the circular, latest by 01 April 2023 and 01 October 2023, respectively to ensure effective compliance function. The said guidelines ensure independence and integrity of the CCO is maintained by not allowing CCO to take dual roles. However, the guidelines may increase the compliance and reporting requirements for NBFCs.

3 Guidelines on compensation of Key Managerial Personnel (KMP) and senior management in NBFCs

Directors play a critical role in the operations and management of a company and are empowered by shareholders to take pivotal decisions for the company. Various regulations including the 2013 Act, the Listing Regulations and the RBI provisions cover several aspects regarding directors such as those pertaining to appointment, remuneration, number of directorships, resignation, compensation, transactions with directors, etc. The RBI has issued the guidelines effective from 01 April 2023 for fixing the compensation policy of Key Managerial Personnel and members of senior management of all Non-Banking Financial Companies under the SBR framework, except those categorized under 'Base Layer'3 and Government owned NBFCs. As per this, the compensation policy of an NBFC should at the minimum include the following provisions:

Constitution of Nomination and Remuneration Committee (NRC): NBFC-ML and NBFC-UL should constitute an NRC, which will have the constitution, powers, functions, and duties as laid down in the sec 178 of the Companies Act 2013. The NRC may work in close coordination with the Risk Management Committee of the NBFC to achieve effective alignment between compensation and risks. The NRC may also ensure 'fit and proper' status of proposed/existing directors, and that there is no conflict of interest in appointment of directors to the Board of Directors, KMPs and senior management of the NBFC.

Principles for compensation

- **Components and risk alignment:** The compensation of KMPs and senior management needs to be reasonable, recognizing all relevant factors, including adherence to statutory requirements and industry practices. The compensation packages may comprise fixed, and variable pay components aligned effectively with prudent risk taking to ensure that compensation is adjusted for all types of risks, the compensation outcomes are symmetric with risk outcomes, compensation pay-outs are sensitive to the time horizon of the risks, and the mix of cash, equity and other forms of compensation are consistent with risk alignment.
- **Composition of fixed pay:** All the fixed items of compensation, including the perquisites and contributions towards superannuation/retiral benefits, may be treated as part of fixed pay. All perquisites that are reimbursable may also be included in the fixed pay, so long as there are monetary ceilings on these reimbursements. Monetary equivalent of benefits of non-monetary nature (such as free furnished house, use of company car, etc.) may also be part of fixed pay.
- **Composition of variable pay:** The variable pay may be in the form of share-linked instruments, or a mix of cash and share-linked instruments. It shall be ensured that the share-linked instruments are in conformity with relevant statutory provisions.
- **Proportion:** The proportion of variable pay in total compensation needs to commensurate with the role and prudent risk-taking profile of KMPs/senior management. At higher levels of responsibility, the proportion of variable pay needs to be higher. There should be a proper balance between the cash and share-linked instruments in the variable pay in case the variable pay contains share linked instruments. The variable pay should be truly and effectively variable and can be reduced to zero based on performance at an individual, business-unit and company-wide level. In order to do so, performance measures and their relation to remuneration packages should be clearly defined at the beginning of the performance measurement period to ensure that the employees perceive the incentive mechanism.
- **Deferral of variable pay:** Not all the variable pay awarded after performance assessment may be paid immediately. Certain portion of variable pay, as decided by the Board of the company, may be deferred to time horizon of the risks. The portion of deferral arrangement may be made applicable for both cash and non-cash components of the variable pay. Deferral period for such an arrangement may be decided by the Board of the company.

Control and assurance function personnel: KMPs and senior management engaged in financial control, risk management, compliance and internal audit may be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the company. Accordingly, such personnel may have a higher proportion of fixed compensation. However, a reasonable proportion of compensation may be in the form of variable pay, so that exercising the options of malus and/or clawback, when warranted, is not rendered infructuous.

Guaranteed bonus: Guaranteed bonus may not be paid to KMPs and senior management. However, in the context of new hiring joining/sign-on bonus could be considered. Such bonus will neither be considered part of fixed pay nor of variable pay.

Malus /claw back provisions: The deferred compensation may be subject to malus/claw back arrangements in the event of subdued or negative financial performance of the company and/or the relevant line of business or employee misconduct in any year. A representative set of situations may be identified by the NBFC, which requires them to invoke the malus and clawback clauses that may be applicable to entire variable pay. While setting criteria for the application of malus and clawback, NBFCs may also specify a period during which malus and/or clawback can be applied, covering at least the deferral and retention periods. The malus and clawback provisions are intended to align the interests of KMPs and senior management with those of the NBFC, and to ensure that compensation is tied to performance and behavior that benefits the NBFC in the long run. This helps to promote good governance, risk management, and financial stability in the NBFC sector.

How we see it: The guidance addresses the issues arising out of excessive risk taking caused by misaligned compensation packages of the KMPs and to ensure that there is no conflict of interest. With the additional requirements under the SBR framework mentioned in the said guidance, the NBFCs will also have to comply with the provisions of Companies Act 2013, in case of listed entity - the listing regulations and RBI regulations. Pursuant to the guidance, NBFCs would have to review the existing compensation structure of Key Managerial Personnel (KMPs) and Senior management and align the Compensation polices in line with the SBR framework.

4 Updates on scale-based regulations

A. RBI releases list of NBFCs in the Upper Layer under Scale Based Regulation

The RBI has introduced a SBR framework for NBFCs to ensure a proportionate and effective regulatory approach based on their size, complexity, and systemic importance. Under this framework, NBFCs have been categorized into three categories: Base Layer (BL), Middle Layer (ML), and Upper Layer (UL). The framework specifies that the Upper Layer shall consist of those NBFCs which are specifically identified by the Reserve Bank based on a set of parameters and scoring methodology as provided in the framework. The framework also envisages that top ten NBFCs in terms of their asset size shall always reside in the Upper Layer. In line with the guidance given in the SBR framework, the RBI has identified sixteen NBFCs as NBFC Upper layer on 30 September 2022.

The NBFCs identified as upper layer shall put in place a Board approved policy for adoption of the enhanced regulatory framework applicable to NBFC-UL and chart out an implementation plan for adhering to the new set of regulations within three months from 30 September 2022. Further, the Board of these NBFCs shall ensure that the stipulations prescribed for the NBFC-UL are adhered to within a maximum time-period of 24 months from the date of this press release.

B. Multiple NBFCs in a group: classification in Middle Layer

RBI vide circular dated 11 October 2022 has clarified that the total assets of all the NBFCs in a group will be consolidated for determination of threshold for their "middle layer" status of NBFCs. If the consolidated asset size of the Group with a common set of promoters is INR 1000 crore and above, then each Investment and Credit Company (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factor and Mortgage Guarantee Company (NBFC-MGC) lying in the Group shall be classified as an NBFC in the Middle Layer. Also, Statutory Auditors are required to certify the asset size as on March 31 of all the NBFCs in the Group every year and which shall be furnished to the Department of Supervision of RBI under whose jurisdiction the NBFCs are registered.

Illustrations

Situation: There are seven NBFCs in a group - an Investment and Credit Company (NBFC-ICC) with asset size of INR300 crores, a Housing Finance Company (HFC) with asset size of INR300 crores, an Infrastructure Finance Company (NBFC-IFC) with asset size of INR500 crores, a Micro Finance Institution (NBFC-MFI) with asset size of INR100 crores, an NBFC-Peer to Peer Lending Platform (NBFC-P2P) with asset size of INR50 crores and an NBFC-without public funds and customer interface with asset size of INR70 crores.

How will these NBFCs be classified in various layers?

Comments: On a standalone basis, as per SBR Regulatory Framework, HFCs and IFCs will, by default, be included in the Middle Layer but may move to the Upper Layer based on the supervisory filtering process.

NBFC-ICC and NBFC-MFI will be classified in Base Layer (as their asset size constitutes less than INR1000 crores in the example).

NBFC-P2P and NBFC without public funds and customer interface will, by default, be included in the Base Layer.

Based on consolidation of assets of all the NBFCs in the Group, the consolidated asset size of the Group becomes INR1320 crores (higher than the asset size threshold of INR1000 crores for classification in Middle Layer). As such, NBFC-ICC and NBFC-MFI will be classified in the Middle Layer. HFC and IFC will continue to be classified in the Middle Layer in this example. However, NBFC-P2P and NBFC without public funds and customer interface will continue to be classified in the Base Layer.

Situation: If the asset size of NBFC-ICC in the above example is INR10 crores, then would it be still classified into Middle Layer?

Comments: Yes, both NBFC-ICC and NBFC-MFI would still be classified in Middle Layer as the consolidated asset size of the Group at INR1030 crores is higher than the asset size threshold of INR1000 crores for Middle Layer.

How we see it: All the regulations applicable to the middle layer category of NBFCs would also be applicable to other NBFCs forming part of the group, unless excluded as per applicable RBI guidelines. This will require additional efforts of SBR framework compliance for even smaller NBFCs in the group, which get classified in the Middle layer based on the consolidated asset size of the group.

C. Large Exposures Framework for Non-Banking Financial Company - Upper Layer (NBFC-UL)

The RBI had prescribed a Large Exposure Framework (LEF) for NBFCs in the upper layer as per the SBR framework. LEF aims at addressing credit risk concentration in NBFCs by setting out how to identify large exposures, refine the criteria for grouping of connected counterparties and put in place reporting norms for large exposures. The guidelines shall be applicable to NBFC-UL, both at the solo level and at the consolidated (group) level.

Large Exposure ("LE") means the sum of all exposure values of a NBFC-UL to a counterparty and/ or a group of connected counterparties, if it is equal to or above 10% of the NBFC-UL's eligible capital base. An exposure to a counterparty shall constitute both on and off-balance sheet exposure. In the case of factoring on "with-recourse" basis, the exposure shall be reckoned on the assignor. In the case of factoring on "without-recourse" basis, the exposure shall be reckoned on the debtor, irrespective of credit risk cover/ protection provided, except in cases of international factoring where the entire credit risk has been assumed by the import factor.

Determining group of connected parties

Group of connected counterparties as defined in LEF means two or more (natural or legal) persons who satisfy at least one of the following conditions:

- Control relationship: one person directly or indirectly, has control over the other(s), or such persons are under the common control of a third party (irrespective of whether the NBFC has exposure to the third party or not). Control relationship criteria is automatically satisfied if one entity owns more than 50% of the voting rights of the other entity
- Economic interdependence: RBI framework has prescribed certain minimum criteria which is to be assessed for establishment of economic interdependence for determination of group of connected counterparties.

While there is detailed guidance on identification of the parties which would be covered under the group of connected parties, there are also specific exemptions for sovereign exposures and NBFC-UL's exposure to group entities (that is deducted from owned funds for calculation of Net Owned Funds (NOF)). While determining group of connected parties, RBI has also exempted an NBFC-UL's investment in the equity capital of an insurance company to the extent specifically permitted in writing by the regulator.

The table below summaries the limit set by RBI on the amount of exposure that NBFC- UL can have to a single counterparty or group connected counterparties. The limits are expressed as a percentage of the NBFC-UL's eligible capital base.

	NBFC-UL (Other than IFC)	NBFC-UL (IFC)
Single Counterparty	▶ 20% ▶ additional 5% with Board approval ▶ additional 5% if exposure towards Infrastructure loan/investment (Single counterparty limit shall not exceed 25% in any case)	▶ 25% ▶ additional 5% with Board approval (Single counterparty limit shall not exceed 30% in any case)
Group of connected Counterparties	▶ 25% ▶ additional 10% if exposure towards Infrastructure loan/investment	35%

Overall, these limits are designed to ensure that NBFC-ULs manage their risk exposures effectively and maintain a healthy financial system. By limiting exposure to a single counterparty or group of connected counterparties, the LEF aims to reduce the potential for systemic risk in the banking system.

Breach of Large exposure framework

Any breach of Large Exposure limits shall be under exceptional conditions beyond the control of NBFC-UL, and it shall be reported to RBI (Department of Supervision, Central Office) immediately and rapidly rectified. NBFC-UL cannot undertake any further exposure (at the entity or group level, as the case may be) until it is brought down within the limit. Failure to comply with the exposure limit may lead to imposition of penalties on the NBFC-ULs by the supervisor.

Reporting to RBI

RBI requires the NBFC-UL to report its large exposures to the RBI. The LEF reporting shall cover the following exposures:

- All exposures, meeting the definition of large exposure
- All other exposures, without offsetting the credit risk transfer instruments, are equal to or above 10% of the NBFC-UL's eligible capital base.
- All exempted exposures with values equal to or more than 10% of the NBFC-UL's eligible capital base
- 10 largest exposures irrespective of the values of these exposures relative to the NBFC-UL's eligible capital base.

How we see it: LEF guidelines are effective from 01 October 2022. The NBFC-UL needs to ensure there is no breach of the exposure limits to single counterparty and group of connected counterparties as prescribed in LEF. The NBFC-UL would need to frame a board approved policy to determine the existence of a group of connected counterparties. This policy and the periodic assessment for completeness checks would be subject to supervisory checks. The guidelines provide a framework for NBFCs to manage credit risk concentration and ensure financial stability. However, the NBFC-UL would now have to comply with the various regulatory and reporting requirements as mentioned under the notification.

D. Provisioning for standard assets by Non-Banking Financial Company – Upper Layer (UL)

As per the revised regulatory framework NBFCs classified as UL are required to adopt differential standard asset provisioning norms. NBFC-UL shall maintain provisions in respect of 'standard' assets at the following rates for the funded amount outstanding:

Category of Assets	Rate of Provision
Individual housing loans and loans to Small and Micro Enterprises (SMEs)	0.25%
Housing loans extended at teaser rates	2.00% which will decrease to 0.40% after one year from the date on which the rates are reset at higher rates (if the accounts remain 'standard')
Advances to Commercial Real Estate - Residential Housing (CRE - RH) Sector	0.75%
Advances to Commercial Real Estate (CRE) Sector (other than CRE-RH)	1.00%
Restructured advances	As stipulated in the applicable prudential norms for restructuring of advances
All other loans and advances not included above, including loans to Medium Enterprises	0.40%

Further current credit exposures arising on account of the permitted derivative transactions would also attract provisioning requirement as applicable to the loan assets in the 'standard' category of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for permitted derivative transactions.

Since NBFCs with net worth of INR 250 crore or above are required to comply with Indian Accounting Standards (Ind AS) for the preparation of their financial statements, they shall continue to hold impairment allowances as required under Ind AS, subject to the prudential floor as prescribed under Paragraph 2 of the Annex to the circular DOR (NBFC).CC.PD. No.109/22.10.106/2019-20 dated 13 March 2020. The above-mentioned provisions shall be included in the computation of the prudential floor but shall not be reckoned for calculating net NPAs.

How we see it: As per the current regulations, systematically important non-deposit taking and deposit taking NBFC applied 0.40% provisions on standard assets and non-systematically important and non-deposit taking NBFC applied 0.25% provisions on standard assets. However, the said provision would be revised under the new guidelines as provided for NBFCs - upper layer with effect from 01 October 2022. The above provisioning norms are in lines with those prescribed for banks.

The above provisions percentages are in line with the existing provisions pertaining to standard asset provisioning applicable to HFCs. Hence, the HFCs that are classified in the upper layer of the SBR may not be impacted by this amendment.

E. Scale Based Regulation (SBR) for NBFCs: capital requirements for Non-Banking Finance Companies – Upper Layer (NBFC-UL)

The RBI vide the SBR framework requires NBFC-UL (except CICs) to maintain on an ongoing basis Common Equity Tier 1 capital of at least 9% of risk-weighted assets, and has provided the detailed guidelines, which are summarized below:

$$\text{CET 1 ratio} = \frac{\text{Common Equity Tier 1 Capital (CET 1 Capital)}}{\text{Total risk-weighted assets (Total RWAs)}}$$

Elements of Common equity Tier 1 capital will comprise the following:

Capital and Share premium

- Paid-up equity share capital issued by the NBFC
- Share premium resulting from the issue of equity shares

Add Reserves

- Capital reserves representing surplus arising out of sale proceeds of assets
- Statutory Reserve
- Revaluation reserves (post adjustments and subject to conditions prescribed)
- Other disclosed free reserves, if any.
- retained earnings at the end of the previous financial year. Accumulated losses shall be reduced from CET 1.
- Profits in the current financial year may be included on a quarterly basis if it has been audited or subject to limited review by the statutory auditors of the NBFC. Such profits shall be reduced by average dividend paid in the last three years and the amount which can be reckoned and would be arrived as:

EPt = NPt -0.25 *D*t

- EPt=Eligible profit up to quarter 't' of the current financial year, t varies from 1 to 4
- NPt=Net profit upto quarter 't'
- D=average dividend paid during the last three years

Losses in the current year shall be fully deducted from CET 1.

Less Regulatory adjustments/deductions

- Goodwill and other intangible assets
- Deferred tax assets
- Investments in shares of other NBFCs and certain securities (as prescribed) with subsidiaries and companies in the same group exceeding, in aggregate, 10% of owned fund of the NBFC
- Impairment reserve
- Unrealised gains and/or losses from regulatory capital in terms of para 3(a) (i) to (iii) of the annexure to RBI Circular dated 13 March 2020 read with RBI Circular dated 24 July 2020 issued for Implementation of Indian Accounting standards
- Securitisation transactions
- Defined benefit pension fund assets and liabilities
- Investment in own shares

How we see it: As per the current RBI guidelines, all NBFCs and HFCs are required to maintain a minimum capital ratio consisting of Tier I and Tier II capital, which shall not be less than 15% of its aggregate risk-weighted assets on-balance sheet and risk adjusted value of off-balance sheet items. However, under SBR, NBFC-UL are also required to ensure that on an ongoing basis Common Equity Tier 1 capital of at least 9% of risk-weighted assets has also been maintained with effect from 01 October 2022. While many large NBFCs may be adhering to the revised capital requirements, they need to have a proper system and processes in place to ensure compliance with the same on an ongoing basis.

5 Guidelines on digital lending

RBI had constituted a Working Group on "Digital lending including lending through online platforms and mobile apps" on 13 January 2021. On 10 August 2022, RBI issued Recommendations of the Working group on Digital Lending – Implementation. Further to above circular, RBI issued detailed guidelines on 02 September 2022 to promote responsible lending practices and protect borrowers. RBI's guidelines are directed towards addressing some primary concerns in relation to digital lending such as mis-selling to customers, unethical business conduct, exorbitant interest rates, and excessive engagement of third parties in digital lending transactions.

The said guidelines are applicable to Regulated Entities (RE) i.e., to all Commercial Banks, Primary (Urban) Co-operative Banks, State Co-operative Banks, District Central Co-operative Banks; and NBFC- including HFCs, effective from:

- **New loans:** Immediately i.e., from 02 September 2022- to the existing customers availing fresh loans and to new customers getting onboarded.
- **Existing loans:** REs would be given time till 30 November 2022 to put in place adequate systems and processes to ensure that existing digital loans comply with the guidelines.

The guidelines focus on three main areas as below:

- Consumer protection and conduct requirements
- Technology and data requirements
- Regulatory framework

Consumer protection and conduct requirements:

Areas covered in guideline	Detailed Guidance
Loan disbursal, servicing, and repayment directly through RE account	▶ Disbursements shall be made by RE directly into the bank account of the borrower, except for: ▶ disbursals covered exclusively under statutory or regulatory mandate, ▶ flow of money between REs for co-lending transactions, ▶ disbursals for specific end use, provided the loan is disbursed directly into the bank account of the end-beneficiary. ▶ All loan servicing, repayment, etc., shall be executed by the borrower directly in the RE's bank account without any pass-through account/ pool account of any third party.
Collection of fees, charges, etc	**Fees/charges:** The Lending Service Providers (LSP) shall not charge any fees, charges, etc. to the borrower directly. All the fees, charges should be directly paid by REs to LSPs. **Penal interest/charges:** The penal interest/charges levied on the borrower should be based on the outstanding amount of the loan. Further, the rate of the penal charge should be disclosed on an annualized basis to the borrower in the Key Fact Statement (KFS).
Disclosure to borrowers	**Annual Percentage Rate (APR):** APR as all-inclusive cost of digital loans for the borrower should be disclosed upfront by REs and shall also be a part of the Key Fact Statement. Key Fact Statement (KFS): ▶ Before execution of the contract for any digital lending product, REs should provide the borrower a KFS in a format prescribed by the guidelines. ▶ The KFS should contain the details of the following: ▶ APR, ▶ Loan amount, ▶ Interest charges, ▶ Processing fees, ▶ Insurance charges, ▶ Tenure of loan, ▶ Loan repayment details, ▶ The recovery mechanism, ▶ Details of grievance redressal officer designated specifically to deal with digital lending/ FinTech related matter and ▶ the cooling-off/ look-up period. Any fees, charges, etc., which are not mentioned in the KFS cannot be charged by the REs to the borrower at any stage during the term of the loan. **Digital signed documents:** REs shall ensure that documents are digitally signed. Documents such as KFS, summary of loan product, sanction letter, terms and conditions, account statements, privacy policies of the LSPs/DLAs with respect to borrower's data, etc. shall automatically flow to the borrowers on their registered and verified email/ SMS upon execution of the loan contract/ transactions. **List of LSPs:** REs are required to publish list of Digital lending Apps/ Platforms (DLAs) and LSPs engaged by them, on their website and DLAs of such LSPs, with the details of activities for which they have been engaged. **Product information:** The DLAs of the REs and/or of the LSPs engaged by the REs should display information relating to the product features, loan limit and cost, etc., at the on-boarding/sign-up stage. **Details of recovery agent:** At the time of sanctioning of the loan and at the time of passing on the recovery responsibilities to an LSP or change in the LSP responsible for recovery, the details of the LSP acting as recovery agent who is authorized to approach the borrower for recovery shall be communicated by REs to the borrower.

Areas covered in guideline	Detailed Guidance
	Link to website: The DLAs of the REs and of the LSPs engaged by the REs should have links to the REs' website where detailed information is provided. Information should be placed at a prominent single place on the website of the RE for ease of accessibility.
Grievance redressal	**Nodal Grievance Redressal Officer:** LSPs of the REs should have a suitable Nodal Grievance Redressal Officer to deal with digital lending related complaints/issues raised by the borrowers against their DLAs. Contact details of the grievance redressal officer should be displayed and facility for lodging complaint should be made available on the DLA and websites of the RE and LSPs. Contact details should also be mentioned in the KFS. **Reserve Bank-Integrated Ombudsman Scheme (RB-IOS):** If any complaint lodged by a borrower against an RE or an LSP engaged by the RE is not resolved within the stipulated period (currently 30 days), he/she can lodge a complaint under the RB-IOS or as per any other grievance redressal mechanism prescribed by RBI.
Assessing the borrower's credit worthiness	▸ Capture the economic profile of the borrowers (covering age, occupation, income, etc.) to assess the borrower's creditworthiness in an auditable way before digital loans can be extended to him/her through the DLA of the RE or of the LSP. ▸ Ensure there is no automatic increase in credit limit unless explicit consent of the borrower is taken on record for such an increase.

Cooling off/look up period	▸ The borrowers shall be given an explicit option to exit digital loans by paying the principal and proportionate APR, without any penalty during this period.
	▸ The cooling off/look up period should be determined by the Board of the RE.
	▸ The period so determined shall not be:
	  ▸ less than three days for loans having a tenure of seven days or more
	  ▸ one day for loans having a tenure of less than seven days.
	Borrowers that continue with the loan even after the cooling-off period, prepayment would continue as per the current RBI guidelines.

Due diligence and other requirements with respect to LSPs	▸ REs are required to conduct enhanced due diligence before entering into a partnership with an LSP for digital lending, taking into account its technical abilities, data privacy policies, storage systems, fairness in conduct with borrowers and the ability to comply with regulations and statutes. ▸ A periodic review of the conduct of the LSPs should be carried out by the REs. ▸ With regard to LSPs acting as recovery agents, REs should impart necessary guidance to such LSPs so that they discharge their duties responsibly and comply with the existing instructions in this regard.

Technology and data requirement:

Areas covered in guideline	Detailed Guidance
Collection, usage and sharing of data with third parties	**Need-based data:** The collection of data by the DLAs of the REs and of the LSPs engaged by the REs should be need-based and with prior and explicit consent of the borrower having an audit trail. **Access to apps:** DLAs should desist from accessing mobile phone resources like file and media, contact list, call logs, etc. A one-time access can be taken with the consent of the borrower for camera, microphone, location, or any other facility necessary for the purpose of e-KYC requirements. **Borrower to manage data:** Borrower should be provided with an option to give or deny consent for use of specific data, restrict disclosure to third parties, data retention, revoke consent already granted to collect personal data and if required, make the app delete/forget the data. **Purpose of obtaining consent:** The purpose of obtaining borrower's consent needs to be disclosed at each stage of interface with the borrowers. **Sharing personal information:** Explicit consent of the borrower should be taken before sharing personal information with any third party, except where such sharing is as per statutory/regulatory requirement.
Storage of data	**Storage of minimal data:** The LSPs/DLAs engaged by the REs should store only the basic minimal data such as name, address, contact details of the customer, etc. to carry out their operations. The ultimate responsibility of customer's personal information and security will be that of the RE. **Policy guidelines for storage of data:** A clear policy guidelines regarding storage of customer data, such as type of data that can be stored, length of time it can be stored, etc. should be put in place and disclosed on the apps and website of the DLAs of the REs and of the LSPs engaged by the REs . **Biometric data:** No biometric data should be collected/stored in the systems associated with the DLA of REs/their LSPs unless allowed under existing statutory guidelines. **Servers in India:** All data should be stored in servers located within India while ensuring compliance with statutory obligations/ regulatory instruction.
Comprehensive privacy policy	The REs should ensure that their DLAs and LSPs engaged by them have a comprehensive privacy policy, which is compliant with applicable laws, associated regulations, and RBI guidelines. It should also include details of third parties allowed to collect personal information through the DLA. Such privacy policies should be made available publicly.
Technology standards	The REs should ensure that the REs, and the LSPs engaged by them comply with various technology standards/requirements on cybersecurity stipulated by RBI and other agencies as specified from time to time.

Regulatory framework:

Areas covered in guideline	Detailed Guidance
Reporting to Credit Information Companies (CICs)	▸ The REs should ensure that any lending done through their DLAs and/or DLAs of LSPs engaged by them is reported to CICs irrespective of its nature/tenure. ▸ Reporting should be done for structured digital lending products extended by REs or LSPs engaged by REs over a merchant platform involving short-term, unsecured/secured credits or deferred payments. ▸ REs shall ensure that LSPs associated with deferred payment credit products shall abide by the extant outsourcing guidelines issued by the Reserve Bank.
Loss sharing arrangement in case of default	LSPs generally provide certain credit enhancement features, such as first loss default guarantee (FLDG), to compensate up to a certain percentage of default in a loan portfolio. REs should comply with the provisions of the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated 24 September 2021, with respect to contractual agreements for FLDG including synthetic securitisation.

How we see it: Digital lending is set to grow exponentially in the future. We expect RBI to issue additional guidelines to safeguard consumer interests, prevent unethical business practices, and regularize the sector of digital lending. This regulation may ensure that there is a sustained long-term growth digital lending sector. However, there may be an increased burden of regulatory compliance on REs and LSP/ DLA (especially around FLDG compliance). Overall, this regulation may help to establish a regulatory framework for digital lending in India, which may increase transparency and accountability in the sector and provide a level of oversight to ensure customer. The regulations are applicable for new loans from the date of circular, i.e., 02 September 2022 and for existing loans from 30 November 2022.

6 Discussion Paper (DP) on Securitisation of Stressed Assets Framework (SSAF) – applicable to all Banks and NBFCs

Securitisation involves pooling of loans and selling them to a special purpose entity (SPE), which then issues securities backed by the loan pool. The existing mechanism only provides for a direct assignment of such assets to ARCs who are required to hold a license from the RBI for operating in this segment and comply with stringent requirements for holding funds and capital. These ARCs, in turn, issue Security Receipts (SRs) which can only be held by a qualified buyer.

However, currently there exists a framework for securitisation of standard assets, the SSA Directions of RBI which deals with standard asset securitisation through SPE route. Under the SSA Directions, the definition of standard assets does not include non-performing loans, i.e., only those assets with a delinquency up to 89 days, would qualify for securitisation under the SSA directions.

For assets that turn non-performing, i.e., 89+ days-past-due ('DPD'), are sold via an ARC route as mentioned above and there is no corresponding mechanism for securitisation of non-performing assets (NPAs) through the SPE route i.e., for all practical purposes, there is no secondary market for SRs.

Further, assets sold through the ARC route require a complete arm's length sale, without any credit support from the seller, and there is typically no tranching. This results in substantial haircuts on these stressed loan pools. Further, most of the NPAs that face a problem in the current scenario are retail loans. These retail pools are not normally sold under the ARC route since ARCs lack the capability in this specific asset class and are more suited for wholesale loans.

To introduce a framework for securitisation of stressed assets, in addition to the ARC route, similar to the framework for securitisation of standard assets, the RBI has issued a Discussion Paper on Securitisation of Stressed Assets Framework ('SSAF') dated 25 January 2023, inviting comments on the same by 28 February 2023, ('discussion paper'). The concept of NPA Securitisation brings a shift in approach to NPAs — from being treated as a dead asset to a tradable commodity — and brings in huge potential to lenders for unlocking the value in NPAs.

This discussion paper brings into light various critical issues, for which feedback is requested by RBI, as cited below, which shall further require RBI guidelines / clarifications to smoothen the implementation exercise of SSAF.

1. **Definition of 'Stressed Assets' eligible for securitisation under SSAF:** Will this be limited only to NPAs, or it shall include standard assets too, up to a certain threshold. Securitisation involving only NPAs may have uncertain cash flows, mainly dependent on recoveries from underlying assets, and issuance of securitisation notes on those underlying assets may not have regular servicing, which may be a limiting factor for the universe of investors.
2. **Determining the assets eligible for SSAF:** Type of assets that will be eligible for Securitisation of Stressed Assets
   - Term loans only with the same asset universe as it is there in Securitisation of Standard Asset.
   - Big ticket loans above a certain aggregate threshold (e.g., INR 100 crores).

- Small ticket loans such as commercial/residential mortgages, loans to MSMEs and unsecured retail assets with a floor on pool specifications such as minimum number of loans/ticket size/cumulative loan amount etc.

3. **Minimum Risk Retention (MRR):** In SSAF the resolvability of the underlying assets is dependent upon the type of loan, quality of mortgages/ hypothecated assets which is generally verified by the investors after thorough due diligence. Hence, the role of a Resolution manager (RM) is of utmost importance. The RMs are generally employed on fee-based mechanism of recovery. Thus, the DP has sought comments to determine the form and quantum of MMR that is required to be prescribed by the regulator and whether the MRR requirement should be fulfilled by the RM, originator or both the parties.

4. **Regulatory Framework with respect to Special Purpose Entity (SPE) and RM:** Clarification on the role and framework of SPEs and whether the Resolution Manager is required to be under RBI ambit and required to be an NBFC/ARC registered with RBI.

5. **Treatment of capital:** The discussion paper proposes a capital regime based on External Ratings Based Approach ('ERBA'), subject to minimum non-refundable purchase price discount ('NRPPD') of 50% and Risk Weight ('RW') floor of 100%. Feedback is sought on the treatment and impact on capital keeping in view of the risks associated with the NPA securitisation exposures.

6. **Regulations related to permissibility of Credit Enhancement and its reset requirements:** Clarification on whether the credit enhancement facility be permitted to all tranches or only to senior tranche or whether extension of credit enhancement will be prohibited.

7. **Other issues:** In addition to the above critical aspects, the DP also talks about the below operational areas which will require due consideration by financial institutions.

- Role of the RM
- Relationship between Originator and the RM
- Access of finance to RM
- Framework and conduct of Due diligence
- Valuation of Securitisation Notes under SSAF

How we see it: The discussion paper certainly comes as a great initiative, given the fact that securitisation of NPAs would introduce a new market for these assets, especially retail. However, the above critical questions/feedback sought by the discussion paper will have to be appropriately assessed during the implementation of final directions received from RBI.

7 Review of regulatory framework for Asset Reconstruction Companies (ARCs)

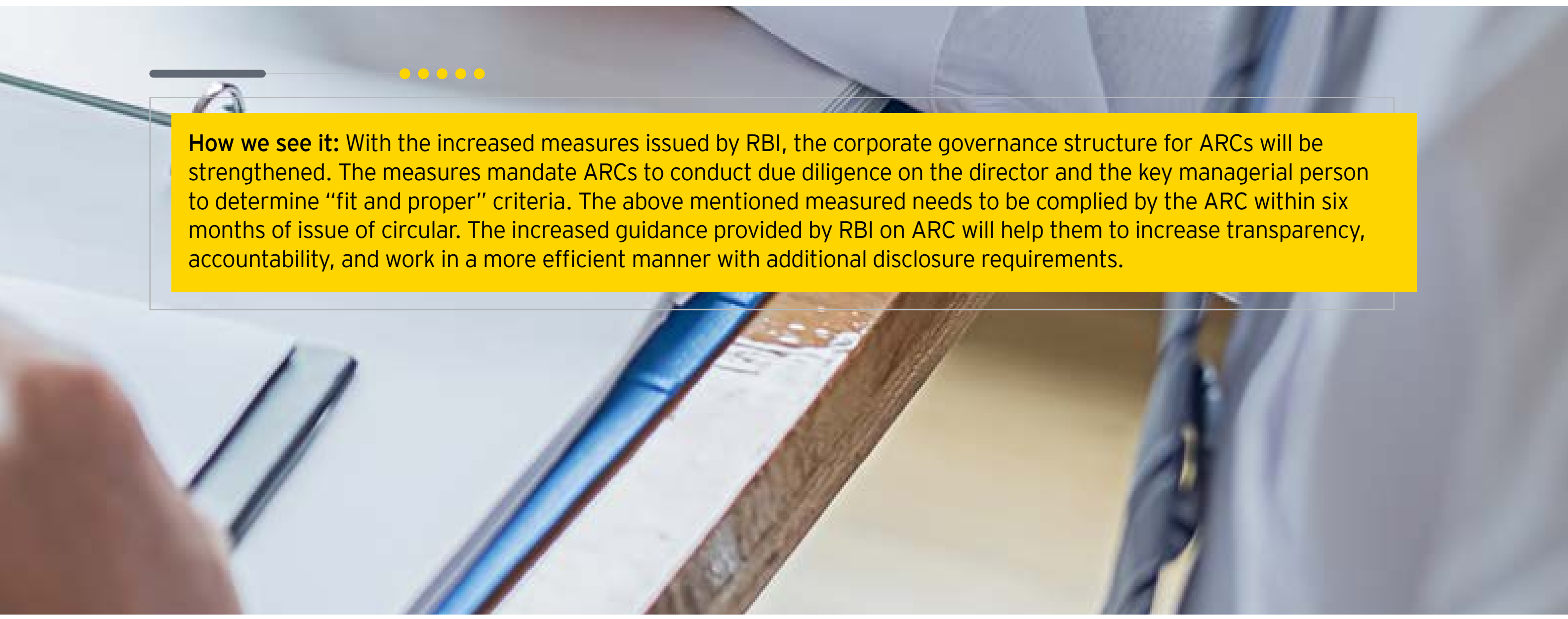
An Asset Reconstruction Company is a financial institution that buys Non-performing Asset from banks / financial institution, enabling banks/financial institutions to perform their other banking / lending activities rather than putting effort into recovering bad assets. Since inception, ARCs have grown in number and size, however their potential for resolving stressed assets is yet to be realised.

Accordingly, as part of the Statement on Developmental and Regulatory Policies released along with the Monetary Policy Statement on 07 April 2021, the Reserve Bank of India had set up a committee to undertake a comprehensive review of the working of ARCs and recommend suitable measures for enabling them to function in a more transparent and efficient manner. Post which RBI issued a circular on "Review of Regulatory Framework for Asset Reconstruction Company" on 11 October 2022 and suggested suitable measures, which are discussed below:

	Particulars	Requirement
I	Corporate Governance Framework	
A	**Measures to enhance governance of ARCs**	
1	**Chair and meetings of the Board of Directors**	
i.	Chair	Shall be presided over by the independent director only
ii.	Quorum	Shall be 1/3rd of the total strength of the board or 3 directors, whichever is higher
iii.	Number of independent directors	At least 50% the directors attending the meeting shall be independent directors
2	**Tenure of Managing Director or CEO OR Whole-time director**	
i.	Tenure	Shall not be more than 5 years at a time + eligible for re-appointment
ii.	Continuous tenure	The post shall not be held by an individual continuously for more than 15 years
iii.	Cooling period	3 years subject to meeting other conditions
3	**Age**	**Not beyond 70 years**
4	**Performance review**	**Shall be reviewed by the board annually**
B	**Committees of the Board**	
i.	Audit Committee	
a	Composition	Shall be presided over by non-executive directors
b	Meeting	Once in every quarter
c	Quorum	3 Members
d	Audit Committee Chair	An Independent Director who will not chair any other committee of the board
e	Knowledge and qualifications	Knowledge to understand financial statements and possess professional expertise in financial accounting and financial management
f	Powers	As per section 177 of the Companies Act 2013
g	Periodical assessment	Responsible for periodically reviewing and assessing the internal control systems, especially the asset acquisition procedures and asset reconstruction measures.
ii.	Nomination and Remuneration Committee	Powers – As per Section 178 of Companies Act 2013. In addition, the Committee shall ensure 'fit and proper' status of proposed/ existing directors and sponsors.
C	**Transition period**	**Within 6 months from the date of the circular.**
D	**Prior Approval for Change in Shareholding**	
i.	Any change in shareholding due to the transfer of shares	Approval from RBI
ii.	Any change in the sponsors of ARCs on account of a fresh issue of shares	Prior approval from RBI

	Particulars	Requirement
E	**Fit and proper criteria for directors and CEO**	▸ due diligence in determining the individual's suitability for the position ▸ shall obtain necessary information and declaration from the appointed or existing directors and MD/CEO ▸ annual declaration of updated information ▸ sign a covenant in the prescribed format at the time of joining
F	**Enhanced disclosure**	▸ Summary of financial information of the ARC for last 5 years or since commencement of business of the ARC, whichever is shorter. ▸ Track record of returns generated for all Security Receipt (SR) investors on the schemes floated in the last 8 years. ▸ Track record of recovery rating migration and engagement with rating agency of schemes floated in the last 8 years.
G	**Credit Rating Agencies (CRAs) and rating of Security receipts**	▸ Mandatorily obtain recovery rating of the SR from CRAs and disclose assumptions and rationale behind such rating to SR holders ▸ Retain a CRA for at least 6 rating cycles (of half year each). If CRA is changed mid-way through these 6 rating cycles, disclose reason for such change
II	**Other measures**	
	Settlement of dues under a one-time settlement	▸ Frame a policy approved by the board ▸ The settlement process shall be initiated only after the approval from the Independent Advisory Committee (IAC) ▸ The IAC shall share its recommendations on the projected earnings and cash flow of the borrower to the ARCs. ▸ The decision on the scheme shall be recorded in the minutes of the board meetings. ▸ Settlement with the borrower should be done only after all possible steps to recover the dues have been taken and there are no further prospects of recovering the debt ▸ The Net Present value (NPV) of the settlement shall not be less than the realisable value of securities. ▸ Reasons for change in the valuation of securities and realisable value shall be recorded.

	Particulars	Requirement
I	**Policy on management fees**	▸ The management fee or incentive shall only be recovered from the recovery of underlying financial assets. ▸ The policy to include the quantitative limit on management fees, and the deviation on it shall require prior approval.
J	**Minimum Net Owned fund (NOF) requirement**	Current - INR 100 crores By 31 March 2024 - INR 200 crores By 31 March 2026 - INR 300 crores
K	**Deployment of surplus funds in short term instruments**	▸ Short-term instruments, viz., Money Market Mutual Funds, Certificate of Deposits, Corporate Bonds and Commercial papers, which have a short-term rating equivalent to the long-term rating of AA- or above by an eligible CRA ▸ The maximum investment in the short-term instrument is 10% of the NOF ▸ There shall be board approved policy for dealing in short-term instruments
L	**Investment in security receipt**	Investment in one scheme and till the redemption of all security receipts issued under such scheme at a minimum of: ▸ 15% of the transferor's investment in the Security Receipts or ▸ 2.5% of the total Security Receipt, whichever is higher
M	**Allowing ARCs to act as resolution applicants under IBC 2016**	▸ Minimum NOF of INR 1,000 crores. ▸ Board-approved policy for resolution Applicant. ▸ A committee composed of a majority of Independent Directors for deciding on the proposal of the resolution plan. ▸ If needed, explore the possibility of preparing a panel of sector-specific management firms /individuals for running firms or companies ▸ No retention of any significant influence or control over the corporate debtor after 5 years from the approval date of the resolution plan. ▸ Additional disclosures in the financial statements with respect to assets acquired under IBC ▸ Quarterly disclosure in the financial statement on the implementation status of the approved resolution plan
N	**Transfer of stressed loans to asset reconstruction company**	Any stressed loans declared as default in the transferor's books can now be transferred to the asset reconstruction companies.



How we see it: With the increased measures issued by RBI, the corporate governance structure for ARCs will be strengthened. The measures mandate ARCs to conduct due diligence on the director and the key managerial person to determine "fit and proper" criteria. The above mentioned measured needs to be complied by the ARC within six months of issue of circular. The increased guidance provided by RBI on ARC will help them to increase transparency, accountability, and work in a more efficient manner with additional disclosure requirements.

8 Some of the Key Master Directions which are updated by the RBI during the FY 2022-23

RBI has updated certain guidelines in some of the existing master directions. Following is the list of such key Master directions which are being updated:

1. Master Direction - Lending to Micro, Small & Medium Enterprises (MSME) Sector (Updated as on 29 July 2022)
2. Master Direction - Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 (Updated as on 02 May 2022)
3. Master Direction - Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions - 2021 (Updated as on 06 April 2022)
4. Master Direction - Exemptions from the provisions of RBI Act, 1934 (Updated as on 01 April 2022)
5. Master Direction – Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022 (Updated as on 25 July 2022)
6. Master Directions – Priority Sector Lending (PSL) – Targets and Classification (Updated as on 20 October 2022)
7. Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (Updated as on 05 December 2022)

8. Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 (Updated as on 05 December 2022)
9. Master Direction - Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 (Updated as on 08 December 2022)
10. Master Direction – Non-Banking Financial Company – Housing Finance Company (Reserve Bank) Directions, 2021 (Updated as on 27 December 2022)
11. Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 (Updated as on 29 December 2022)
12. Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 (Updated as on 29 December 2022)
13. Master Direction - Core Investment Companies (Reserve Bank) Directions, 2016 (Updated as on 29 December 2022)
14. Master Directions - Mortgage Guarantee Companies (Reserve Bank) Directions, 2016 (Updated as on 29 December 2022)

Section 2

Insurance

Introduction

IFRS 17 establishes principles for recognition, measurement, presentation, and disclosure of insurance contracts issued, reinsurance contracts held and investment contracts with discretionary participation features that an entity issue. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents the insurance contracts within its scope. IFRS 17 provides a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance, and cash flows.

About the history of IFRS 17, International Accounting Standards Board (IASB) had issued the IFRS 4 Insurance contract in March 2004, which was an interim standard and meant to be in place until the board could complete its project on insurance contracts. Board completed its project on insurance contracts with the issuance of IFRS 17 Insurance contracts in May 2017 and issued final amendments to IFRS 17 in June 2020.

IFRS 17 is effective for annual reporting periods beginning on or after 01 January 2023.

The journey of adopting Ind AS by Indian Insurance companies has been as follows:

- The Ministry of Corporate Affairs (MCA) had issued a press release dated 18 January 2016, for Insurance companies to prepare its Standalone and consolidated financial statements under Ind AS for FY 2018-19 with comparatives of FY 2017-18.
- Insurance companies were required to submit 'pro forma Ind AS financial statements' to the Insurance Regulatory and Development Authority of India (IRDAI) from the quarter ending 31 December 2016 onwards and disclose the strategy for Ind AS implementation, the progress made, in their Annual Reports for FY 2015-16 until implementation. Currently, Insurance companies follow Ind AS (including Ind AS 104 Insurance contracts which is consistent with IFRS 4) as notified by MCA for their pro forma Ind AS financial statements reporting
- In May 2017 when IASB issued IFRS 17, IRDAI deferred the implementation of Ind AS for Insurance companies till 2020-21.
- The Institute of Chartered Accountants of India (ICAI) issued an Exposure Draft (ED) on Indian Accounting Standard (Ind AS) 117, Insurance Contracts and amendment thereof, which are similar to IFRS 17. The ICAI has submitted the proposal for Ind AS 117, along with the results of public consultations to the National Financial Reporting Authority (NFRA). However, the MCA has not yet notified Ind AS 117. Further, the regulators are yet to notify the regulations on preparation of Ind AS compliant financial statements.

Key focus areas of the standards

IFRS 17 requires an entity to:

- Identify a contract as insurance contracts under which the entity accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.
- Group the contracts based on risks, management, profitability, and date of issue of insurance contracts.
- Recognize the profit from a group of insurance contracts over the period the entity provides insurance contract services and based on the release of risk. If a group of contracts is or becomes loss-making, an entity recognizes the loss immediately.
- Present separately insurance service revenue (that excludes the receipts of any investment component), insurance service expenses (that excludes the repayment of any investment components) and insurance finance income or expenses. Disclosed information to enable users of financial statements to understand the nature and magnitude of the risks connected to the insurance contracts, and the significant judgments and assumptions made to estimate the insurance contract liabilities.

IFRS 17 introduces the following new measurement models:

- General Measurement Model (GMM), also called the building block approach. This model comprises computation of fulfillment cash flows (comprising expected future cash flows, an adjustment to reflect the time value of money and financial risk, and a risk adjustment for non-financial risk) and contractual service margin.
- Modified version of general measurement model (called the Variable fee approach (VFA)) for contracts with direct participation features. This generally does not apply to reinsurance contract held or issued.
- Premium Allocation Approach (PAA), which is an optional simplified model applied for groups of insurance contracts meeting the specified criteria and introduces lesser changes from current practice compared to the other measurement models. The presentation requirements under IFRS 17 have undergone a substantial change. Results of insurance contracts are bifurcated into insurance service result (insurance revenue and insurance service expenses presented separately) and insurance finance income and expenses. Further, income or expenses from reinsurance contracts held are required to be presented separately. Also, an entity should disclose the significant judgements and changes in judgements. Similarly, the disclosure requirements have undergone a substantial change requiring more transparency and more granular information, for example, reconciliation of the movement of insurance and reinsurance liabilities during the reporting period.

Key impact of IFRS 17

Until now, insurance entities following IFRS accounting standards used to report their financial statements in accordance with IFRS 4. Key impact areas for entities due to shift from IFRS 4 to IFRS 17 are as follows:

A new concept is introduced under IFRS 17, called the Contractual Service Margin (CSM), which represents the expected profitability of a group of insurance contract. The unearned profit is recorded as CSM measured using locked-in discount rate as on initial recognition and that changes to CSM in subsequent measurement of the CSM are based on those locked in rates. Any changes in estimated fulfillment cash flows that relate to future service are adjusted in CSM and not recognized in Profit & loss account When compared to IFRS 4, the total profit under IFRS 17 remains unchanged over the lifetime of an insurance contract. However, the timing of profit recognition will change, resulting in increased long-term predictability of profits. IFRS 17 would result in a more stable release of profits as CSM is released based on the pattern of services provided. Further, under IFRS 17, losses from onerous contracts are recognized immediately in profit or loss statement.

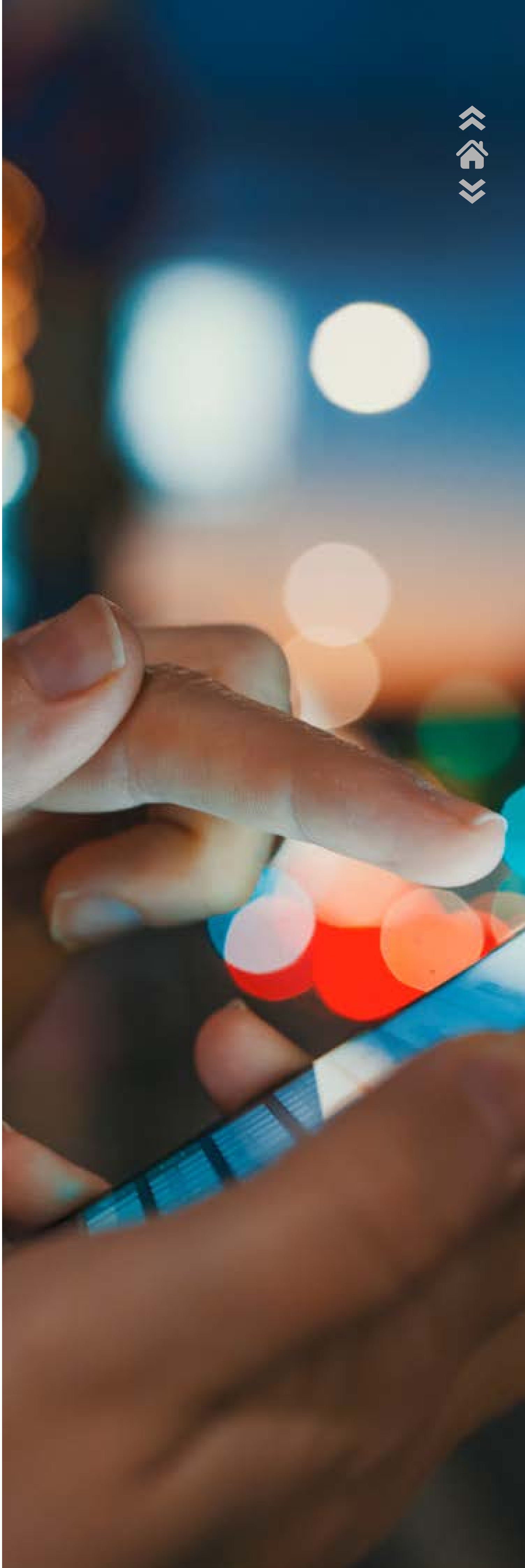
Discount rates should represent the characteristics of the cash flows and be consistent with market observable prices. The standard does not prescribe any specific approach for computation of discount rate; however, it discusses two broad approaches i.e., top-down approach and bottom-up approach. Insurance entities that are required to comply with Solvency II framework may prefer the bottom-up approach that is more closely aligned with the Solvency II framework.

IFRS 17 allows accounting policy choice at portfolio level to either include insurance finance income or expenses in profit or loss or disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (OCI). The disaggregation allows for lower volatility in P&L, as liabilities need to be measured at current discount rates at each reporting date.

General insurance companies, which majorly cover short-term insurance products, are less impacted by change in the measurement model on account of simplification provided under Premium Allocation Approach (PAA). The liability for incurred claims also needs to be based on the Net Present Value of best estimate cash flows with risk adjustment.

Life insurers are comparatively more impacted on account of implementation of IFRS 17 and are more likely to use GMM, or the VFA approach.

IFRS 17 provides for three transition approaches i.e., Full Retrospective Approach (FRA), Modified retrospective approach (MRA) and fair value approach (FVA). Full Retrospective Approach is the default approach to be applied unless it is impracticable. Where the full retrospective approach is impracticable, there



is an option to choose from a modified retrospective approach and fair value approach. Global insurance companies are generally using a mix of FRA, MRA and FVA, with more weightage to FRA and MRA approaches.

IFRS 17 Implementation project

Considering the complexity and impact of IFRS 17 on insurance companies, its implementation can be carried out in a phased manner, where the phases being gap assessment, design, implementation, including testing and post implementation support.

Gap assessment focuses on operational impact assessment, financial impact assessment, trainings, and workshops. Operational impact assessment provides a detailed understanding of gaps in current data, systems, and processes. Financial impact assessment provides a high-level impact of IFRS 17 implementation on Financial Statements based on the preliminary policy choices.

In the design phase, the objective is to make required decisions and prepare the design documents which would be required for implementation. This will majorly comprise technical position papers, methodology document, business requirement and functional specification documents, target operating model, system solution architecture, vendor assessment and system implementation roadmap.

Implementation phase will focus on development (actuarial models, source system enhancements, ETL development for data flow, sub-ledger implementation etc.), testing (unit test, system integration testing and user acceptance testing) and transition (opening balance sheet and parallel run for comparative period).

Post implementation support will majorly comprise support in resolving auditors and regulatory queries and post implementation trainings and knowledge transfer. It can also include providing review support for production runs.

Section 3

Wealth and asset management

Impacting financial statements and disclosure

SEBI directs Ind AS implementation for Mutual Funds: regulatory framework for Mutual Funds

The SEBI via SEBI (Mutual Fund) Regulation 1996 is responsible for laying down the regulatory framework for operations and functioning of Mutual Funds (MFs). On 25 January 2022, SEBI vide a notification issued the SEBI(Mutual Funds) (Amendments) Regulation, 2022, mandating the AMCs of the MF to prepare the financial statements of their MF schemes in accordance with Ind AS effective from 01 April 2023. The Notification contains a proviso which state that in case there is any conflict between the requirements of IND AS and these regulations and guidelines issued thereunder, the asset management companies shall follow the requirements specified under these regulations. Further to the above notification, a circular was issued on 04 February 2022 to provide guidelines on accounting with respect to Ind AS for MFs.

The requirements of the circular will become applicable from 01 April 2023 and are detailed as below:

- **First Ind AS financial statements**

As per the circular, MFs shall prepare the financial statements for the following period:

a. First Ind AS financial statements for the year ending 31 March 2024

b. Comparatives Ind AS financial statement for the year end 31 March 2023 and

c. Opening balance sheet as on date of transition i.e., 01 April 2022, as per the principles laid down in Ind AS 101 – First Time Adoption of Ind AS.

MFs will be required to prepare two-sets of financial statements for the year-ended 31 March 2023, one based on existing Indian GAAP (for statutory reporting) and the other based on Ind AS (Comparative period to First Ind AS FS - refer to point (b) above).

- **Perspective historical unit statistic**

As per clause 6 to the 11th Schedule of the MF Regulations, MF are required to disclose the unit statistic for past 3 years. Circular states that the MF may not mandatorily restate the unit statistic data as per requirement of Ind AS for the first two years from first time adoption of Ind AS. For e.g., the unit statistic data as per existing GAAP may be disclosed for the year ended 31 March 2021 to 31 March 2023 and unit statistic data as per Ind AS to be disclosed for the year ended 31 March 2024. The MF shall provide with following details in case the unit statistics for the previous years are not restated :

a. Label the previous GAAP information prominently as not being prepared in accordance with Ind AS

b. Disclose the nature of adjustments that would be required to make it comply with Ind AS. Mutual fund schemes need not quantifying those adjustments.

- **Formats for financial statement of Mutual funds**

a. The financial statements are to be prepared scheme wise and amounts to be presented in lakhs. The components of the financial statements are as follows:

   i. Balance sheet (current reporting period and previous reporting period)

   ii. Statement of changes in net asset attributable to unit holder of the scheme (Figures for the current reporting period and Figures for the previous reporting period)

   iii. Movement of Unit Capital (current reporting period and previous reporting period)

   iv. Revenue Account

   v. Notes to Balance sheet and revenue account.

b. Other requirements:

   i. All applicable disclosures as per Ind AS shall form part of notes to accounts

   ii. Accounting policy to include recognition of revenue and income from investments.

   iii. Accounting policy of valuation of Investments shall be disclosed

   iv. Details with respect to security in default beyond its maturity date viz., ISIN, name of security, value of security considered under net receivables and total amount due to the scheme. Further, this disclosure shall continue till the value of the security recognized in the NAV is received or for a period of 3 years from the date of maturity of security, whichever is later.

   v. Indicate the Total income and expenditure expressed as a percentage of average net assets at plan level, calculated on a Daily Average Net Assets basis.

   vi. Contingent liabilities disclosure to specifically include Underwriting commitments, Uncalled liability on partly paid shares and other commitments.

   vii. The balance sheet and revenue accounts to be signed by CEO, COO/CFO and such KMP as designated by Board of AMC, CIO, Scheme wise fund manager, Board of Trustee, and the Auditors.

   viii. The Financial statements should be approved at the Board meeting of AMC and also at a meeting of the trustees or in the case of a trustee company by the Board of Directors of the trustee company.

- **Modifications to Para C (2) of SEBI circular CIR/IMD/DF/24/2012 dated 19 November 2012**

   a. Brokerage and transaction cost: As per Regulation 52(6A)(a), Brokerage and transaction cost up to 12 bps for cash market transactions and 5bps for derivatives transactions shall be charged to the scheme. Any payment above such prescribed rate may be charged to the Scheme within the maximum limit of Total expense ratio (TER) as prescribed under Regulation 52 of the SEBI (Mutual Finds) Regulations, 1996.

   b. Transaction cost: The circular clarifies that in order to align with Ind AS requirement all transaction cost shall be expensed out i.e., debited to revenue account instead of capitalization.

How we see it: The circular provides guidance to MF with respect to preparation of the financial statement, including a detailed format of the financial statements, clarification on the authorized signatory and approval of financial statements.

Mutual funds need to perform detailed impact assessment for transition to Ind AS, align its chart of accounts, identify and prepare the relevant disclosures, and assess any potential impact on its systems and processes for areas such as valuation of investments, detailed disclosure requirements as per Ind AS. Fund houses that have outsourced the preparation of financial statements to service providers will need to initiate the discussions for the activities required for transition to Ind AS. Considering the large volume of financial statements that a mutual fund needs to prepare for individual mutual fund schemes, it should also aim to deploy solutions to automate the financial reporting process. The guidance provided would be effective from 01 April 2023.

Following are few important points for consideration:

1. As per proviso to clause 50(1A) of the MF regulation, in case of any conflict between the requirements of Ind AS and MF regulations and guidelines issued thereunder, the AMC shall follow the requirements specified under MF regulation.

- **Valuation of investments:** The 8th Schedule of the MF regulation provides a detailed guideline for valuation of the investments. The said guidance does not consider the requirements of Ind AS 113 – Fair valuation measurement, such as evaluation of principal and most advantages markets, present value techniques, option pricing models, fair value hierarchy, etc. In the area of conflict, it seems that the requirements as per MF regulations shall prevail.
- **Formats for periodic reports:** The circular provided guidance only with respect to annual financial statements of the MF. Apart from the audited financial statement MF requires submitting periodic reports to SEBI such as abridged scheme wise annual report, quarterly statement of movement in net assets for each scheme of the fund and a quarterly portfolio statement for each scheme. The circular does not provide any format for these periodic reports. In the absence of such details, it seems that the formats as prescribed by the MF regulation shall prevail. SEBI may consider issuing clarification in this regard.

2. Statement of cash flows: Currently, as per the opinion by Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), MF prepare their cash flow based on the criteria for classification of non-corporate entities for applicability of accounting standards issued by ICAI. As per Ind AS, all reporting entities are required to present statement of cash flow. However, the circular has not prescribed any format for Statement of Cash flow. To align with Ind AS requirements, the MF may be required to present their statement of cash flow as per Ind AS 7.
3. Assessment of equity vs. liability for unit capital: Depending on the nature of the Scheme i.e., close ended scheme or open-ended scheme, the classification of the unit capital is assessed considering the guidance provided under Ind AS 32 Financial Instruments: Presentation. As per Ind AS 32, an instrument containing an obligation for the issuer to transfer cash, or another financial asset are to be classified as a financial liability. Para 16A of Ind AS 32 states that a puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. Para 16C of Ind AS 32 states, some financial instruments include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation. The obligation arises because liquidation either is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain to occur but is at the option of the instrument holder. As an exception to the definition of a financial liability, an instrument that includes an obligation as specified in Para 16A and 16C of Ind AS 32 are classified as an equity instrument when certain criteria as specified in Ind AS 32 are met. These criteria are rule-based. MF entities need to carry out detailed assessments of all applicable aspects including but not limited to the fact and circumstances of each scheme, legal and regulatory framework, etc., to conclude the classification of the unit capital of each scheme as a financial liability or equity.

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