Why NBFCs need ICAAP

Why in news?

RBI has stated that the Upper and Middle Layer NBFCs will have to follow Internal Capital Adequacy Assessment Process (ICAAP).

What is ICAAP?

- ICCAP is Internal Capital Adequacy Assessment Process (ICAAP).
- The ICAAP will inform NBFC about
    - Risks associated with assets.
    - The way management intends to mitigate those risks
    - Amount of current and future capital necessary.
- The objective is to ensure that NBFCs hold adequate capital to support the relevant risks in their business.

Why RBI proposes ICAAP?

- **Size and nature of NBFC -** The RBI is concerned about the growing size of NBFCs and their interconnectedness with other segments of the financial system.
- Some larger NBFCs are equivalent to smaller, new generation private banks in terms of size and complexity of business.
- The risk-management of these NBFCs is similar to commercial banks counterparts.
- **The impact of pandemic –** Pandemic has led to substantial reduction in consumption demand which have resulted in slowdown in credit growth.
- The impact is visible on asset quality, profitability, and capital position of NBFCs.
- The profitability of NBFC has dipped in 2021.
- **Deterioration in credit quality -** This deterioration in credit quality in the MSME portfolio of NBFCs has drawn regulatory attention.
- The concern is about Asset Liability Management (ALM) and credit risk for these NBFCs.

What are the key elements of ICAAP?

- The key elements of ICAAP policy are:
    1. Risk Appetite Statement – It provides the aggregate level and types of risk associated with a financial institution.
    2. Risk Profile Analysis - It will indicate the ability to accept or reject risks.
    3. Capital Management.
    4. Capital Strategy and Targets
    5. ICAAP reporting and Independent Review.

What NBFC needs to do?

- NBFCs has to
  - establish a board-approved policy and framework of ICAAP
  - assess their existing and future capital requirements based on credit, market, operational and other residual risks.
- The risk appetite defined by the board has to be reviewed periodically to take into cognizance the changing business perspective of the environment and hence of the NBFC.
- An assessment of the current and desired risk profile has to be made.
- The assessment states
  - The level of risk the NBFC is willing to take.
  - The action plan to achieve it.

What are the measures taken by RBI to regulate NBFCs?

- The ICAAP policy and framework laid down by the NBFCs will be subject to regulatory oversight.
- RBI has permitted restructuring of temporarily impaired MSME loans up to 25 crore.
- It has been further boosted by Emergency Credit Line Guarantee Scheme (ECLGS) disbursements to eligible categories.
- RBI has now put in place a PCA framework for NBFCs as an early supervisory intervention which will be effective from March 31, 2022.

Reference

1. https://www.financialexpress.com/opinion/why-nbfcs-need-icaap/2402035/

SHANKAR IAS PARLIAMENT
Information is Empowering