Module-B Unit-17

JAIIB PAPER-2

Principles and Practices of Banking (PPB)

JAIIB PPB Module B Unit- 17: Finance to MFIs/Co-Lending Arrangements with NBFCs

Non Banking Finance Companies (NBFCs)

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956.

It is engaged in the business of -

- **Loans and advances**
- **Acquisition of shares/ stocks/ bonds/ debentures/ securities issued by Government or local authority**
- **Leasing, hire purchase, insurance business, chit business etc.**

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

Microfinance provides small loans and other financial services to poor and low-income households.

Source of Financing for NBFCs

- NBFCs have several sources of finances.
  - **Public Deposits (with specific approval of RBIs)**
  - **Debentures**
  - **Bank Borrowings**
  - **Commercial Papers**
- Bank borrowings are a major source of funds for NBFCs including NBFC-MFIs. This helps in widening the reach of institutional credit to the sectors and areas that are not fully covered by banks.
- NBFCs largely cater to priority sectors, this channel contributes to the priority sector lending of banks.

Bank Finance To NBFCs

- Banks may extend need based working capital facilities as well as term loans to all NBFCs registered with RBI and engaged in infrastructure financing, equipment leasing, hire-purchase, loan, factoring and investment activities subject to the guidelines.
- Banks may also extend finance to NBFCs against second hand assets financed by them.

All NBFCs including HFCs are required to register with RBI, except few exempted categories:-

- Micro Finance Companies
- Asset Reconstruction Companies registered with the RBI under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- Nidhi Companies
- Mutual Benefit Companies
- Chit Companies (under Chit Funds Act, 1982)
- Merchant Banking Companies (subject to conditions)

NBFC Activities Not Eligible for Bank Finance

- Bills discounted/ rediscounted by NBFCs.
- Investments of NBFCs both of current and long-term nature, in any company/entity by way of shares, debentures
- Unsecured loans/ inter-corporate deposits by NBFCs to/ in any company.
- All types of loans and advances by NBFCs to their subsidiaries, group companies/ entities.
- Finance to NBFCs for further lending to individuals for subscribing to IPOs and for purchase of shares from secondary market.
- Shares and debentures cannot be accepted as collateral securities for secured loans to NBFC.

Prudential Ceilings for Exposure of Banks to NBFCS

- **Exposure to a single NBFC**: Maximum 20% of the bank's Tier I capital.
- **Exposure to a group of connected NBFCs:** Maximum 25% of the bank's Tier I Capital.
- **Exposure to a single NBFC predominantly lending against collateral of gold Jewellery:** Maximum 7.5% of the bank's Tier I plus Tier II Capital. The ceiling may go up to 12.5% if the additional exposure is on account of funds on-lent by the NBFCs to infrastructure sector.
- **Aggregate exposure to NBFC Sector:** Banks may fix internal limits for their aggregate exposure to all NBFCs put together.
- **Aggregate exposures to all NBFCs, having gold loans to the extent of 50% or more of their total financial assets:** Banks should have an internal sub-limit on their aggregate exposures to all such NBFCs.

Bank Loans To NBFCs For On-lending

- Banks can extend loans to NBFCs for the purpose of on-lending to the priority sectors. This mode is not applicable to RRBs, UCBs, SFBs and LABs.
- Loans to MFIs (NBFC-MFIs, Societies, Trusts, etc.)
- Loans to NBFCs for on-lending is eligible for classification as priority sector under respective categories subject to specified conditions.
- Loans to HFCs approved by NHB

- Bank credit to NBFCs (including HFCs) for on-lending, should be within 5% of its total priority sector lending, averaged across four quarters.

NBFC-MFI

An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Companies Act, 1956 - Section 8 of the Companies Act, 2013) that fulfills the following conditions:

- **Minimum Net Owned Funds: Minimum Rs. 5 crore. (Registered in the North Eastern Region, Minimum Rs. 2 crore).**
- **Qualifying Assets Share: Not less than 85% of net assets to be "qualifying assets."**

Qualifying Asset: A loan which satisfies the following criteria: **–**

- **Household Income Ceiling**: Borrower with annual income not exceeding Rs. 1,25,000 (rural household) or Rs. 2,00,000 (urban and semi-urban household).
- **Ceiling on Loan Amounts:** Maximum loan amount Rs. 75,000 (first cycle) and Rs. 1,25,000 (subsequent cycles).
- **Total indebtedness:** Maximum Rs. 1,25,000. Education and medical expenses are excluded for total indebtedness**.**
- **Tenure of Loan:** Not less than 24 months for loan more than `30,000 with prepayment without penalty**.**
- **Collateral:** Any loan should be extended without collateral.
- **Loan Portfolio:** Aggregate of loans for income generation to be at least 50% of the total loans of the NBFC-MFI, and the rest can be for other purposes (housing repairs, education, medical and other emergencies).
- **Repayment Mode:** Weekly, fortnightly or monthly instalments at the choice of the borrower.
- **Other Income**: Income from remaining 15 percent assets to be as per the regulations.
- **Restriction on Micro-finance**: An NBFC not qualifying as an NBFC-MFI to extend loans to micro finance sector not exceeding 10% of total assets.

Certain MFIs which fulfill the following criteria are exempted from registration with RBI:

- **Purpose and Quantum of Credit:** Providing credit not exceeding Rs. 50,000 for a business enterprise and Rs. 1,25,000 for a dwelling unit to any poor person; and
- **Licensing**: Under Sec. 25 of the Companies Act, 1956 (Sec. 8 of the Companies Act, 2013); and
- **Public Deposits:** It does not accept public deposits as defined in RBI Directions.

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Prudential Norms

Capital Adequacy

Tier I and Tier II Capital to be not less than 15% of aggregate risk weighted assets. Tier II Capital not to exceed Tier I Capital.

Asset Classification Norms:

- **Standard asset**: No default in repayment of principal or payment of interest is perceived.
- **Non-performing asset:** Interest/principal payment remained overdue for a period of 90 days or more.

Provisioning Norms:

Aggregate loan provision to be not less than the higher of:

- 1% of the outstanding loan portfolio, or
- 50% of the aggregate loan instalments overdue for more than 90 days and less than 180 days, and 100% of the aggregate loan instalments overdue for 180 days or more.

An advance covered by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) guarantee becomes non-performing: No provision for guaranteed portion. Provision for the excess outstandings as per the norms.

Membership of CIC:

Every NBFC-MFI has to be a member of all Credit Information Companies (CICs), provide timely and accurate data to them and use the data available with them.

Pricing of Credit:

- **Margin cap:** Difference between the rate to the borrower and the cost of funds - Maximum 10% for large MFIs (portfolio exceeding Rs. 100 crore) and 12% for others.
- **Interest Rates Charged:** Shall be the lower of the following (a) The cost of funds plus margin or (b) The average base rate of the five largest commercial banks by assets multiplied by 2.75.
- **Variance in Interest rate:** On individual loans not more than 4%.
- **Processing Charges:** Not more than 1% of gross loan amount.
- **Insurance Cost**: To recover only the actual cost of insurance. Administrative charges, where recovered, shall be as per IRDA guidelines.

Co-lending By Banks and NBFCs To Priority Sector

- **In November, 2020 RBI revised its guidelines for co-origination as "Co-Lending Model" (CLM) that is available to banks** (excluding SFBs, RRBs, UCBs and LABs), with a view to providing greater operational flexibility to the lending institutions. The CLM shall not be applicable to foreign banks with less than 20 branches.
- Banks are permitted to co-lend with all registered NBFCs (including HFCs) based on a prior agreement. **Co-lending banks will take their share of the individual loans on a back-to-back basis in their books. NBFCs shall be required to retain a minimum of 20% share of the individual loans on their books.**
- The bank retains the discretion to reject certain loans after their due diligence prior to taking in their books, subject to the conditions specified.
- The NBFC shall enter into a loan agreement with the borrower, containing the features of the arrangement and roles and responsibilities of the NBFC and the bank.
- Suitable arrangement must be put in place by the co-lenders to **resolve any complaint registered by a borrower with the NBFC within 30 days**.
- The co-lending bank and the NBFC shall maintain each individual borrower's account for their respective exposures.
- All transactions (disbursements/ repayments) between the bank and the NBFC relating to CLM shall be routed through an escrow account maintained with the bank.
- Each lender shall adhere for its share of the loan account to respective IRAC and provisioning requirements, reporting to Credit Information Companies.

Framework For Scale Based Regulation (SBR) For NBFCs

- Reserve Bank of India has put in place a revised regulatory framework for NBFCs effective from October 01, 2022.
- Regulatory structure for **NBFCs shall comprise of four layers based on their size, activity, and perceived riskiness.**
- **Base Layer (NBFC-BL), NBFC - Middle Layer (NBFC-ML), NBFC - Upper Layer (NBFC - UL) and NBFC - Top Layer (NBFC - TL).**
- NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.
- NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer). SPD and IDF-NBFC will always remain in the Middle Layer.
- The remaining NBFCs, viz., NBFC-ICC, NBFC-MFI, NBFC-MGC could lie in any of the layers.
- Government owned NBFCs shall be placed in the Base Layer or Middle Layer.

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