RBI Reduces Risk Weights on NBFCs and MFIs Loans

Source: IE

Why in News?

Reserve Bank of India (RBI) reduced the **risk weights of** bank loans to **NBFCs** and **Microfinance Institutions** to **boost credit flow** and enhance lending to the retail sector of the economy.

What is the Risk Weight on Loans and How Does It Impact NBFCs and Banks?

- **About: Risk weight** is a **percentage factor** assigned to a **bank's assets**, including loans, to determine the amount of **capital required to cover potential losses.**
    - **Higher** risk weight **increases capital requirements**, making loans costlier, while **lower** risk weight **reduces capital needs**, enabling more lending.
- **Criteria:** Risk weights depend on **credit rating, asset type, and regulations**. **Highly rated** borrowers get **lower risk weights**, while **low-rated** ones face **higher risk weights.**
- **Impact of Lower Risk Weights:**
    - **Encouraging Bank Lending to NBFCs: Banks** need to hold **less capital** for loans, increasing their **lending capacity to NBFCs.**
    - **Positive Impact on Credit Growth:** Enhanced liquidity will boost **NBFC lending in housing, consumer finance, and MSMEs.** The retail sector gains from improved access to credit.
    - **Enhancing Financial Stability:** Boosting credit growth increases **employment, income levels and financial resilience.**

Capital Adequacy Ratio (CAR)

- **About:** It measures a **bank's financial strength**, ensuring a bank has **enough capital** to **absorb potential losses** and protect depositors.
- **Components:**
    - **Tier-1 Capital**: Core capital (**equity, share capital, retained earnings**) used to absorb losses while the bank continues operating.
    - **Tier-2 Capital**: Secondary capital (**unaudited reserves, subordinated debt**) used when the bank is winding down.
- **Regulatory Requirement**: It is set by the **Basel Accords** and enforced by central banks (e.g., RBI in India).
    - As per **Basel III norms**, banks are required to maintain a **minimum CAR of 8%** globally, while **RBI mandates 9% for Indian banks.**
- **Importance**: A higher CAR indicates a bank is **financially stable** and capable of handling financial crises.

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Non-Banking Financial Companies (NBFCs)

A Non-Banking Financial Company (NBFC) provides loans, acquires financial securities, and offers leasing & insurance services. However, it excludes companies primarily engaged in agriculture, industrial activities, trading, or real estate.

About:

- Do not have a banking license; not part of the payment system; cannot issue cheques
- Insurance by Deposit Insurance & Credit Guarantee Corporation→ not available for NBFC depositors
- Can accept public deposits for 12-60 months (no demand deposits)
- NBFCs require an investment-grade credit rating
- Registration→ Companies Act, 1956
- Key Services Offered- Personal loans, Home loans, Vehicle Financing, Gold Loans, Microfinance, Infrastructure Financing, Insurance Services, Investment Management

About

Classification:

Classification

By Major Activity:

- Asset Finance Company
- Investment Company
- Loan Company
- Infrastructure Finance Company
- Core Investment Company
- Infrastructure Debt Fund
- Micro Finance Institution (NBFC-MFI) → Malegam Committee Recommendation
- NBFC-Factors
- Mortgage Guarantee Companies
- Non-Operative Financial Holding Company

By Deposits:

- Deposit-taking NBFCs
- Non-deposit taking NBFCs-
  - Systemically Important (NBFC-NDSI)
  - Other non-deposit holding (NBFC-ND)

Systemically Important NBFCs

- Assets of ₹500 crores or more

Regulation:

Type of Institution	Regulatory Authority
NBFCs registered with RBI	RBI
Housing Finance Institutions	National Housing Bank
Merchant Banking Companies, Venture Capital Fund Companies, Stock Broking, Collective Investment Schemes (CIS)	SEBI
Nidhi Companies, Mutual Benefit Companies	Ministry of Corporate Affairs (MCA)
Chit Fund Companies	State Government
Insurance Companies	IRDAI
Non-Banking Non-Financial Companies	Statute- Companies Act 1956 Regulator- Ministry of Corporate Affairs Enforcement Agency- State Governments

Benefits of NBFCs:

- Financial Inclusion
- Innovative Products
- Liquidity
- Support for MSMEs

Challenges of NBFCs:

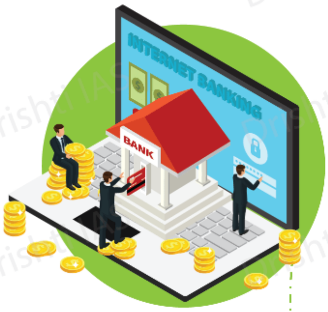
- Funding Constraints
- Asset Quality & Credit Risk
- Regulatory Compliance
- Corporate Governance

Microfinance Institutions (MFIs)

About MFIs

- Provides financial services & small-value loans
- **Targets** – Low-income households, small businesses, & entrepreneurs in rural & urban areas
- Maximum annual income criteria – **Rs 3 lakh** (for collateral-free microloans)

Evolution of Microfinance Sector

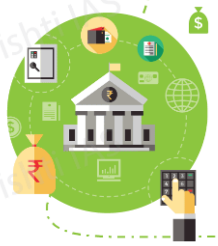


- **Initial Period (1974–1984):**
  - Shri Mahila Sewa Sahakari Bank established for women
  - NABARD promoted SHG linkage
- **Change Period (2002–2006):**
  - Unsecured lending norms for SHGs were aligned with secured loans
  - RBI included microfinance in the priority sector
- **Growth and Crisis (2007–2010):**
  - Private equity investments→ Rapid MFI growth
  - Microfinance Institutions Network (MFIN) formed
- **Consolidation and Maturity (2012–2015):**
  - Malegam Committee (2012) recommended regulatory changes
  - New Category of NBFCs – Non Banking Financial Company-Micro Finance Institutions (NBFC-MFIs)
  - Universal banking license to Bandhan Bank (largest microlender) by RBI (2014)
  - MUDRA Bank launched (2015)

MFIs in India are regulated by the RBI through the NBFC-MFIs framework 2014.

Business Models

- **Self Help Groups (SHGs):**
  - Informal groups (10-20 members) saving together & accessing credit
  - Linked to banks through the SHG-Bank Linkage Programme
- **Microfinance Institutions (MFIs):**
  - Offer micro-credit & financial services
  - Loans through Joint Lending Groups (JLGs) of 4-10 members



Types of MFIs

- **NGO-MFIs** (under Society Registration Act 1860 or Indian Trust Act 1880)
- **Co-operative Societies**
- **Section 8 Companies** (under Companies Act, 2013)
- **NBFC-MFIs** (accounts for 80% of microfinance market)

Benefits

- Digitization and financial inclusion
- Self-sufficiency (entrepreneurship and improved livelihoods)
- Steady income (assets building)
- Women entrepreneurship

Challenges of MFIs	Way Forward
High Interest Rates	Improve regulatory oversight and encourage interest rate caps
Over-Indebtedness of Borrowers	Strengthen credit risk assessment and promote financial literacy
Dependency on External Funding	Diversify funding sources through partnerships and capital markets
Low Financial Literacy Among Borrowers	Promoting financial education programs/campaigns

UPSC Civil Services Examination Previous Year Questions (PYQ)

Prelims

Q. Microfinance is the provision of financial services to people of low-income groups. This includes both the consumers and the self-employed. The service/services rendered under microfinance is/are (2011)

1. Credit facilities
2. Savings facilities
3. Insurance facilities
4. Fund Transfer facilities

Select the correct answer using the codes given below the lists:

(a) 1 only

(b) 1 and 4 only

(c) 2 and 3 only

(d) 1, 2, 3 and 4

Ans: (d)