NIBM WORKING PAPER SERIES

(Policy Research Notes)

Lending by Banks to NBFCs for On-lending to Priority Sectors: Recent RBI Guidelines and Way Forward

M Manickaraj
Elizabeth James

Working Paper
(WP20/2022)

NATIONAL INSTITUTE OF BANK MANAGEMENT
Pune, Maharashtra, 411048
INDIA
June 2022

The views expressed herein are those of the authors and do not necessarily reflect the views of the National Institute of Bank Management.

NIBM working papers are circulated for discussion and comment purposes. They have not been peer-reviewed or been subject to the review for Journal or Book Publication

© 2022 by M Manickaraj and Elizabeth James

Citation Guideline:

Manickaraj M, Elizabeth James (2022), "Lending by Banks to NBFCs for On-lending to Priority Sectors: Recent RBI Guidelines and Way Forward". NIBM Working Paper Series: Policy Research Notes WP 20/June.

https://www.nibmindia.org/static/working_paper/NIBM_WP20_MMEJ.pdf

Lending by Banks to NBFCs for On-lending to Priority Sectors:
Recent RBI Guidelines and Way Forward

M Manickaraj
Elizabeth James
NIBM Working Paper No. 20
June 2022

ABSTRACT

The Reserve Bank of India (RBI) has allowed scheduled commercial banks (SCBs) and small finance banks (SFBs)to lend money to Non-Banking Finance Companies (NBFCs) and NBFFC – Micro Finance Institutions (NBFC-MFIs) respectively for the purpose of on-lending to the priority sectors. As per the Master Directions on Priority Sector Lending the facility was allowed till March 31, 2022. However, the circular issued by the RBI on May 13, 2022 makes this facility to continue on an ongoing basis. The article gives a background for the facility, discusses few related questions and suggesting a way forward. The authors opine that there is synergy between banks and NBFCs and lending for on-lending creates a win-win for all the stakeholders. They also recommend that the banks shall engage NBFCs and NBFC-MFIs as channel partners for reaching out to the priority sectors.

M Manickaraj (*Corresponding Author*)
manick@nibmindia.org

Elizabeth James
elizabeth@nibmindia.org

Lending by Banks to NBFCs for On-lending to Priority Sectors: Recent RBI Guidelines and Way Forward

1. Background

Certain sectors of the economy are classified by the Government of India (GoI) and Reserve Bank of India (RBI) as priority sectors and SCBs have been directed to lend money to these sectors. In July 1968 the National Credit Council emphasised that commercial banks need to increase their contribution in the financing of priority sectors and the description of priority sector was formalised in 1972 by the Informal Study Group on Statistics relating to advances to the Priority Sectors constituted by the Reserve Bank in May 1971. By 1979 the commercial banks were required to increase their share in these sectors in their aggregate advances by 33.33 percent and subsequently on the basis of recommendations of the Working Group on Modalities of Implementation of Priority Sector Lending and the Twenty Point Economic Programme by Banks (Chairman: Dr. K. S. Krishnaswamy), all commercial banks were advised to achieve the target of priority sector lending (PSL) at 40 per cent of aggregate bank advances by 1985. To further the objective of boosting credit to the needy sector bank credit to registered NBFCs (other than MFIs) for on-lending was made eligible for classification as priority sector according to RBI circular of June 10, 2019. Further to this the latest notification issued on May 13, 2022 allows lending by SCBs to NBFCs and lending by Small Finance Banks (SFBs) to NBFC-MFIs, for the purpose of on-lending to certain priority sectors, on an ongoing basis.

Originally, the target sectors for PSL were agriculture, micro and small manufacturing enterprises and exports. It is evident that the SCBs have been experiencing great difficulties in achieving the PSL targets and most of the banks could not achieve the targets. Therefore, the RBI has opened up new ways for achieving the targets. For instance, banks are allowed to investment in Rural Infrastructure Development Fund (RIDF) bonds issued by the Small Industries Development Bank of India and the National Bank for Agriculture and Rural Development (NABARD) to offset the shortfall in achieving the targets. Later, Priority Sector Lending Certificates were allowed to offset the shortfall in PSL targets. Currently the priority sector includes the following *(i)* Loans to startups, *(ii)* Loans to cooperatives of artisans, *(iii)* Loans to startups, *(iv)* Loans to cooperatives of artisans, *(v)* Overdraft in Jan Dhan Yojana accounts, *(vi)* Education loans, *(vii)* Housing loans, *(viii)* Loans for social infrastructure, *(ix)* Loans for renewable energy projects, *(x)* Interbank participation certificates, *(xi)* Investment in securitised priority sector loans.

Other measures for enabling the banks to achieve their PSL targets are:

- ✓ Enlarging the scope of MSMEs: Definition of MSMEs under the MSMED Act has been amended to include service enterprises and trading firms.
- ✓ Inclusion of medium enterprises in priority sector
- ✓ Co-lending : SCBs are allowed to co-lend jointly with the NBFCs.
- ✓ On-lending: Since 2019 banks are allowed to lend money to NBFCs for the purpose of on-lending to the priority sectors. The details of which are briefed in the next section.

2. Notification by the RBI on Lending to NBFCs for On-Lending to Priority Sectors

The purpose of the notification issued on May 13, 2022 was to communicate that the lending by SCBs to NBFCs and lending by Small Finance Banks (SFBs) to NBFC-MFIs, for the purpose of on-lending to certain priority sectors, is allowed on an on-going basis.

As per earlier guidelines lending by SFBs to NBFC-MFIs for on-lending was not considered for priority sector lending (PSL) classification. Due to the fresh challenges brought on by the COVID-19 pandemic and to address the emergent liquidity position of smaller MFIs, it has been decided to classify fresh credit extended by SFBs to registered NBFC-MFIs and other MFIs as PSL.

As per the guidelines bank credit to NBFCs (including HFCs) for on-lending will be allowed up to an overall limit of 5 percent of an individual bank's total PSL portfolio in case of SCBs. In case of SFBs, credit to NBFC-MFIs and other MFIs (Societies, Trusts, etc.) which are members of RBI recognized 'Self-Regulatory Organisation' of the sector, will be allowed up to an overall limit of 10 percent of an individual bank's total PSL portfolio.

3. Few Questions

Ever since nationalization of banks in 1969 the RBI has issued several guidelines regarding PSL and the latest one is the notification regarding SCBs lending to NBFCs for on-lending. This has prompted the authors to address the following questions:

(a) What prompted RBI to make the facility continue?

NBFCs face liquidity crisis since last few years, particularly during the Covid-19 Pandemic and the RBI opened up a window for the SCBs to provide liquidity support under which the public sector banks were allowed to purchase pooled assets of NBFCs. The government of India launched the partial credit guarantee scheme for the loans given under the scheme.

NBFCs and NBFC-MFIs extend credit to the sections of the society that are unserved and/or underserved by the SCBs and contribute significantly to financial inclusion. As per Figure 1, the total share of NBFCs and NBFC-MFIs to micro credit is around 40%.

(b) Is lending by banks directly to the priority sector riskier than lending through NBFCs?

Table 1[1] shows that the GNPA of SCBs is significantly higher than the GNPA of NBFCs. This statistics make it clear that the NBFCs are more efficient in managing the PSL portfolio. One can also believe that the cost of operations of NBFCs is lower than that of the SCBs. Therefore, NBFCs and MFIs need to be strengthened with necessary funding support.

(c) Does the notification open up new ways of achieving PSL targets by banks?

Table 2[2] shows that the banks have increased their exposure to NBFCs over time and as of March 31, 2022 it was around 10% of their total non-food credit. Whereas, the 5% of PSL target of 40% will make it 2% of total non-food credit. Table 3 shows that growth

---

1 Nonbanking Financial Institutions, Trend and Progress of Banking in India, Table 1, Table 4 and Figure 1 are extracted and compiled from this said reference. For further reference please see https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=20946

2 Database is extracted from DBIE, RBI. The path follows as Home>Statistics>Financial Sectors>Non-Food Gross Bank Credit. The same database is used for Table 2 and Table 3.

in credit from SCBs to NBFCs has been the highest and the CAGR of credit to NBFCs was 21.8% as against the CAGR of total non-food credit of 8.1%. Therefore, it seems that the notification does not really open up one more doorway for the banks to achieve their PSL targets.

(d) Could the banks manage their PSL portfolios efficiently?

The data presented in Table 1 shows that the NBFCs are more efficient in managing their advanced portfolio and their NPA level is significantly lower than that of the SCBs. Moreover, the size of NBFCs' advanced portfolio is growing faster than that of the SCBs.

(e) Is it a good proposition to allow NBFCs to lend to the priority sector?

NBFCs and NBFC-MFIs have been serving the unserved and underserved sections of the society since long time back. As they are registered with the RBI and are being regulated they are becoming more and more resilient and the trust of the public in them has grown significantly over time. Few of them have become small finance banks and Bandhan Bank is a MFI turned universal bank. The number of NBFCs is quite large and the NBFCs registered with the RBI as on January 31, 2022 was 9592 detailed of the same are in Table 4. There are many more in the country which are not registered. Given their large number and performance their role in achieving financial inclusion is indispensable.

4. The Way Forward

As discussed above, NBFCs and NBFC-MFIs play a critical role is providing credit to the unserved and underserved sections of the society. NBFCs are becoming stronger thanks to regulation by the RBI. They are also complementing as well as supplementing the services of SCBs particularly in serving the unserved and underserved sections of the society. However, because of their very nature NBFCs cannot access low cost deposits from the public. Therefore, both NBFCs and NBFC-MFIs should be given access to bank funds for on-lending. Moreover, the ceiling of 5% and 10% of PSL that can be lend by SCBs or small finance banks respectively may be removed. Other recommendations of the authors are below.

NBFCs and NBFC-MFIs as Channel Partners: NBFCs and NBFC-MFIs can be considered by SCBs as channel partners for the purpose of reaching out to the sections of the society that could not be served by the SCBs. The case of Electronica Finance Ltd has demonstrated that the NBFCs can be engaged by banks for sourcing customers, credit analysis, credit monitory and recovery of loans. The bank and the NBFC concerned will share revenue as well as risks per agreed ratios. (Manickaraj, 2010). This model can be replicated by many banks with many NBFCs and NBFC-MFIs.

NBFCs and NBFC-MFIs as Franchisees of Banks: About a decade back Indian Bank had devised a new business model, Rural Credit Franchisee (RCF), for providing micro credit to the poor in villages. This model demonstrates lending for on-lending in true sense. It also showcases how unregistered/informal lenders can be brought to the mainstream business of formal lending. This is a case that demonstrates the fact all the stakeholders including the bank, the RCFs, and the borrowers are benefited (Dasgupta and Manickaraj, 2013).

5. Conclusion

There are large number of NBFCs and NBFC-MFIs in the country which are engaged in the business of moneylending. Nearly 10,000 of them are registered and are regulated by the RBI. Banks lend money to the NBFCs and NBFCs in turn do on-lending the same to their end customers. This has created a win-win for the banks, the NBFCs and the borrowers. It also enables increasing the supply of formal credit to the unserved and underserved sections of the society. As such, the RBI's notification that makes lending by SCBs to NBFCs and SFBs lending to NBFC-MFIs for on-lending is a welcome development. NBFCs and NBFC-MFIs can also be engaged by banks as channel partners for achieving greater financial inclusion and more efficiently.

Reference

Dasgupta R and Manickaraj M (2013), *"RCF model of Indian Bank for micro credit"*, Journal of Asia Business Studies (an online journal from Emerald Group), January

Manickaraj M (2010), *"Electronica Finance Limited: Designing the Future of Micro, Small and Medium Enterprises"* Vikalpa, vol. 35, No.3, pp. 117 – 127.

Master Circular-Priority Sector Lending - Credit facilities to Minority Communities https://rbi.org.in/scripts/NotificationUser.aspx?Id=2983&Mode=

Priority Sector Lending Scheme for financing Agriclinics and Agribusiness Centres RBI notification dated August31,2001.https://rbi.org.in/scripts/Notification of August 2001 User.aspx?Id=455&Mode=0

Priority Sector Lending -Revision of Target-UCBs- RBI Notification dated November 30 2007 https://rbi.org.in/scripts/NotificationUser.aspx?Id=3960&Mode=0.

"Priority sector lending needs a tweak" https://www.thehindubusinessline.com/opinion/priority-sector-lending-needs-to-be-tweaked/article65252249.ece

RBI, Priority Sector Lending – Status, Issues and Future Agenda, (Speech by Shri S S Mundra, Deputy Governor - June 27, 2017 - at the "Conference on Credit flow to Priority Sector –Policy and Implementation" held at College of Agricultural Banking, Pune) https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1043

RBI circular No. RBI/2022-23/50 FIDD.CO.Plan.BC.No.5/04.09.01/2022-23 dated May 13, 2022,

Lending by Commercial Banks to NBFCs and Small Finance Banks (SFBs) to NBFC-MFIs, for the purpose of on-lending to priority sectors https://rbidocs.rbi.org.in/rdocs/notification/PDFs/50ONLENDINGMARCH2022D9D1B2A7C5C34394A809BC7D8D8C069A.PDF

RBI, Master Directions – Priority Sector Lending (PSL) – Targets and Classification, dated Sep 04, 2020 (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11959)

RBI, Financial Stability Reports 2020-21, 2019-20.

Table 1: NPA of SCBs and NBFCs

Year	*GNPA*		*NNPA*	
	SCBs	*NBFCs*	*SCBs*	*NBFCs*
2015-16	7.5	4.0	4.4	2.3
2016-17	9.3	6.5	5.3	4.1
2017-18	11.2	5.6	6.0	3.3
2018-19	9.1	6.4	3.7	2.9
2019-20	8.2	6.3	2.8	3.2
2020-21	7.3	6.0	2.4	2.7

Source: Extracted and Compiled from Trend and Progress of Banking in India, RBI Database

Table 2: Share of various sectors in total non-food credit of SCBs

Sector	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*	*2020-21*
PSL	40.5%	41.1%	39.7%	40.3%	39.3%	40.9%
NBFCs	**5.4%**	**5.5%**	**6.5%**	**8.2%**	**10.2%**	**9.8%**
Agriculture	13.5%	21.7%	24.2%	29.3%	36.1%	35.9%
Industry	41.7%	37.8%	35.1%	33.4%	31.5%	30.2%
Services	23.5%	25.4%	26.7%	28.0%	28.2%	27.2%

Source: Authors' computation from RBI database

Table 3: Growth in Bank Credit to Various Sectors during the Five Years Ending March 2021

Sector	*2016-17*	*2017-18*	*2018-19*	*2019-20*	*2020-21*	*CAGR*
Total Non-Food Credit	8.4%	8.4%	12.3%	6.7%	4.9%	**8.1%**
Agriculture	12.4%	3.8%	7.9%	4.2%	12.3%	**8.0%**
Industry	-1.9%	0.7%	6.9%	0.7%	0.4%	**1.3%**
MSEs	6.4%	10.5%	5.2%	3.1%	2.5%	**5.5%**
Priority Sector	10.0%	4.6%	14.0%	4.0%	9.1%	**8.3%**
NBFCs	**10.9%**	**26.9%**	**42.8%**	**32.0%**	**1.0%**	**21.8%**

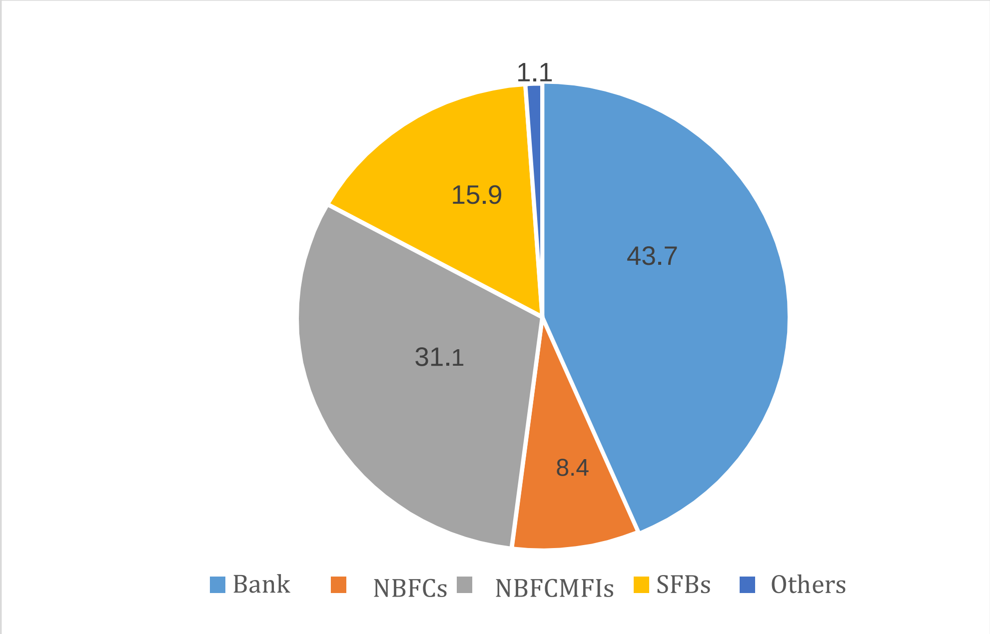
Source: Authors' computation from RBI Database

Table 4: Number of NBFCs Registered with the RBI

Type of NBFC	*No. of NBFCs*
Deposit taking NBFCs	49
NBFC-ND-SI	316
NBFC-ND	9130
No. of NBFC-MFIs	97
Total	**9592**

Source: Extracted and Compiled from Trend and Progress of Banking in India and Non-Banking Financial Companies, RBI Database

Figure 1: Microcredit Loan outstanding across lenders as on March 2021(in %)



Source: Extracted and Compiled from Trend and Progress of Banking in India, RBI Database