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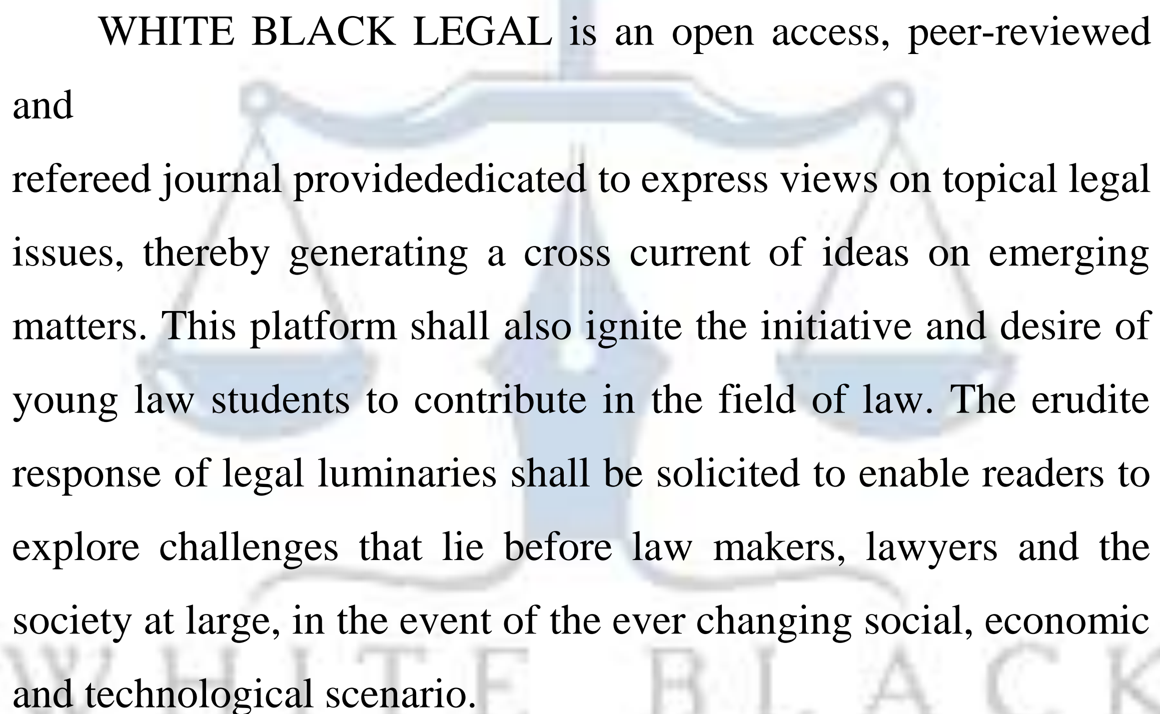

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With this thought, we hereby present to you

CREDIT CONCENTRATION NORMS FOR NBFCS

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Introduction

In this paper, an attempt will be made to understand the meaning of the terms credit concentration, NBFCs and credit concentration norms for NBFCs (Non-Banking Financial Companies) in light of the RBI notification dated 15th January 2024 relaxing the credit concentration norms for NBFCs (Non-Banking Financial Companies).

Non-Banking Financial Companies act as an alternative institution providing financial services other than banks, they present the customers with an option when the traditional banks are not an option. It is the case for marginalized sections of society who are not eligible to avail financial services from traditional banks owing to their socio-economical background. NBFCs also act as an alternative for customers who find the rates and terms set by banks as unfavourable, keeping competition affluent in the market for financial services.

This paper will focus on gaining an understanding of what the changes in credit concentration norms for NBFCs concern themselves with and how they impact the financial sector in India while also debating the need for such a change.

The potential of economic growth relying on the shoulders of NBFCs is being explored by RBI, there is a prevalent sentiment that excessive regulation has been smothering growth in the private sector, however the lack of regulations can lead to exploitation of investors and borrowers.

To assess the specific impact of recent or proposed changes in India, it would be helpful to analyse data on lending practices, risk exposure, and financial stability of NBFCs before and after the relaxations provided by RBI.

Conceptual Analysis

This paper seeks to identify the relevant concepts and operationalize them into variables so as to make them measurable. Concept here would be that of credit concentration, while the variables would be the credit concentration norms for NBFCs. This paper will discuss the meaning and definition of the terms credit concentration, NBFCs and other terms relevant to this theme.

NBFCs

NBFC stands for Non-Banking Financial Company which refers to a company that provides banking-adjacent services without obtaining a full banking license. In this paper the meaning of NBFCs will be studied and a difference will be established between banks and NBFCS. NBFCs act as an alternative financial institution to provide services similar to that of banking services, such as putting up for offer various financial products similar to banks, including loans, investment options, and insurance in certain cases.

NBFCs are defined as 'A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956[1] engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but 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. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).' by RBI.[2]

The Key Distinction between banks and NBFCs is that unlike banks, NBFCs cannot accept funds via conventional demand deposits from raise funds the public, such as savings or checking accounts. This limits their ability to create money. As the modus operandi of banks is to have customers deposit money in exchange of an interest rate and loan the money back to customers at a higher interest rate, thus pocketing the difference as profit. However, as NBFCs

[1] Companies Act 1956 (India).

[2] RBI, 'FAQs on NBFCS' (*RBI* 2017) <https://www.rbi.org.in/commonperson/english/scripts/FAQs.aspx?Id=1167> accessed 7 April 2024.

operate without a full banking license, they cannot offer to accept public deposits and have to raise funds via other sources. Undertaking credit is one of major ways NBFCs raise funds. NBFCs are generally classified into two categories based on whether they accept public deposits i.e. deposit taking NBFCs (NBFC-D) and non-deposit taking Accepting NBFCs (NBFC-ND). [3]

Reserve Bank of India (RBI) acts as the regulatory body for NBFCs in India, as they do not operate as a proper bank but operate as an alternative financial institution, the level of scrutiny they face in terms of stringent regulations is far less compared to banks.

There are 4 major types of NBFCs, each with a specific focus and demarcated on the basis of the nature of their operation. While providing financial services remains common, for what purpose these services are provided separates the different types of NBFCs into the following-

- Personal Loan NBFCs- These NBFCs provide various loans, including personal loans, business loans, and vehicle loans to customers after evaluating their personal status and determining collateral.
- Investment Credit NBFCs- These NBFCs operate by fronting credit to investors. The investors invest this money into speculative ambit of their preference, keeping the profit that remains after paying the amount of interest to the NBFCs.
- Infrastructure financing companies: These NBFCs provide loans to enterprises for infrastructure projects such as building of roads, bridges and tunnels. There has been an impetus for NBFCs to finance infrastructure as per government policy.
- Microfinance institutions: These NBFCs specialize in providing small loans to underserved populations of society, as they offer banking services to the marginalized sections of society that by their socio-economic background are not eligible for banking services.

NBFCs play a crucial role in the financial system by operating as an alternative financial service provider to banks. NBFCs play a vital role in the economy by contributing in the following ways-

Financial Inclusion- They extend financial services to segments of the population that are systematically deprived of financial services offered by traditional banks. Thus providing

[3] Bühlmann H, Pelsser A and Schachermayer W, *Concentration Risk in Credit Portfolios* (Springer Berlin Heidelberg 2009).

banking services to a broader range of people from weaker socio-economical backgrounds.

Credit Availability- NBFCs offer an alternative source of credit for individuals and businesses in addition to banks, increasing the net availability of credit for financial sector in India.

Market Competition: They promote competition in the financial services sector, by acting as an alternative to the banking sector they potentially keep the rates and terms for consumers under check. As banks risk losing consumers to NBFCs if they attempt to tilt the terms of financial services in their favour too much.

Indian non-banking financial companies (NBFCs) had humble beginnings emerge in the decade of 1960s, the initial aim was to serve professionals and investors whose financial needs were not met by India's existing banking infrastructure. NBFCs started demanding a fixed deposit from the investors and entered into leasing agreements with large industrial companies. At first they operated on a limited scale and could not place themselves in a situation to significantly influence the financial system. But subsequently in the 1980s-1990s, NBFCs gained a good foothold and started attracting interested investors due to their customer-friendly image.

In India, non-banking financial companies or NBFCs are registered companies that operate similarly to conventional banks. Their banking activities include offering loans and advances to consumers and businesses, obtaining liquid insurance, leasing hard assets such as cars, payments and insurance. Although they are similar to banks, they differ in many ways. NBFCs cannot accept demand deposits, cannot issue checks to customers and their deposits are not insured by DICGC (Deposit Insurance and Credit Guarantee Corporation). NBFCs are regulated by either RBI (Reserve Bank of India) or SEBI (Securities and Exchange Board of India) or both. India's NBFC sector has seen significant changes in recent years and is systematically recognized as a core part that form the banking financial system. There have been recent consolidations in the NBFC segment, particularly in the NBFC-ND segment. Indeed, it is evident in India that with the development of the NBFC segment throughout the financial system, it has challenged other segments viz. banks to innovate, improve quality and expertise and deliver flexibility at competitive rates. In fact, many unburnt fields, NBFCs were the first to rush into the market, to explore and develop the market before banks entered the sector.

Furthermore, there are only two non-banking financial companies (RNBC) left, which are depository companies of a different nature. In recent years, infrastructure financing has become stronger and NBFCs involved in infrastructure financing are called "Core investment companies".

In Conclusion NBFCs are a crucial part of the financial system, fulfilling a gap that traditional banks might leave behind. While they offer many financial products, it's important to remember that they differ from banks in terms of deposit-taking capabilities and regulations.

Credit Concentration

Credit concentration is defined as '' by.[4] Credit concentration arises when a lender has a disproportionately large exposure to a specific set of borrowers. Credit concentration refers to a situation where a lender has a large exposure to a single borrower, a group of connected borrowers, or a specific industry. In simpler terms, it means putting too many of your eggs in one basket. This can be risky because if the borrower defaults on the loan, or if the industry as a whole suffers a downturn, the lender could lose a significant amount of money.

It is not unbeknown that when a corporation partakes in financial activities such as lending money there is a possibility of the money lent becoming unrecoverable due to a number of factors, credit concentration is a situation where the credit offered is structured as such that it is concentrated in one area to such an extent that if this particular area faces financial hardships it will have a sizeable negative impact on the corporation who has offered them credit.

This exposure can be in terms of:

Borrower concentration: Loans to a single borrower make up a significant portion of the lender's portfolio. If this single borrower fails to repay their debt owing to bankruptcy or insolvency the consequences for the lender will be dire.

Sector concentration: Loans are heavily concentrated in a particular industry, like real estate or technology. Thus a downwards trend is such segment is bound to drag down the lenders with them.

[4] Hibbeln M, 'Concentration Risk in Credit Portfolios and Its Treatment under Basel II' [2010] Contributions to Economics 57.

Geographic concentration: Loans are concentrated in a specific geographic location, although the exposure in this nature of concentration is the least alarming.

Product concentration: Loans advanced are all related to a similar type of product across different sectors, concentrating credit in different stages of the vertical chain for one product.
The main concern with credit concentration is risk amplification. If the borrower defaults, the industry suffers a downturn, or the geographic location experiences economic hardship, the lender faces significant losses. This can be particularly damaging for banks, whose primary business is lending.

Examples:
Imagine a bank with a large loan to a single company. If that company goes bankrupt, the bank could lose a substantial amount of money.

Before the 2008 financial crisis, many banks had a high concentration of loans in the commercial real estate market. When the real estate bubble burst, these banks suffered significant losses.[5]

To safeguard financial institutions and the overall financial system, regulators impose limits on credit concentration. Banks are required to maintain a diversified loan portfolio to minimize risk. Here are some strategies to mitigate credit concentration risk:

- Setting limits: Banks establish individual limits for exposure to a single borrower or a specific industry.
- Diversification: Lending across different borrowers, industries, and geographic locations helps spread out risk.
- Hedging: Financial instruments can be used to offset potential losses if a particular borrower or sector defaults.
- Selling exposures: Selling off some loans to other institutions can reduce concentration in a specific area.

Managing credit concentration in an efficient way to reduce concentration of exposure yields

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[5] 'The 2008–2009 Recession' [2012] The Great Recession 1.

the following benefits-

- Financial stability: By managing credit concentration, lenders can protect themselves from significant losses and ensure their long-term financial health.
- Public trust: Maintaining a diversified portfolio fosters confidence in the financial system and promotes stability.

In conclusion, credit concentration is a significant risk factor for lenders. By understanding the different types of concentration and implementing strategies for mitigation, lenders can safeguard their financial health and contribute to a more stable financial system.

Credit Concentration Norms for NBFCs

The Reserve Bank of India has the authority to regulate NBFCs, it uses the Master Direction on SBR for NBFCs[6]

In India, the Reserve Bank of India (RBI) implements a Scale-Based Regulation (SBR) framework to categorize NBFCs based on their size, activity profile, and perceived risk. This framework plays a crucial role in determining the level of regulatory scrutiny each NBFC faces, including credit concentration norms. While Upper Layer NBFCs (NBFC-UL) follow a specific credit concentration framework outlined by the RBI, the regulations for Base Layer NBFCs (NBFC-BL) and Middle Layer NBFCs (NBFC-ML) are less rigid. Here is a brief reference into the different categorizations of NBFCs

1. Upper Layer

These are the largest and most systemically important NBFCs. They are specifically identified by the RBI based on their size, activity, and potential impact on the financial system. They face the most stringent regulations, including a framework similar to that for banks, to ensure their financial stability.

Examples: Large HFCs, All India Financial Institutions (AIFIs) focused on infrastructure financing, specific deposit-taking NBFCs designated by the RBI.

2. Mid Layer

These are mid-sized NBFCs with an asset size of INR 1,000 crore and above. They have a more diverse range of activities compared to base layer NBFCs. They follow the same broad regulatory framework as base layer NBFCs, but may be subject to additional reporting

[6] Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023. RBI/DoR/2023-24/106 DoR.FIN.REC.No.45/03.10.119/2023-24.

requirements.

Examples: Many deposit-taking NBFCs (accepting public deposits), some housing finance companies (HFCs), Standalone Primary Dealers (SPDs) involved in government securities trading.

3. Base Layer

These are the smallest NBFCs with an asset size of below INR 1,000 crore (approximately $1.2 billion as of April 2024). They typically have a simpler business model and cater to a limited clientele. They face less stringent regulations compared to higher layers. However, they still need to have an internal board-approved policy for managing credit concentration risk.

Examples: Microfinance institutions providing small loans, small loan companies catering to specific niches.

Base Layer and Middle Layer NBFCs (NBFC-BL and NBFC-ML):

1. No Specific Ratio: These NBFCs are not mandated by the RBI to adhere to a specific credit concentration ratio. This means they don't have a pre-defined limit on the amount they can lend to a single borrower, group of connected borrowers, or a particular industry.
2. Internal Policy Requirement: However, both base layer and middle layer NBFCs are required to have an internal board-approved policy for managing credit concentration risk. This policy essentially serves as a self-imposed framework to ensure prudent lending practices and mitigate the risk of overexposure to any single borrower or sector.

Key Elements of the Internal Policy: The internal policy for credit concentration should address the following aspects.

a. Concentration Limits: The policy should define clear limits for exposure to a single borrower, group of connected borrowers, or a specific industry. These limits can be expressed as a percentage of the NBFC's total capital or assets.
b. Calculation Methodology: The policy should outline a clear methodology for calculating credit concentration. This includes determining which types of loans and borrowers are considered for the calculation.
c. Monitoring and Review: The policy should establish a process for monitoring compliance with the concentration limits and reviewing the policy periodically to ensure its effectiveness.

Benefits of an Internal Policy: Having a well-defined internal policy for credit concentration offers several benefits for base layer and middle layer NBFCs such as firstly risk mitigation by

setting limits, NBFCs can avoid excessive exposure to a single borrower or sector, thereby mitigating the risk of significant losses if that borrower defaults or the sector experiences a downturn. Secondly financial stability, prudent credit concentration management promotes financial stability for the NBFC itself, fostering confidence from investors and depositors (if applicable). Thirdly regulatory compliance, having a documented policy demonstrates to the RBI that the NBFC is taking proactive steps to manage risk, potentially reducing scrutiny. It's important to note that the RBI can still exercise oversight and intervene if it finds an NBFC's internal policy for credit concentration inadequate or if the NBFC's lending practices pose a risk to financial stability. While there's no mandated ratio, the RBI might expect base layer and middle layer NBFCs to follow similar concentration limits as upper layer NBFCs (governed by the Large Exposure Framework) to ensure a level playing field.

Upper Layer NBFCs in India (NBFC-ULs), including Housing Finance Companies (HFCs), are considered critical due to their size and impact on the financial system. To ensure financial stability and reduce risks, the RBI has put in place stricter rules, including a specific framework for credit exposures. This framework is called the Large Exposure Framework (LEF). Below is a detailed breakdown of credit concentration criteria for Upper Layer NBFCs:

Large Exposure Framework (LEF): LEF defines the limit of exposure that an NBFC-UL can afford. These limits are as follows:

a. Single Borrower- Generally a percentage of Tier 1 capital of NBFC. Tier 1 capital refers to the highest and most stable form of NBFC capital and loss protection.
b. Groups of linked borrowers- This limit applies to the following situations and number of state-linked lines of credit. The limit is usually a percentage plus high in comparison. to the single credit limit.
c. Group of unlinked borrowers with similarities- This limit is in relation the exposure of borrowers or groups that are not directly connected. This helps prevent overconcentration in a specific sector that could become vulnerable to economic downturns.

There are a few additional considerations as well, the specific limits under the LEF are not publicly available on the RBI website. However, they are likely to be stricter than the internal concentration limits set by base layer and middle layer NBFCs. The RBI may adjust the LEF limits based on the risk profile of the borrower or sector. For instance, higher risk borrowers or sectors might have lower exposure limits. Upper layer NBFCs are also subject to reporting requirements regarding their credit concentration levels. This allows the RBI to monitor

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compliance and identify potential risks. Benefits of the LEF include a reduced risk, by limiting exposure to single borrowers or sectors, the LEF helps NBFC-ULs mitigate the risk of significant losses if a borrower defaults or a sector experiences a downturn. Financial stability, as stricter concentration norms promote financial stability for upper layer NBFCs, which are crucial players in the financial system. It also boosts investor confidence as knowing that NBFCs are subject to a robust framework for managing credit concentration can instil confidence in investors and depositors.[7]

Proposed relaxation in the Credit Concentration Norms for NBFCs

The RBI has relaxed the Credit Concentration Norms for middle layer and base layer NBFCs via notification[8] dated 15th January 2024. The notification effected the following changes

For Middle Layer NBFCs (NBFC-MLs)

In addition to the use of Credit Default Swaps (‘CDS’), RBI has now allowed NBFC MLs to offset the aggregate exposure with the following additional Credit Risk Transfer (CRT) instruments: Cash margin/ caution money/ security deposit held as collateral on behalf of the borrower against the advances for which right to set off is available.

It is pertinent to note that, as per para 84 of the SBR Directions, the norms already require NBFCs, for the purpose of assignment of risk weight to net off the amount of cash margin/ caution money/security deposits held as collateral against the advances out of the total outstanding exposure of the borrower.

ML NBFCs can under the new norms offset their exposure by the following guaranteed claims – Central Government guaranteed claims which attract 0 per cent risk weight for capital computation. State Government guaranteed claims which attract 20 per cent risk weight for capital computation, and Guarantees issued under Credit guarantee Schemes of Credit Guarantee Fund Trust for Micro and Small Enterprises, Credit Risk Guarantee Fund Trust for Low Income Housing and individual schemes under National Credit Guarantee Trustee Company Ltd. Given the fact that the guarantees are issued to micro and small enterprises where the scale are, it is safe to say that the exposures on such micro or small enterprise may

[7] Master Directions (n6).
[8] Credit/Investment Concentration Norms – Credit Risk Transfer, RBI/2023-24/112 DOR.CRE.REC.70/21.01.003/2023-24

not be big enough in comparison to the scale of operation of the NBFC MLs. Thus, the exposure will not be big enough to be considered under the concentration norms. In addition to the existing credit/investment concentration norms as per the SBR Master Directions and HFC Master Directions, the following shall be excluded from the credit/investment concentration norms: Exposures to Central and State Government which carry zero per cent risk weight; and Such exposure where the principal and interest are fully guaranteed by the Government of India. (Those to state government shall not be excluded) to disclose in their Notes to Accounts (NTA) when they breach the exposure limit.

However, moving forward the said disclosure shall be made after considering the above-mentioned changes. It may be noted that violation of the concentration limit is considered a violation of RBI rules and the authority has the right to take appropriate action and impose penalties on the defaulting NBFCs.

For Base level NBFCs (NBFC-BLs): BL NBFCs must have an internal board approved policy on credit/investment concentration limits for single borrowers/groups and same number/groups of borrowers, where the computation shall be made as per the requirements applicable to NBFC MLs.

No changes have been proposed for Upper layer NBCs.

Impact of the changes

ML NBFCs now have additional tools to limit their exposures and can remove the aforementioned exposures from credit/investment processes. It also states that to be eligible as a credit risk transfer vehicle, the guarantee must be fair, clear, irrevocable and unconditional. (Applicable to NBFC UL also) NBFC BL shall have an internal policy approved by the Board of Directors on the lending/investment limits specified in the above document.

What these changes effectively mean is that Middle Layer NBFCs will be able to advance credit aggressively as they would now have the benefit of offsetting exposure with guarantees. This will increase lending in the financial sector and possibly reduce the rate of interests as well. Relaxed credit concentration norms will also empower NBFCs to compete effectively with the banking sector and ensuring a competitive market.

The possible downsides of easing credit concentration norms for NBFCs are increased risk factor for NBFCs as they will be open to the consequences of credit concentration. And as the investors will know of this increased risk, it will lead to financial insecurity in the NBFC sector.

Conclusion and Suggestions

In this paper, the meaning of credit concentration and NBFC was studied to understand the credit concentration norms. After which and the changes effected by RBI via notification easing the credit concentration norms were analysed.

Credit concentration is the situation in which a lender can find himself if there is a concentration of credit in one specific area, it is the anti-thesis to credit diversification. NBFCs are non-banking financial companies, companies that offer financial services akin to that of banking but on a limited scale.

Credit concentration norms are regulations imposed by RBI to monitor and regulate the credit diversification of NBFCs, the norms propose limitation in lending for NBFCs as they are required to offset lending. Which restricts their ability to end up in credit concentration situation. Credit concentration norms mandate that NBFCs are restricted from allocating more than 15% of their total lending to one borrower and cannot allocate credit to end up holding more than 26% credit of a single borrower. Along with sectoral regulations that are imposed on NBFCs by dividing them into 3 categories by volume- Base Level NBFCs, Middle Level NBFCs and Upper Level NBFCs.

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RBI has decided to ease the credit concentration norms in this notification, allowing middle layer NBFCs to offset their lending by guarantees from central and state governments. Essentially increasing the lending ability of NBFCs, at the cost of increased exposure to credit concentration.

The motive behind the change is to aim for accelerated economic growth by forsaking risk mitigation measures. This is a gamble being taken by RBI to promote economic activity in the financial sector. The consequence of this move can go in either way, seeing the relative normalcy in the economy one argument that presents itself is whether there was a need for

risking financial stability of NBFCs for the sake of accelerated economic growth.

This policy could result in a bubble in the financial sector which may hurt investors and borrowers upon bursting.