Modes of Collaboration between Banks and NBFC's

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Financial Institutions play a major role in structuring and developing the Indian Financial system. The banking as well as non-banking financial sector have defined roles to play in this regard. Under the Regulation of RBI, Banks and Non-Banking Financial Companies (NBFC's) undertake the business of accepting deposits, granting loans and advances, investment in shares/bonds/debentures/G-Secs and so on. Although the overall nature of services provided by Banks and NBFC's are similar, there are certain factors that distinguish the two. For instance, as compared to Banks, NBFC's cannot accept demand deposits or issue cheques drawn on itself.

Given the significant contribution of Banks and NBFC's in enhancing the growth of the economy, an alliance between a Bank and an NBFC can only be more beneficial, by combining the far and extant outreach and network of NBFC's for exploitation by banks to meet their Priority Sector Lending (PSL) and other business requirements. Collaboration between banks and NBFC's, which give them a competitive edge, can be done through various modes such as co-origination of loans, on-lending, securitisation and several others. These modes would aim to align the interests of the Banks with that of the NBFC and create additional credit in the market. Liquidity concerns would be mitigated with the enhanced participation of Banks with the NBFC's.

Recent regulatory changes revolving Banks and Non-Banking Financial Institutions have opened up a new space for alliances between the dominant financial intermediaries to combine arms and increase their competitive edge in the market. The Reserve Bank of India (RBI) has made several changes to existing guidelines, granting enhanced scope for collaboration between Banks and NBFC's in the Indian Financial system.

In this article we will discuss some of these modes and conduct a comparison between the same.

Reasons for Collaboration

Considering the overall need to provide credit to the deserving parts of the country and to ensure the growth of the economy, the need for collaborations between a bank and an NBFC cannot be ignored. The following are the other main reasons behind collaboration:

- Meet Priority Sector Lending Targets
- Increase Banking Outreach
- Enhance Financial Inclusion
- Strengthen Credit Delivery Mechanism
- Strengthen Priority and other Sectors
- Ensuring Liquidity in the Market
- Avoid Liquidity Crunch

Priority Sector Lending: Driver behind Collaborations

The need for partnership between a bank and an NBFC is highlighted by the inherent benefits such as boosting credit to borrowers, increasing outreach and ensuring greater financial inclusion. However, there exists one main factor that drives banks to engage with NBFC's for fulfilling their own requirements.

This factor, known as Priority Sector Lending (PSL), mandates all scheduled commercial banks (Excluding Regional Rural Banks and Small Finance Banks) to undertake PSL up to 40% of their Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposure whichever is higher, in accordance with the PSL guidelines[1] in this behalf. This poses a difficulty on banks while trying to achieve the said target of 40% due to lack of outreach in the priority sector areas especially rural areas. Moreover, there are sub-targets for specific sectors within the overall target of 40% that need to be achieved on an annual basis. Following are the other difficulties faced by banks:

- Banks must ensure the end use is continuously monitored. The banks should put in place proper internal controls and systems in this regard.
- Sub-Target (For SCB's and Foreign Banks with 20 branches and above):
    - 18% for Agriculture (8% for Small and Marginal Farmers)
    - 7.5% for Micro Enterprises
    - 10% for Weaker Sections
- In case of Shortfall, contribution is to be made to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds.
- Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.

To overcome the above challenges and any shortfall in the targets, Banks can either purchase Priority Sector Lending Certificates (PSLC) in accordance with the PSLC guidelines issued in this regard or Banks may engage with NBFC's through various modes to reach the PSL targets.

Modes of Collaboration

1. Co-origination of Loans:

The Co-origination or co-lending is a model wherein a Bank and an NBFC originate a loan jointly in their respective names at the very inception of the loan. This would involve sharing of risks and rewards between the Bank and the NBFC. The co-origination model can be used for both PSL as well as Non-PSL, however RBI has specified guidelines only for co-lending to the priority sector.

Ideally the co-lending model allows for a Bank and an NBFC to share the risks and rewards by deciding a risk sharing ratio of their respective exposures. The model works by executing a tripartite agreement between the Banks, NBFC and the ultimate customer. The whole idea is to have a rational and acceptable sharing of risks and rewards between the banks and the NBFC's thereby increasing Banks participating in the lending arrangement.

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[1] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10497&Mode=0

The PSL guidelines for co-origination[2] between a bank and an NBFC specifies a minimum of 20% of the exposure to be on the NBFC's books and the balance to be on the banks books. Both are free to price their part of the exposure, however the Borrower will be offered a single/blended Interest Rate. In comparison to Direct Assignment where the loan is originated and then sold off to an investor, the co-origination model provides for origination of the loan in both the participants books at inception itself.

Moreover the PSL guidelines on co-lending arrangement apply only to an NBFC-ND-SI (Non-deposit taking- Systematically Important), whereas this would not be the case in case of co-lending for Non-PSL.

2. Business Correspondents:

As per the Discussion Paper[3] on Engagement of 'for profit' Companies as Business Correspondents (BC):

"Business Correspondents are retail agents engaged by banks for providing banking services at locations other than a bank branch/ATM."

BC are entities that are engaged by banks to provide a wide array of services such as identification of borrowers, collection and preliminary processing of loan applications including verification of primary information/data, creating awareness about savings and other products and education and advice on managing money and debt counselling and many more.

Initially NBFC's were excluded from being eligible entities that banks could engage as BC. This exclusion was due to concerns that there could be a conflict of interest in case of deposit taking NBFCs as they are engaged in the same business. Also concerns were raised relating to risks of co-mingling of funds.

Subsequently based on the recommendations of the Mor Committee, it was decided that banks would be permitted to engage Non-Deposit Taking NBFCs as BCs, subject to certain conditions[4].

3. Securitisation and Direct Assignment

Securitisation involves pooling of homogeneous assets and subsequent sale of the cash flows from these asset pools to investors, thereby shifting the credit risk away from the originator onto investors. This model thus provides for a transfer or assignment of the credit risk to investors as well as immediate funding to the originator. This mode allows Banks and NBFC's to collaborate by either acting as originators or investors.

RBI has specified guidelines on securitisation of standard assets[5] which specify that the underlying asset should represent the debt obligations of a homogeneous pool of obligors.

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[2] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11376&Mode=0
[3] https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2234
[4] https://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=8955
[5] https://rbidocs.rbi.org.in/rdocs/content/pdfs/FIGUSE070512_I.pdf

The guidelines also prescribe that certain on-balance sheet standard assets will not be eligible for securitisation such as revolving credit facilities, assets purchased from other entities, etc.

In order to avoid any unhealthy practices like origination of loans with the sole intention of immediate securitisation, the guidelines on securitisation of standard assets specify a Minimum Holding Period (MHP) requirement prior to securitisation and a Minimum Retention Requirement (MRR) to ensure that the originators have a continuing stake in the performance of securitised assets so as to ensure that they carry out proper due diligence of loans to be securitised.

There are additional conditions specified in the PSL guidelines with respect to securitisation as well as direct assignment, such as the maximum interest rate cap and other eligibility conditions.

4. On-Lending

This mode of collaboration is where an NBFC borrows from a Banks and further utilizes the money to give loans to its customers. On-lending is a mode which has been frequently used by banks to meet their PSL Targets. In addition, NBFCs get additional funding for lending to their customers.

The on-lending model may be done for both lending to PS as well as non-priority sector. This proves as an additional mode of funding for NBFC's generally and allows them to sanction additional loans to their customers. This would indirectly increase Banking outreach, where they could indirectly lend to other customers who are more associated with NBFC's rather than Banks.

In order to boost credit to the priority sector, it was decided that bank credit to registered NBFC's (other than MFIs) for on-lending will be eligible for classification as priority sector under respective categories subject to certain conditions and limits on amount. The guidelines[6] are applicable to all Scheduled Commercial Banks (excluding RRBs and Small Finance Banks).

Moreover, Bank credit to NBFCs for On-Lending is allowed up to a limit of five percent of individual bank's total priority sector lending on an ongoing basis. The guidelines in this regard are valid up to March 31, 2020 and are to be reviewed thereafter.

5. Partial Credit Guarantee Scheme[7]

In light of the recent on-going liquidity crisis, the Government of India in the Union Budget 2019-20, introduced a Partial Credit Guarantee Scheme. This scheme is offered by the Government of India to Public Sector Banks for the purchase of high-rated (typically 'AA' or higher Rated) pool of assets from financially sound NBFC's/ HFC's. The guarantee is provided by the Government of India and can be invoked by Banks in case of a default.

[6] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11659&Mode=0

[7] https://pib.gov.in/newsite/PrintRelease.aspx?relid=192618

The Guarantee is given only for the assets that are standard assets in the books of the NBFCs as on the date of sale. The banks must purchase these assets at fair value, while the pool of assets must have minimum rating of ‘AA’ or equivalent at fair value prior to the partial credit guarantee by the Government of India. Also, the Scheme comes with a first loss credit guarantee of up to 10% of the amount guaranteed. Which means if there is a direct transfer of a pool of assets by an NBFC to a bank which is covered under this scheme, any first losses will be compensated or indemnified by the Government up to 10% of the guaranteed amount.

Comparative Analysis

Co-origination of Loans		Securitisation	Direct Assignment	On-Lending (For PSL)	Business Correspondents	Partial Credit Guarantee Scheme
PSL	**Non-PSL**					
Eligibility Criteria						
All SCB's (excluding RRBs & SFBs)	All SCB's	All Commercial Banks (excluding RRB's and LABs)	All Commercial Banks (excluding RRB's and LABs)	All SCBs (excluding RRBs and Small-finance Banks)	All Commercial Banks (Including RRBs and LABs)	All Public Sector Banks
All NBFC-ND-SIs	All NBFCs	All NBFCs	All NBFCs	NBFCs (MFIs have separate instructions in this regard)	NBFC Non- Deposit Taking (NBFC-ND)	All NBFCs (excluding MFIs and CICs)
Qualifying Assets						
Loans made to Priority Sector	Loans made to other than Priority Sector	Pool standard assets except the following:	Pool of standard assets except the following:	Loans to NBFC's for further lending to Priority Sector.	-	Highly Rated Pool of Assets of NBFC's
Seasoning Requirement						
Direct Exposure on NBFCs Books till Maturity, right from inception.	Direct Exposure on Books of NBFC right from inception.	Minimum Holding Period (MHP) prior to Securitisation depending on Tenure of Loan is required.	Minimum Holding Period (MHP) prior to Assignment depending on Tenure of Loan is required.	No seasoning requirement specified for on-lending to priority sector.	No requirement. Distance Criteria would apply.	Assets originated up to 31. 03. 2019 only will be eligible under the scheme. MHP requirement as per guidelines will also be required.
Risk Retention and other similar requirements:						
Minimum 20% Risk Retention	Risk Retention by Banks	MRR of 5% or 10% of the Book Value of Loans being	Retention of the right to receive 5% or 10% of the cash	Bank credit to NBFCs for On-Lending will be allowed up to a limit of	No Risk Retention requirements, however Banks must	MRR will have to be complied with.

Co-origination of Loans		Securitisation	Direct Assignment	On-Lending (For PSL)	Business Correspondents	Partial Credit Guarantee Scheme
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by NBFC and Balance by Banks	and NBFC will be as per mutually agreed T&C.	securitized depending on Tenure of the Loan	flows from the assets transferred on pari-passu basis, depending on tenure of the loan.	5% percent of individual bank's total priority sector lending on an ongoing basis.	continue to take measures to address possible reputational risks arising out of appointment and functioning of BCs.	
Limit on Amounts and Interest Rate						
Banks and NBFC's will be free to price their part of the exposure, however customer will be offered a single/ blended interest rate.	Both parties will price their part of the exposure as per mutual agreement between them.	Originator profits from the excess spread. **In case of PSL:** The all-inclusive interest charged to the ultimate borrower by the originating entity should not exceed the Base Rate of the investing bank plus 8 percent per annum. (Separate caps on interest rates are specified for MFI's)	**In case of PSL:** The all-inclusive interest charged to the ultimate borrower by the originating entity should not exceed the Base Rate of the purchasing bank plus 8 percent per annum. (Separate caps on interest rates are specified for MFI's)	**Agriculture:** On-lending by NBFCs for 'Term lending' component under Agriculture will be allowed up to ₹ 10 lakh per borrower. **Micro & Small enterprises:** On-lending by NBFC will be allowed up to ₹ 20 lakh per borrower.	The banks may pay reasonable commission/ fee to the BC, the rate and quantum of which may be reviewed periodically.	NBFCs/HFCs can sell up to a maximum of 20% of their standard assets as on 31.3.2019 subject to a cap of Rs. 5,000 crore at fair value. The assets must be standard assets on the books of the NBFC as on date of sale.
Assignment / Transfer of Risk						
Co-origination at inception itself.	Co-origination at inception itself.	Involves assignment by transfer of pool of assets to SPV.	Involves Direct Assignment.	Involves Transfer of Funds for creation of PSL assets.	Involves Transfer of Banks Responsibility to the BCs.	Assignment by NBFC to PSB's of a pool of assets. Involves partial

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PSL	**Non-PSL**					
Assignment can be done with mutual consent of both lenders.	Assignment may be done as per mutually agreed terms.					transfer of risk by way of first loss credit guarantee of up to 10% of guaranteed amount.
True Sale						
No Requirement.	No Requirement.	Yes True Sale requirement applies.	True Sale of pool of assets generally required.	Not Applicable.	Not Applicable.	True sale of pool of assets generally required.
Credit Rating						
Credit Rating of the Borrower is more relevant.	Credit Rating of the Borrower is more relevant.	Senior most Tranche is Highly Rated. (Typically AAA) Losses are absorbed by lower rated tranches first	Pool of Assets Assigned could generally have high rating.	Credit Rating of the Borrowers would be more relevant in this case.	Bank must ensure proper due diligence of the NBFC before engaging them. No credit rating as such.	High rating of pool of assets (Typically 'AA')
Other Specific Conditions or Restrictions						
The Mutually Decided agreement between the Banks and the NBFC should contain the	Other Specific Conditions and requirement to be as per the mutually decided agreement	**In case of PSL:** Investments made by banks in securitised assets originated by NBFCs, where the underlying assets are loans against gold jewellery, are not	**In case of PSL:** (i) Purchase/ assignment/ investment transactions undertaken by banks with NBFCs, where the underlying assets are loans against gold jewellery, are	The existing guidelines on bank loans to MFIs for on-lending as detailed in para 19 of Master Directions on Priority Sector Lending will continue to be applicable for NBFC-MFIs.	It should be ensured that: (i) There is no comingling of bank funds and those of the NBFC-ND appointed as BC. (ii) There should be a specific contractual arrangement	The purchasing bank can invoke the GoI guarantee if the interest and/or instalment of principal remains overdue for a period of more than 90 days during the validity

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essential Features as indicated in Annex 1 of the guidelines.	of the Bank and NBFC.	eligible for priority sector status.	not eligible for priority sector status. (ii) Banks must report the nominal amount actually disbursed to end priority sector borrowers and not the premium embedded amount paid to the sellers.		between the bank and the NBFC-ND to ensure that all possible conflicts of interest are adequately taken care of. (iii) The NBFC-ND does not adopt any restrictive practice.	of such guarantee, subject to the condition that the guarantee is for the first loss up to 10 per cent.

Conclusion

Financial inclusion has always been the top agenda of the Government of India. Thus, there have been a number of initiatives on the part of the Government to extend the scope of collaboration between Banks and NBFCs. The relaxations provided in this regard are bound to increase the outreach of banks and provide additional funding for NBFC's and bring them out of the on-going liquidity crisis.

Further, NBFC's and Banks can combine their arms to their own mutual benefit by exploiting the resources of one another. Apart from these benefits, the priority sector targets can be easily achieved by banks through various modes. External benefits include achieving the goal of ease of doing business in India, by extending and making available all kinds of services to all sectors especially the Priority sector.