

RBI eases risk weight on consumer credit and bank loan: relief for NBFCs and Microfinance Institutions

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Introduction

Amidst the economic slowdown, Reserve Bank of India (RBI), in its recent move to bolster and augment credit flow to the retail segment involving microfinance institutions and non-banking financial companies (NBFCs), has undertaken revision of the risk weights of certain bank loans to microfinance institutions and NBFCs, post holding consultations with NBFCs and banks in terms of: (i) the RBI Notification No. RBI/2024-25/119DOR.CRE.REC.63/21.06.001/2024-25 on Review of Risk Weights on Microfinance Loans dated 25 February 2025 (Microfinance Loan Notification); and (ii) RBI Notification No. RBI/2024-25/120 DOR.STR.REC.61/21.06.001/2024-25 on Exposures of Scheduled Commercial Banks (SCBs) to Non-Banking Financial Companies (NBFCs) – Review of Risk Weights dated 25 February 2025 (NBFC Notification), respectively, and shall cumulatively be referred to as the (2025 Notifications). By way of the said revision in risk weightage for bank loans, requiring adjustment in capital requirements for banks, RBI aims at stabilising the financial sector.

Pursuant to the 2025 Notifications: (i) RBI reduced the risk weight for microfinance loans in the nature of consumer credit from 125% to 100%; and (ii) the risk weights for bank loans to NBFCs rated A and above were reduced by 25 percentage points in cases where the extant risk weight as per external rating of NBFCs was below 100%, thereby reversing the increase in risk weightage in terms of the NBFC Notification. This move is a strategic response to the evolving dynamics of the retail segment.

The revised risk weight provisions under the Microfinance Loan Notification are applicable to both outstanding and new loans, effective immediately from the date of issuance of the said notification, while the instructions under the NBFC Notification shall be operational from 1 April 2025.

Key changes pursuant to the 2025 Notifications:

(A) Microfinance Loan Notification

RBI *vide* its notification bearing No. RBI/2023-24/85 DOR.STR.REC.57/21.06.001/2023-24 on Regulatory measures towards consumer credit and bank credit to NBFCs dated 16 November 2023 (November 2023 Notification) had increased the risk weight on consumer credit (including personal loans, but excluding housing loans, education loans, vehicle loans and loans secured by gold and gold jewellery), from 100% to 125%.

RBI further in terms of the Master Circular No. RBI/2024-25/08DOR.CAP.REC.4/21.06.201/2024-25 on Basel III Capital Regulations dated 1 April 2024 (Basel III Master Circular) clarifies that fund-based and non-fund based loans that meet all the four qualifying criteria listed in paragraph 5.9.3 of the Basel III Master Circular (Qualifying Criteria) may be considered as retail claims for regulatory capital purposes and will be part of the regulatory retail portfolio (RRP) and will attract a risk weightage of 75%. RBI however excluded consumer credit from the RRP and risk weightage in terms of the November 2023 Notifications continued to be applied.

Now in light of the requirement to increase the credit availability in the microfinance sector, RBI pursuant to the Microfinance Loan Notification has clarified the following:

- (i) microfinance loans that are categorised as consumer credit will no longer be assigned the higher risk weight of 125% that was introduced by way of the November 2023 Notification and will now carry a reduced risk weight of 100%;
- (ii) microfinance loans that are not in the nature of consumer credit but fulfil the Qualifying Criteria, may be classified under RRP provided that the banks put in place appropriate policies and standard operating procedures to ensure that all four Qualifying Criteria are met, and in which case such loans will carry a risk weight of 75% in terms of the Basel III Master Circular; and
- (iii) all microfinance loans that are extended by regional rural banks and local area banks, will uniformly attract a risk weight of 100%.

(B) NBFC Notification

Typically, exposures of Scheduled Commercial Banks (SCBs) to NBFCs are risk weighted as per the ratings assigned by accredited external credit assessment institutions. The November 2023 Notification, increased the risk weightage on the exposures of SCBs to NBFCs by 25% over and above the risk weight associated with the given external rating (as specified in paragraph 5.8.1 of the Basel III Master Circular) in all cases where the extant risk weight as per external rating of NBFCs was below 100%.

Under the NBFC Notification, RBI reviewed the position stipulated under the November 2023 Notification and decided to restore the risk weights applicable to exposures of SCBs to NBFCs. Accordingly, the risk weights for bank loans to NBFCs rated "A" and above were reduced by 25 percentage points in cases where the extant risk weight as per external rating of NBFCs was below 100%.

Impact of the 2025 Notifications

The market expectations are that the 2025 Notifications would result in increased credit availability and lending capacity of banks, as reduction in risk weights implies a reduction in the capital that banks must set aside for extending loans. In other words, with lower capital requirements, banks have more flexibility to extend credit. As this will drive the banks towards increased lending to the microfinance sector and NBFCs it is expected to increase credit availability in the retail segment, benefiting both NBFCs and microfinance institutions.

The reduction in risk weights will also improve capital adequacy ratios of banks, allowing them to operate with optimal leverage and reducing the need for short-term capital raises. However, maintaining the risk weight as per the revised standards ensures that banks remain cautious and helps striking a balance between risk, growth objectives and financial stability.

Banks would also be required to make some operational adjustments as a consequence of the 2025 Notifications and they will need to update their internal policies and systems to align with the new risk weight framework, ensuring compliance and optimising their lending strategies.

Conclusion

The NBFC and microfinance sectors were experiencing a slowdown in terms of lending due to a tightening of the lending norms by the RBI when it increased risk weight by way of the November 2023 Notification. Rolling out the 2025 Notifications is a significant step towards the broader strategy of RBI to enhance credit flow and stabilise the financial sector.

The above move signifies a pivotal step toward bolstering the financial sector by enhancing credit flow and supporting economic growth and the 2025 Notifications also evidence a more balanced regulatory approach on part of the regulator, addressing both risk management and the need for economic growth.

Despite the positive impact, growth in the microfinance and NBFC segments may remain subdued due to asset quality challenges. While this recent move of the RBI presents opportunities for banks and NBFCs, it also acknowledges the need to manage asset quality risks effectively. Nevertheless, by recalibrating risk weights, the central bank aims to stimulate credit flow, provide regulatory clarity, and balance growth with financial prudence.

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