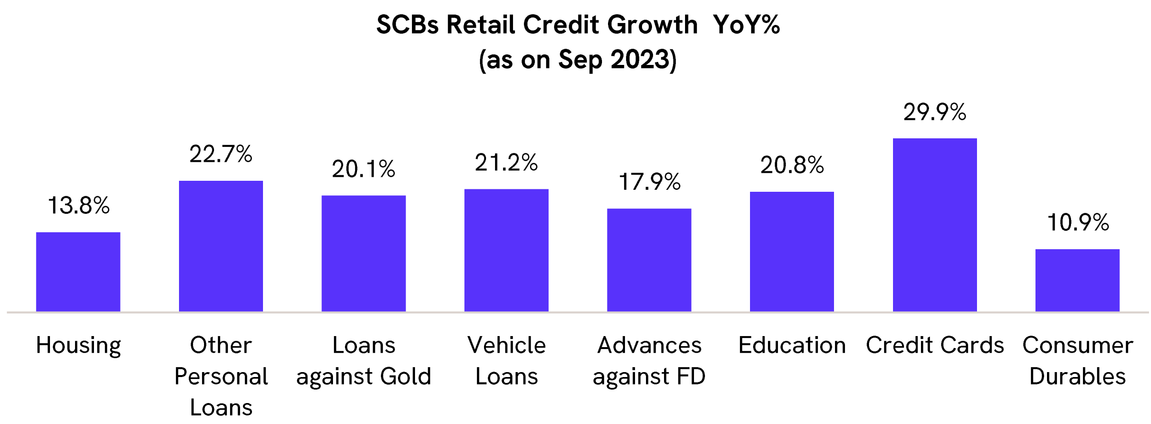
RBI pre-empts potential stress in consumer credit by increasing risk weights

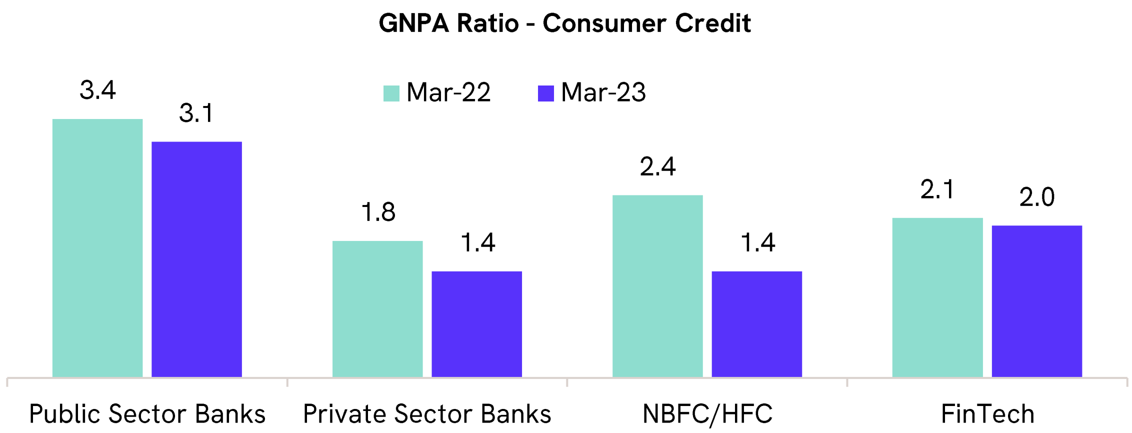
During the RBI Monetary Policy Committee (MPC) in October 2023, Governor Shaktikanta Das cautioned against the very high growth in certain components of personal loans (refer to Chart 1) and advised banks to strengthen their internal surveillance mechanisms, address the build-up of risks, and institute suitable safeguards. The Governor also mentioned that RBI is closely monitoring any signs of incipient stress and will act proactively to maintain financial stability. Subsequently, on November 16th 2023, the RBI announced a series of regulatory measures aimed at restricting credit to the high-growth consumer segment, pre-empting any potential stress (refer to Chart 2).

Chart 1: Retail/personal loan components are growing over 20% YoY, outpacing the banking system's credit growth of around 15.5% YoY



Source: RBI, 360 ONE Asset Research

Chart 2: Consumer credit portfolios of banks, NBFCs, and FinTechs have not exhibited signs of stress so far



Source: RBI, 360 ONE Asset Research

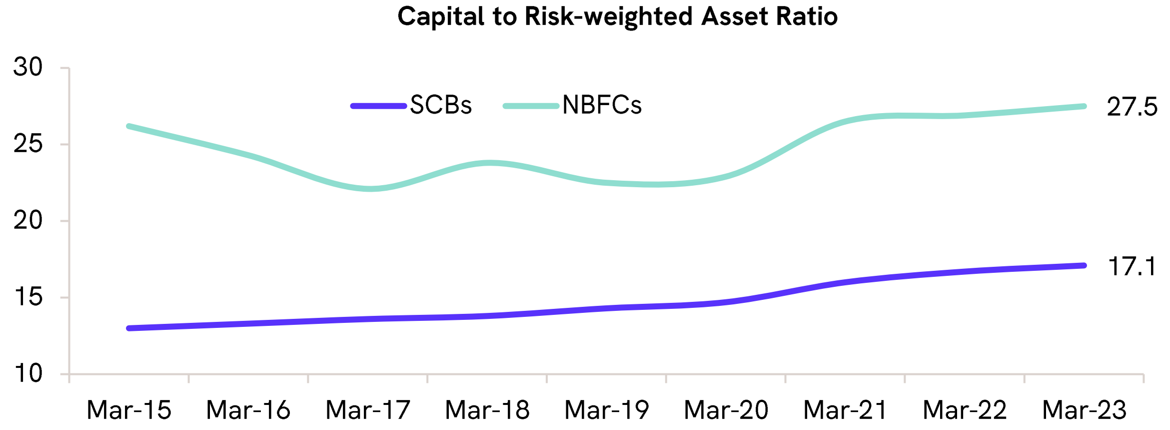
The following measures were announced by RBI –

1. Increase in the risk weights of outstanding and new consumer credit exposure (excluding housing loans, education loans, vehicle loans, and loans against gold) of commercial banks and NBFCs by 25 percentage points to 125%. For NBFCs, microfinance/SHG loans are also excluded from the higher risk weight.
2. A 25 percentage points increase in the risk weights for credit card receivables, setting them at 125% for NBFCs and 150% for Scheduled Commercial Banks (SCBs).
3. Increase in risk weight of SCBs exposure to NBFCs by 25 percentage points in all cases where the extant risk weight as per external rating of NBFCs is below 100%. Loans eligible for priority sector classification are exempted from higher risk weight.
4. Top-up loans extended against depreciating movable assets, such as vehicles, shall be treated as unsecured loans.
5. Banks and NBFCs to review extant sectoral exposure limits for consumer credit and put in place Board approved limits for various sub-segments.

Implications:

1. **An increase in risk weights will lead to higher capital requirements for banks and NBFCs.** Most scheduled commercial banks (SCBs) and NBFCs are well-capitalized and may not face major issues in maintaining the minimum capital requirements set by the RBI (refer to Chart 3). However, it's worth noting that the elevated capital requirements may eat into the growth capital for some banks/NBFCs.

Chart 3: Most Banks and NBFCs are well-capitalized to comfortably meet the minimum capital requirements



Source: RBI, 360 ONE Asset Research

2. **Higher capital requirements are likely to moderate the growth of personal loans, particularly unsecured loans**. Nevertheless, unsecured loans have not exhibited higher inherent risk compared to the secured segment thus far. As per the RBI's Financial Stability Report in June 2023, Special Mention Accounts (SMA) for unsecured credit in scheduled commercial banks (SCBs) are lower than those for secured credit (refer to Table 1). Additionally, the gross non-performing asset (GNPA) ratio for unsecured retail credit has improved from

3.2% in March 2021 to 2.0% in March 2023. However, there have been recent reports of stress emerging in small-ticket unsecured personal loans[1]. Banks/NBFCs may also pass on the burden of additional capital requirements to consumers by charging higher interest rates.

Table 1: Special Mention Accounts (SMA) Share of Retail Advances - Banks (as of 31st March 2023)

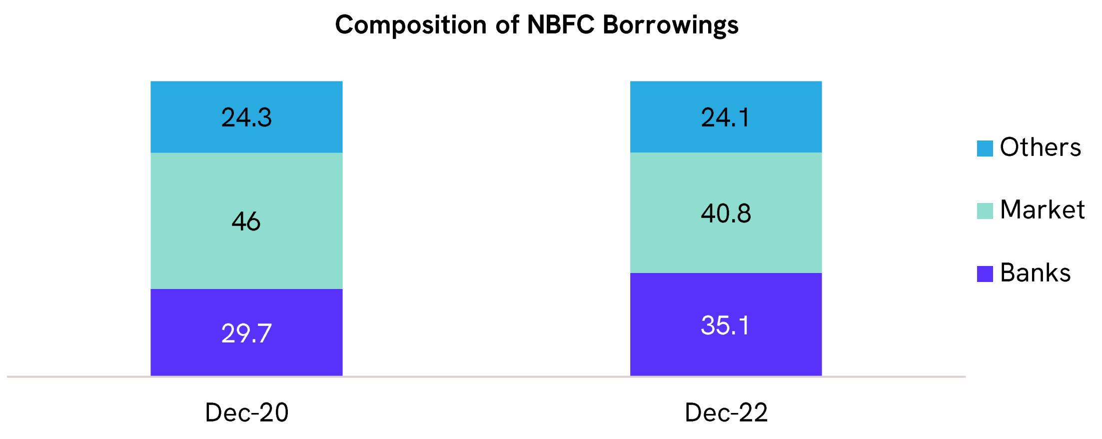
	SMA-0	SMA-1	SMA-2	Total
Unsecured	4.6	1.7	0.6	6.9
Secured	4.7	2.0	0.7	7.4
Total	4.7	1.9	0.7	7.3

Source: RBI, 360 ONE Asset Research

Note: Special Mention Accounts (SMA) are defined as follows: if the principal or interest payment, or any other amount, is wholly or partly overdue and remains outstanding for up to 30 days, it is categorized as SMA-0; for 31-60 days overdue, it is classified as SMA-1; and for 61-90 days overdue, it falls under the SMA-2 category

3. **An increase in the risk weight on bank lending to NBFCs will result in higher funding costs for NBFCs.** Bank credit to NBFCs has exhibited robust growth of ~26% YoY (as of Sep'23). Banks play a crucial role as a source of funding for the NBFC sector. The reliance of NBFCs on banks has also grown over the years (refer to Chart 4). Banks are likely to restrict credit to NBFCs due to higher risk weights, or they may demand higher interest rates to compensate for additional capital charge.

Chart 4: Banks are accounting for an increasingly higher share of NBFC borrowings

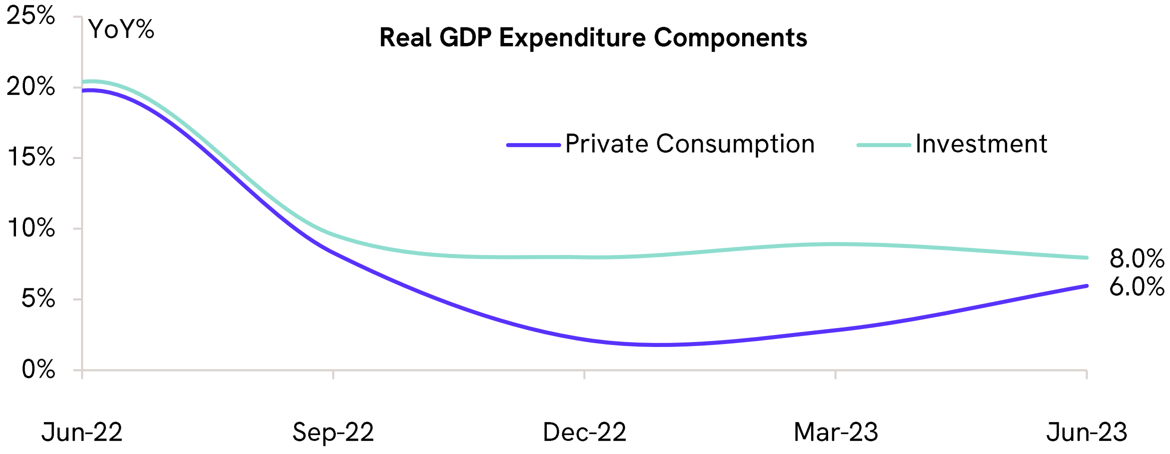


Source: RBI, 360 ONE Asset Research

[1] https://www.bqprime.com/business/intensifying-stress-in-unsecured-lending-puts-banks-on-watch

4. **Moderation in personal loan growth could have an impact on consumption.** The post-COVID recovery in private consumption has already been weak (refer to Chart 5). The slowdown in consumer lending could further impact the recovery. There are also reports suggesting that personal loans have contributed to significant growth in the equity derivates market[2]. Banks/NBFCs are expected to intensify scrutiny of loans, thereby discouraging the use of funds for speculative purposes.

Chart 5: Private consumption's recovery post-COVID has been lacklustre



Source: MOSPI, 360 ONE Asset Research

5. **A slowdown in consumer lending could bring forth financial stress in the system**. Consumers facing financial stress may encounter challenges in evergreening loans, a practice that typically involves transferring funds among various credit lines. GNPA ratio could also increase, statistically, on account of a lagged increase in defaults (numerator) as lending (denominator) slows.

[2] https://www.cnbctv18.com/finance/are-unsecured-personal-loans-from-banks-fuelling-exponential-growth-in-equity-derivatives-18276171.htm

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