Overheating Concerns of Unsecured Consumer Credit in India Banking

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Introduction

Retail banking has emerged as a major growth engine as the Indian economy narrative unfolds. Economic prosperity and the resulting boost in purchasing power of its 1.4 billion populaces has fuelled a consumption boom. Despite global slowdown, the strong domestic demand has been supporting consumption led economic growth. Changing consumer demographics with median age nearly 28, signal enormous potential for consumption growth, going forward both qualitatively and quantitatively. In India, the customer pie is growing, which is very important for retail banking and at the same time private final consumption expenditure constitutes nearly 60% of the GDP. Digital penetration and convenience banking in the form of usage of UPI, credit and debit cards, internet and phone banking, and anywhere and anytime banking has resulted into mass financial inclusion in the country and is making the process seamless.

Commercial banks in India are well poised to grab the opportunity retail banking offers. The emergence of the Indian middle class is a significant element in this regard. The Gen Z and Gen Y are more comfortable with personal debt than their prior generations. Rising aspiration along with more liberal views regarding personal debt, are building robust demand for retail credit in India.

From supply side, global economic uncertainty driven by geopolitical unrest and supply driven inflation and consequent central bank interest rate hikes have resulted into reduced income from investment book as well as moderation in corporate credit growth. Retail banking is treated as an excellent vehicle for driving credit growth momentum. Retail loans have imposed a comparably lower provisioning burden on banks while also diversifying their income sources. Higher margin and lower delinquency are the factor driving banks crazy for retail credit expansion. Moreover, retail loans being diffused across a wide borrower base mitigate the accumulation of systemic risk as all borrowers may not default together.

Recent RBI action to tight unsecured retail credit

To curb possible overheating in the sector, Reserve Bank of India (RBI) on 16 November has increased risk weights on these types of loans. The RBI measures are broadly segregated into two categories, consumer credit and bank credit to Non-Bank Financial Companies (NBFCs).

Consumer Credit (Banks, Non-Banks and Credit Card exposure): The RBI increased the risk weights in respect of consumer credit exposure of commercial banks (outstanding as well as new), including personal loans, but excluding housing loans, education loans, vehicle loans and loans secured by gold and gold jewellery, to 125% from its existing level of 100%.

Similarly, RBI increased the risk weights on consumer credit exposure of NBFCs (outstanding as well as new) categorised as retail loans, excluding housing loans, educational loans, vehicle loans, loans against gold jewellery and microfinance/SHG loans, to 125% from 100% earlier level.

Against the existing risk weights of 125% for credit card receivables of scheduled commercial banks (SCBs) and 100% for NBFCs, the RBI has increased the risk weights on such exposures by 25 percentage points to 150% for SCBs and 125% for NBFCs.

Bank Credit to NBFCs: The RBI increased the risk weights on the exposures of SCBs to NBFCs (excluding core investment companies) by 25 percentage points (over and above the risk weight associated with the given external rating) in all cases where the extant risk weight as per external rating of NBFCs is below 100%. These guidelines exclude loans to housing finance companies (HFCs) and loans to NBFCs which are eligible for classification as priority sector.

Risk Weights: Bank Credit to NBFCs						
Rating (External Agency)	AAA	AA	A	BBB	BB & below	Unrated
Existing Risk Weight (%)	20	30	50	100	150	100
Revised Risk Weight (%)	45	55	75	100	150	100

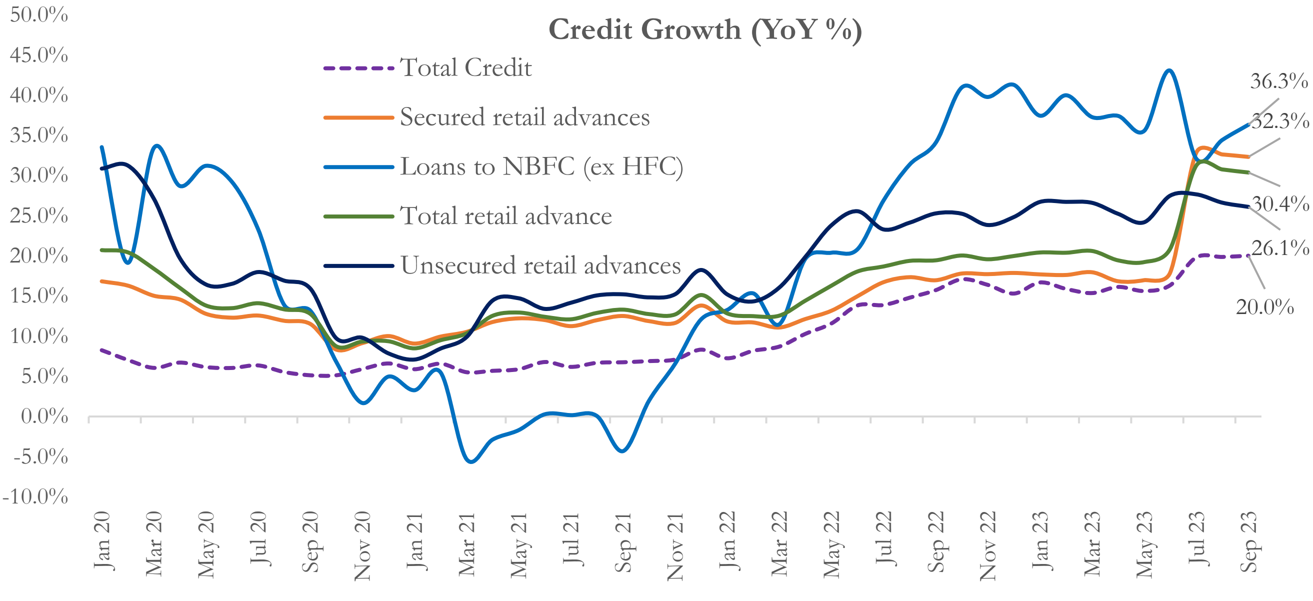
Background – Previous Revisions in Risk Weights

This is not the first time the RBI has changed the risk weights. RBI has been using this instrument time to time as and when required. In 2004 the growth of housing and consumer credit was very strong and was showing signs of overheating. As a temporary counter cyclical measure for risk containment, on December 23, 2004, RBI increased the risk weights from 50% to 75% in the case of housing loans and from 100% to 125% in the case of consumer credit including personal loans and credit cards.

On a procyclical measure, on September 12, 2019, RBI reduced the risk weight assets requirement for unsecured retail lending, aiming to stimulate consumer spending. The move resulted in a reduced RWA of 100% for consumer loans, including personal loans, while credit cards continued with a 125% RWA. Credit cards had attracted 125% RWA back then, and it was left unchanged.

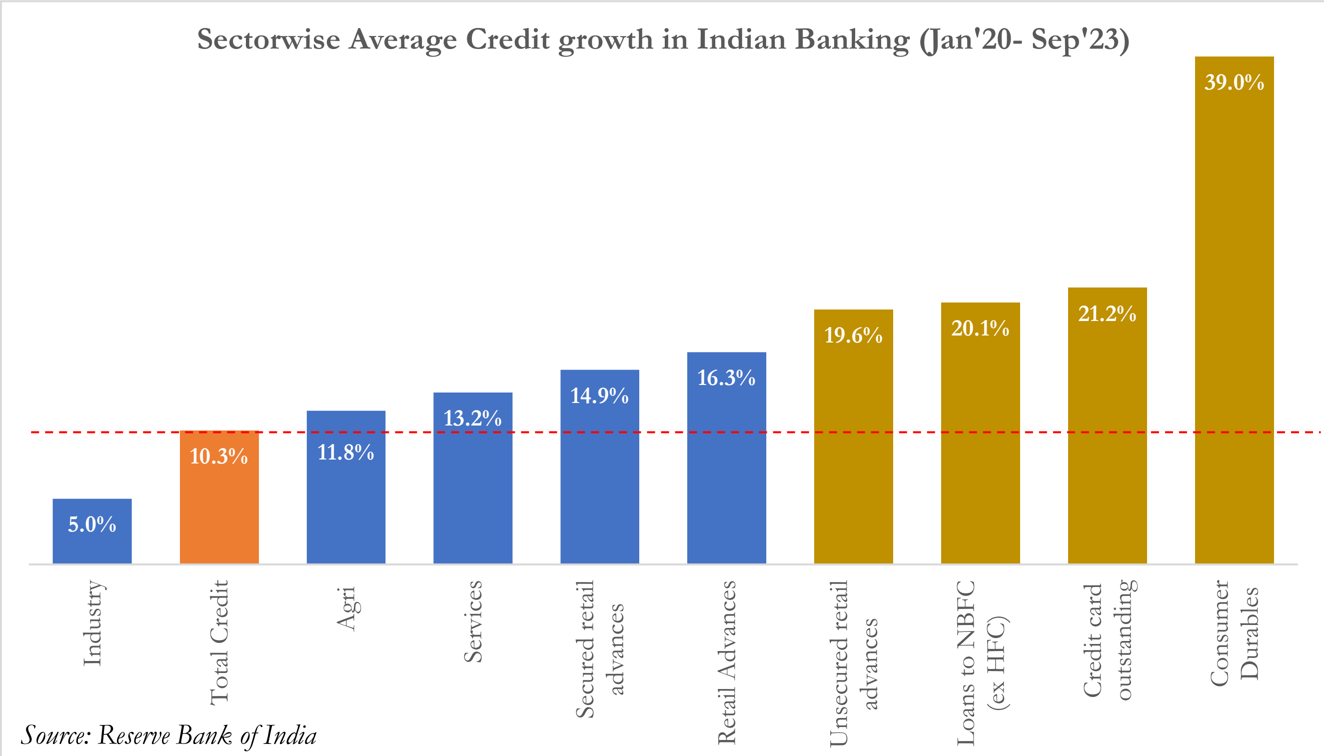
Rationale for RBI's recent action

Retail loans have been growing at an average rate of 22.8% in last one year, against an average growth of 17% in total credit. During the same period, unsecured retail credit growth (25.9%) has outpaced secured retail credit growth (21.4%) by 4.5%.

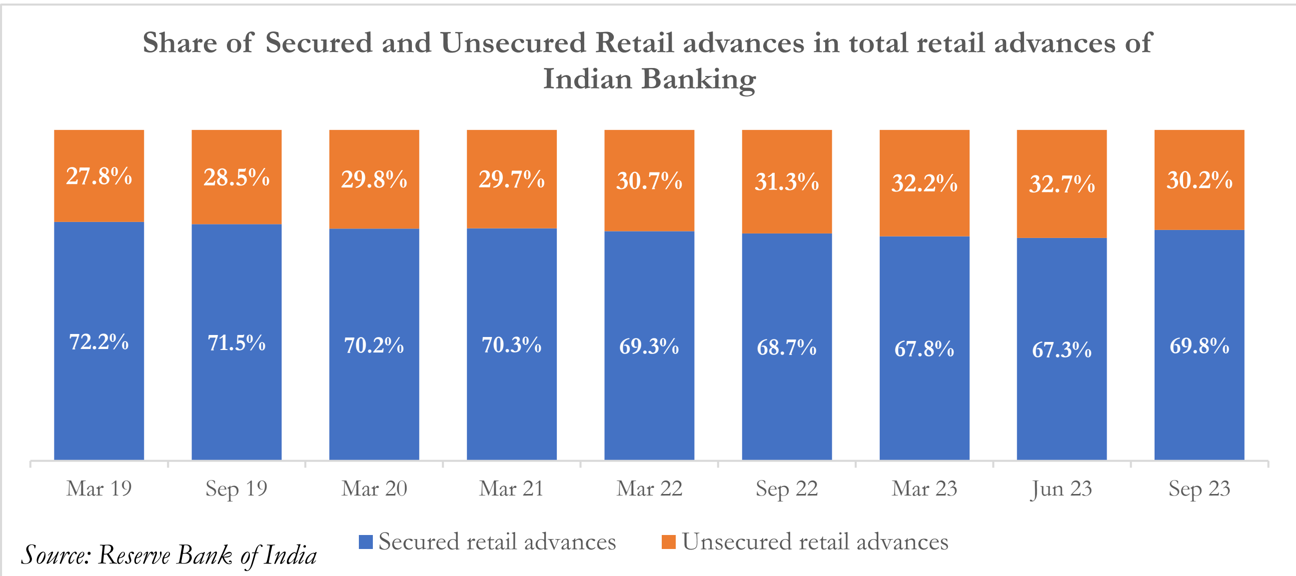


Source: Reserve Bank of India

Note: Unsecured retail credit is inclusive of Other Personal Loans and Credit Card Outstandings; Post merger with HDFC Bank, HDFC Ltd data is added since July 2023.



In recent times the unsecured retail lending growth has been robust and has outpaced other major segments. The composition of secured and unsecured (other personal loans and credit card outstandings) advances in retail advances have undergone a change after RBI relaxing risk weightage in September 2019, with share of unsecured retail loans increasing from 28.5% to 30.2% and that of secured loans declining from 71.5% to 69.8% as of September 2023. These unsecured



retail loans forms 9.6% of the total banking system credit as of September 2023 increasing from 7.1% in September 2019.

As per the latest Financial Stability report of the RBI (June 2023), although the GNPA ratio of retail loans at the system level has remained low at 1.4% in March 2023, the share of special mention accounts (SMA) was relatively high at 7.3% for SCBs. Before a loan account turns into a NPA (Interest and or instalment of principal remain overdue for a period of more than 90 days), banks are required to identify incipient stress in the account by creating three sub-categories under the Special Mention Account (SMA).

SMA Share of Retail Advances (as on March 31, 2023)

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

Source: RBI Financial Stability Report June 2023

SMA-0: Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress
SMA-1: Principal or interest payment overdue between 31-60 days and
SMA-2: Principal or interest payment overdue between 61-90 days

The data from the TransUnion CIBIL also highlights that the personal loan transition matrix shows moderation in risk tiering, with downgrades from super-prime and prime-plus category exceeding upgrades in sub-prime and near-prime customers, indicating an incipient sign of stress.

Transition Matrix - Personal Loans (Unsecured)

(per cent)

Risk Tier as of March 2022	Risk Tier as of March 2023: Subprime	Near prime	Prime	Prime plus	Super prime	Score Tier Downgrade	Score Tier Upgrade
Subprime	71.0	18.3	8.4	2.0	0.2	0.0	29.0
Near prime	21.6	32.1	35.4	10.2	0.7	21.6	46.3
Prime	8.8	16.8	47.7	24.9	1.8	25.6	26.7
Prime plus	4.0	9.5	28.9	52.1	5.4	42.5	5.4
Super prime	2.3	7.9	22.8	27.6	39.4	60.6	0.0

Source: TransUnion CIBIL
The segregation of risk tiers based on CIBIL scores is as follows – Super Prime:791-900, Prime Plus: 771-790, Prime:731-770, Near Prime:681-730 and SubPrime:300-680.

As per the latest TransUnion CIBIL Credit Market Indicator Report (October 2023), the vintage delinquency (accounts that have ever been 30-plus days past due within six months of origination) has been on a rising trend for consumption-led loans, and loans against property. Consumption-led products and loan against property continue to have early delinquency higher than pre-covid level. Vintage delinquency for personal loans had increased to 9%, as of the end of 2022 from a pre-pandemic level of 6%. The vintage delinquency for credit cards has risen to 4% from 3% prior to the pandemic. Moreover, this stress is predominantly in personal loan segment below Rs. 50,000 where 30-plus days past due is 10.2%, compared with 3.2% for loans that are above Rs. 50,000.

Impact of the RBI measures

Banks and NBFCs require higher capital to sustain current credit growth momentum. As the risk weights are also applicable to the existing loan book, they need to allocate higher capital on existing loan portfolio. This might lead to repricing of loans by lenders to accommodate increased cost of capital and hence interest rates charged by the lenders may go up. Moreover, the interest rate spike by NBFCs will be higher compared to banks as they get double hit of rise in cost of funds and increased risk weights on existing and new credit. This might impact profit margin of Banks and NBFCs subject to the absorption of the rising capital cost. Going forward, credit growth may moderate and NIM may adversely be impacted based on whether and how much banks/NBFCs pass on the rising cost of capital to the borrowers. A simple calculation at system level shows that the revised risk weight may create a need for Rs. 0.84 trillion of additional capital.

<table>
<tr><th colspan="7">Excess Capital Required for the Banking System due to Revised Risk Weights
(As of September 2023)</th></tr>
<tr><td rowspan="2">Item</td><td rowspan="2">Outstanding credit (Rs trillion)</td><td colspan="2">Risk Weights</td><td colspan="2">Capital Requirement @ 11.50%</td><td rowspan="2">Excess capital required (Rs trillion)</td></tr>
<tr><td>Old (100%)</td><td>New (125%)</td><td>Old</td><td>New</td></tr>
<tr><td>Consumer Loans (ex. housing, education, vehicle and gold)</td><td>16.00</td><td>16.00</td><td>20.00</td><td>1.84</td><td>2.30</td><td>0.46</td></tr>
<tr><td>NBFC (ex HFC)*</td><td>11.13</td><td>11.13</td><td>13.91</td><td>1.28</td><td>1.60</td><td>0.32</td></tr>
<tr><td colspan="7"></td></tr>
<tr><td>Item</td><td></td><td>Old (125%)</td><td>New (150%)</td><td>Old</td><td>New</td><td></td></tr>
<tr><td>Credit Card</td><td>2.20</td><td>2.75</td><td>3.30</td><td>0.32</td><td>0.38</td><td>0.06</td></tr>
<tr><td colspan="6">TOTAL Excess Capital Required due to Revised Risk Weights</td><td>0.84</td></tr>
<tr><td colspan="7">*Total bank credit to NBFC excluding HFC is considered irrespective of external ratings</td></tr>
</table>

Conclusion

The RBI's directions on increasing risk weights on unsecured consumer credit exposure of commercial banks (outstanding as well as new) along with increased risk weights on consumer credit exposure of NBFCs (outstanding as well as new); and higher risk weights on consumer credit exposure on credit card receivables of banks and NBFCs is a prudential measure to address the overheating in the unsecured retail lending segment. However, exclusion of some of the important sub-segments of retail credit including housing loans, educational loans, vehicle loans, loans against gold jewellery and microfinance/SHG loans etc. shows that the measures are mainly to limit reckless unsecured retail lending which have been showing signs of incipient stress.

This is one of the countercyclical measures taken by the RBI to control the unsecured credit growth and RBI has used this measure previously whenever a requirement was felt. With the current higher growth in unsecured retail credit segment, which is growing at much faster rate than overall credit growth, the share of unsecured retail loans has overgrown, reaching almost 10% of banking sector credit outstanding and 30% of the total retail credit. More recently, the RBI data shows that unsecured lending segment has been showing stress as the share of special mention accounts has been relatively high.

The transition matrix of personal loans unsecured segment by the TransUnion CIBIL also shows moderation in risk tiering, with downgrades from super-prime and prime-plus category exceeding upgrades in sub-prime and near-prime customers, indicating an incipient sign of stress. The early delinquency in consumption-led products and loan against property has gone even higher than the pre-covid level. Hence, the action of the RBI emphasising on risk management is in tune with the objective of financial stability and is expected to maintain asset quality.

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