What is RBI's latest move to increase risk weight for lending about? | Explained

PREMIUM

The Reserve Bank of India (RBI) on Thursday issued regulatory measures to banks and NBFCs to increase risk weights associated with consumer credit and bank credit by an additional 25 percentage points.

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Representational Image | Photo Credit: EMMANUAL YOGINI

The story so far: Seeking to rein in an observed rise in unsecured personal loans and credit cards, the Reserve Bank of India (RBI) directed banks and non-banking financial companies (NBFCs) to reserve more capital for risk weights. The mandatory risk weight

requirement has been increased by 25 percentage points. This would be applicable to unsecured personal loans, credit cards and lending to NBFCs. The directions are expected to result in higher capital requirements for lenders and thereby, an increase in lending rates for consumers. They come into force with immediate effect, with mandatory adherence being sought before February-end next year.

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What has the RBI proposed?

The idea is to address the notion of 'credit risk.' It refers to the risk entailed by a borrower being unable to meet their obligations or defaulting on commitments. 'Risk weights' are an essential tool for banks to manage this risk.This metric, in percentage factors, adjusts for the risk associated with a certain asset type. In other words, it is an indicator of the essential holding the lender should ideally have to adjust the associated risk. This is what the RBI has directed be increased.

The primary purpose for effective risk management by banks is to maximise their returns by maintaining credit risk exposure within acceptable parameters.

Earlier, in interactions with the MDs and CEOs of major banks, RBI had raised concerns about the growth seen in consumer credit and increased dependency of NBFCs on bank borrowings.

Now, it has directed that the risk weight for consumer credit exposure be increased by 25 percentage points to 125%, for all commercial banks and NBFCs. This would apply to personal loans, excluding housing loans, education loans, vehicle loans and loans secured by gold and gold jewellery. This would also not apply to SHG loans and microfinance. At present, exposures in this realm mandate a risk weight of 100%.

Credit card loans of scheduled commercial banks (SCBs) currently attract a risk weight of 125% while that of NBFCs attract 100%. The apex banking regulator has decided to increase the risk weight on such exposures by 25 percentage points, thus, placing the risk weight at 125% for NBFCs and at 150% for SCBs.

Lastly, bank credit to NBFCs, excluding core investment companies, also had their risk weights increased by 25 percentage points. This is over and above the risk weights on such exposures assigned by an accredited external assessment institution (a mandatory requirement). The direction would be applicable in all cases where the extant risk weight as per the external rating is below 100%. This would however not apply to housing finance companies and loans to NBFCs classified into the priority sector.

Why were the changes deemed necessary?

While presenting the monetary policy statement in October this year, Governor Shaktikanta Das had flagged concerns about the "high growth" in "certain components of consumer credit." He advised banks and NBFCs to "strengthen their internal surveillance mechanisms, address the build-up of risks, if any, and institute suitable safeguards, in their own interest." The governor said these were being closely monitored by the apex banking regulator for "any signs of incipient stress."

"The need of the hour is robust risk management and stronger underwriting standards," he had said.

Ratings agency Moody's also put forth that higher risk weights are intended to "dampen lenders' consumer loan growth appetite." The unsecured segment, it adds, has grown rapidly in the past few years, exposing financial institutions to a potential spike in credit costs in the event of a sudden economic or interest rate shock.

RBI's latest figures stipulate that unsecured personal loans have increased approximately 23% on a year-over-year basis, as on September 22 this year. Outstanding loans from credit cards increased by about 30% during the same period. Furthermore, news agency *Reuters,* quoting data from credit bureau Transunion CIBIL, highlighted that delinquencies, defined as loans overdue by more than 90 days, stood at 0.84% for all personal loans.

Major concerns emerge for loans below Rs 50,000 – these carry the utmost default risk. Delinquencies in this segment, as reported by *Reuters* citingTransunion CIBIL data, stood at 5.4% as of June this year. Ratings agency S&P in their assessment held that borrowers in this segment are often highly leveraged and may have other lending products. Loans of this kind comprise only 0.3% of total retail loans. However, it added, "Financial technology firms are more exposed to these loans, as around 80% of their personal loans is to this customer segment."

According to Moody's, several NBFCs that until now focussed on secured lending categories (such as infrastructure, real estate and vehicle loans) have pivoted to riskier segments. Additionally, net interest margins (an important profitability metric for banks) are declining because of steep competition.

What are the chief concerns?

The primary concerns relate to the impact on capital adequacy and the bank's overall profitability. The latter ensures that banks have sufficient capital to absorb losses arising out of unanticipated events or risks within the business.

S&P's latest report states that slower loan growth and an increased emphasis on risk management will likely support better asset quality in the Indian banking system. However, it adds, "The immediate effect will likely be higher interest rates for borrowers, slower loan growth for lenders, reduced capital adequacy, and some hit on profits."

The ratings agency estimates Tier-1 capital adequacy will decline by about 60 basis points. Tier-1 capital adequacy represents banks' highest quality of capital as it helps banks absorb losses immediately as and when they occur. According to S&P, the drop may prompt lenders with weaker capital adequacy to raise capital. Unrelatedly, it observed that public sector banks generally have lower capital adequacy than large private sector banks.

However, the worst-affected might be finance companies, as their incremental bank borrowing might surge, besides the impact on their capital adequacy, S&P states.

NBFCs face a "double-whammy" because of higher risk weights on their unsecured loans and on account of the bank lending mandates to NBFCs. "This would squeeze the reported capital adequacy of NBFCs and push up their funding costs," the report concluded. Bank lending to NBFCs remained the principal source of funding for NBFCs — constituting 41.2% of the total borrowing of the entities (excluding core investment companies) as of March end. It is expected that the increased costs would be passed onto borrowers; inability to do so would translate to a hit on profit.