RBI Tightens Capital Norms for Unsecured Loans

For Prelims: RBI Tightens Capital Norms for Unsecured Loans, **Reserve Bank of India (RBI),** Risk weight on Bank Exposure, **NBFCs (Non Banking Financial Companies).**

For Mains: RBI Tightens Capital Norms for Unsecured Loans, Inclusive growth and issues arising from it.

Source: IE

Why in News?

Recently, the **Reserve Bank of India (RBI)** has increased **Risk Weight on Bank Exposure** to check on **Unsecured Loans,** like Personal Loans, Credit Card Receivables etc.

- The RBI's move to increase the risk weight on unsecured loans is a way of increasing the **Capital to Risk-Weighted Assets Ratio (CRAR)** requirement for banks that lend to these categories.
- An Unsecured Loan is a loan that **does not require one to provide any collateral to avail them.** It is issued by the lender on one's creditworthiness as a borrower. And hence, having an excellent credit score is a **prerequisite for the approval of an Unsecured Loan.**

What is Capital Adequacy Ratio (CAR)?

- The CAR is a **measure of a bank's available capital expressed** as a percentage of a bank's risk-weighted credit exposures.
- The Capital Adequacy Ratio, also known as Capital-to-Risk Weighted assets ratio (CRAR), is used to protect **depositors and promote the stability and efficiency of financial systems** around the world.

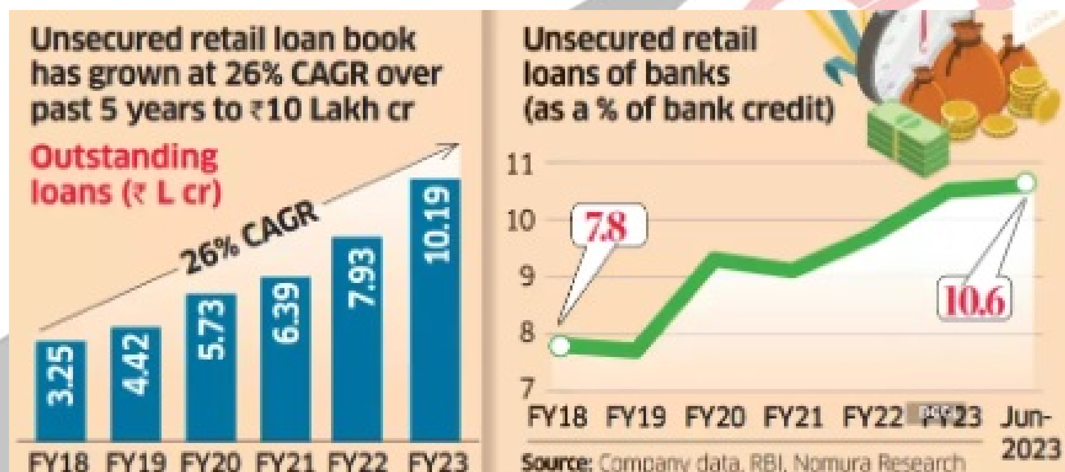
What is Risk Weight on Bank Exposure?

- **About:**
    - Risk weight on bank exposure refers to a method used by regulators, such as central banks or financial supervisory authorities, to assess the risk associated with various types of assets held by banks.
    - This method determines the amount of capital that banks need to hold against these assets as a **buffer to cover potential losses.**
    - The risk weight assigned to different categories of assets is based on their perceived riskiness.
    - Lower risk assets receive lower risk weights, **requiring banks to allocate less capital against them**, while higher risk assets have higher risk weights, necessitating a greater capital allocation.
- **Examples:**

- Low-risk assets like cash or government securities might have a risk weight of 0% or a very low percentage. This implies that **banks need to allocate minimal capital against these assets**
- Higher-risk assets like unsecured consumer loans, corporate loans, or derivatives may have risk weights ranging **from 20% to 150% or higher,** depending on their perceived risk. This means banks must allocate more capital as a buffer against potential losses from these assets.

What is the RBI's Move Pertaining to Unsecured Loans and Need for it?

- **Increased Risk Weights:**
  - The RBI has raised the risk weight on banks' exposure to certain categories like consumer credit, credit card receivables, and NBFCs.
    - The risk-weights on banks' unsecured personal loans and consumer durable loans have been **increased to 125% from 100%,** and that on credit cards have been increased to 150% from 125%.
    - Further, the risk-weights on NBFCs' unsecured personal and consumer durables loans, and credit cards have **been increased to 125% from 100%.**
    - It means that banks and financial institutions **need to set aside more capital as a buffer** against potential losses arising from these specific loan categories.
  - The RBI has, however, exempted microfinance loans by NBFCs from the risk-weight increase.



- **Need for Such a Move:**
  - **Control Unbridled Growth:** Unsecured Loans, especially consumer Loans, had been expanding rapidly, surpassing the **growth rate of less risky lending assets.** This unchecked growth could pose risks to the stability of the financial system.
    - These loans are not backed by collateral, making them riskier for lenders. If borrowers **default on these loans due to economic downturns** or personal financial issues, it can lead to significant credit losses for banks and other lending institutions.
  - **Risk Mitigation:** By increasing risk weights on consumer loans provided by banks, **NBFCs (Non Banking Financial Companies),** and credit card providers, the RBI aims to make these loans more capital-intensive for financial institutions.
    - This helps in **aligning the capital requirements with the associated risks,** making it more expensive for lenders to extend such loans.
  - **Prevent Escalation of Risk:** Establishing board-monitored processes for these advances helps ensure that **banks have proper risk assessment mechanisms** in place. This step intends to prevent the escalation of risk associated with unsecured retail lending.
  - **Maintain Financial Stability:** The overarching goal is to maintain financial stability by **addressing the imbalance in lending practices** and ensuring that the rapid growth in unsecured retail loans doesn't pose a systemic risk to the banking and financial sectors.

What is the Current Scenario of Unsecured Credit for Banks?

- Unsecured credit, excluding microfinance institutions, for large banks is only about 5-13% of their total loans. Further, loans extended to **NBFCs constitute another 5-12% for banks.**
- According to analysts' estimates, the share of the total impacted book, which is NBFC and unsecured loans, is the **lowest for IndusInd Bank at 10%**, and ranges from 15 to 20% for other major banks.
- Among NBFCs, the most affected would be SBI Cards, as **100% of the loans are unsecured.**
    - The next would be Bajaj Finance as unsecured loans form 38% of the total loan, followed by Aditya Birla Capital with a 20% exposure in unsecured consumer loans.

What will the Implications of this Move on Banks and NBFCs?

- **Impact on Borrowing Costs:**
    - It can cause a rise in lending rates for consumers due to these regulatory changes.
    - This increase in lending rates by banks to non-banking financial institutions might also **affect corporate bonds,** leading to higher yields and widening credit spreads for these institutions.
- **Can Address Systemic Risks Associated with Such Lending:**
    - The higher capital requirements are expected to moderate the growth of unsecured loans and potentially **address systemic risks associated** with such lending.

Way Forward

- Banks and NBFCs may need to reassess their risk models and lending practices for unsecured loans.
- They might focus more on creditworthiness assessments and consider alternative strategies to manage risk while continuing to lend.
- Financial institutions might diversify their loan portfolios by shifting focus to more secured lending or exploring other creditworthy segments to balance the impact of increased risk-weighting on unsecured loans.

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