Risk Weightage Change to Impact Private Banks Most, SFBs the Least

December 15, 2023 | Ratings

Summary

On November 16, 2023, RBI, through its notification '**Regulatory measures towards consumer credit and bank credit to NBFCs**' announced the increase in Risk Weights assigned to consumer credit (excluding specific asset classes), credit card receivables and NBFCs exposures of the banks. This will have an impact on the capital adequacy of the entire banking sector.

CareEdge Ratings estimates that the impact of the regulations on the overall capital adequacy of the banking sector is likely to be moderate in the range of 30-70 bps for the public sector banks and 30-100 bps for private sector banks given the relatively higher exposure to unsecured personal loans (please refer to Strong Signal by Regulator to Control Unsecured Personal Loans).

This is in addition to the additional capital requirements for the banks under the proposed change from accounting for losses under IRAC norms to the ECL method (please refer to Proposed ECL Framework Likely to Have Moderate Impact on Banks).

The impact on small finance banks, which are mandated to have at least 75% of their loans disbursed under priority sector lending, is expected to be lower in the range of 10-50 bps, as their exposure to consumer credit is relatively lower.

CareEdge Ratings expects that out of the total NBFC exposure of the banks worth ₹13.42 lakh crore as on March 31, 2023, approximately ₹7.5 lakh crore will get repriced. The overall cost of borrowing for NBFCs would go up as banks will seek to pass on the cost (of additional capital) to NBFCs, especially on the higher rated ones (Rating of A category and above), exposure to whom will attract a higher risk weight now. With this, RBI is looking to regulate the credit extended towards NBFCs by the banks, which has seen an aggressive growth over the past couple of years. According to RBI's press release on Sectoral Deployment of Bank Credit, NBFC exposure of the banks has grown by twice the growth of overall bank credit in FY23.

According to the regulations:

1. The exposures of banks under the personal loans segment (existing as well as fresh) will now attract the risk weight of 125% as against 100% currently. This will include the credit card receivables of the bank but exclude home loans, vehicle loans, education loans, and loans against gold. All consumer loans except for credit cards will now have risk weights of 125% from 100% earlier, while credit cards will now attract 150% risk weights from 125% earlier.

2. Currently, the risk weights attached to the NBFC exposures are based on the external rating of the NBFCs. As per regulations, the risk weights attached to loans given to NBFCs will now be increased by 25 percentage points over and above the current risk weights. This applies only to the NBFC loans for which risk weights are less than 100% currently. However, loans to Housing Finance Companies (HFCs) and NBFCs categorized under the priority sector are excluded from the above regulations.

The guidelines come on the back of rising concerns about aggressive growth in certain asset classes under personal loans including unsecured loans over the last couple of years. The increase in risk-weighted assets of the bank will cause the capital adequacy ratios to drop and henceforth, the banks will have to set aside more capital to comply with the minimum regulatory requirements pertaining to capital adequacy. The public sector banks and private sector banks are required to maintain a minimum CAR of 11.5% while for Small Finance Banks the requirement stands higher at 15%.

The RBI's move is aimed at calibrating the aggressive growth witnessed in the unsecured personal loans, credit card receivables and loans given to NBFCs. The latest regulations address the general concerns regarding the possible deterioration in the asset quality of these loans given the aggressive growth. Expectedly, interest rates are likely to rise from here on as the banks will seek to compensate for the higher capital adequacy required to be maintained. CareEdge expects that the overall cost of borrowing from banks for NBFCs will go up. As on March 31, 2023, the total exposure of banks to NBFCs stood at ₹13.42 lakh crore. Of this total exposure, ₹6,00,000 crore for PSU Banks and around ₹1,50,000 crore for private banks will see an increase in risk weights as per CareEdge Ratings estimates.

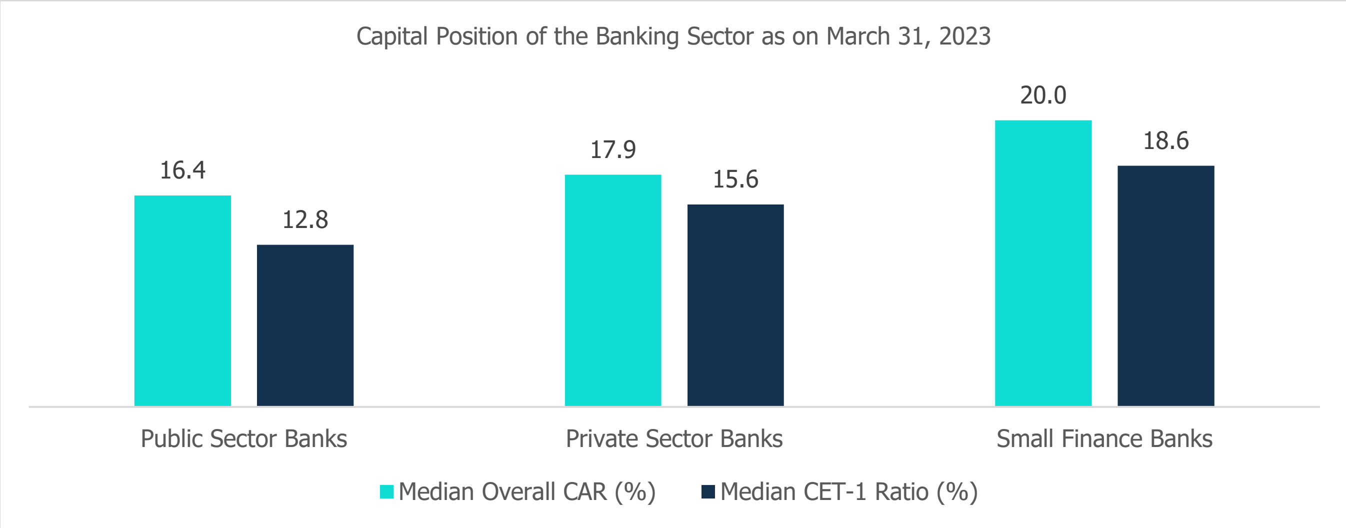
Due to a rise in the cost of borrowings from the banks, NBFCs are likely to tap the bond markets to diversify their funding requirements. As per RBI's Financial Stability Report, June 2023, bank borrowings constituted 41.2% of NBFC's total borrowings (excluding core investment companies). This is expected to come down as NBFCs, especially the higher-rated ones, will now resort to other resource markets as a result of costlier bank borrowings to optimise costs. NBFCs might also look towards securitization markets for additional funding requirements. Lower rated NBFCs may approach bond markets as well but the investors will differ amongst family offices, credit funds, AIFs and HNIs. The NBFCs bond spread over G-Sec is likely to get impacted due to the same.

Risk Weight Change: Private sector Banks impacted the most while SFBs impacted the least

CareEdge estimates that the impact of the regulations on the overall capital adequacy of the banking sector is likely to be moderate in the range of 30-70 bps for the public sector banks and 30-100 bps for private sector banks given their relatively higher exposure to unsecured personal loans. The impact on small finance banks, which are mandated to have at least 75% of their loans disbursed under priority sector lending, is expected to be lower in the range of 10-50 bps.

Banks are well capitalized to absorb impact of the increase in risk weight

Over the last few years, the capitalisation levels of banks have improved due to capital raise and improvement in profitability. Private sector banks raised equity capital in anticipation of expected losses during Covid-19 and were supported with internal accruals while the public sector banks saw infusion by the Government of India (GoI) as well as equity capital raise from capital markets (through QIP) apart from accretion of profits.



Tier-1 Ratio (%) is used in place of CET-1 Ratio (%) for Small Finance Banks
Source: RBI

Conclusion

The minimum CAR required to be maintained as per the RBI regulations is 11.5% for public and private sector banks, while it is 15% for the small finance banks.

The median CAR for public sector banks and private sector banks stood at 16.4% and 17.9% respectively, indicating a buffer of 4.9% and 6.4% respectively over and above the minimum regulatory requirement of 11.5%. The small finance banks also have maintained a buffer of 5% over and above the minimum regulatory requirement for CAR. Therefore, the banks are comfortably capitalised to absorb the one-time impact which arises due to the adjustment in the risk-weighted assets to comply with the above regulation in addition to the impact arising due to the shift towards ECL-based provisioning.

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