Money & Banking

Risks in India's banking sector may rise, says Fitch Ratings

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Risks in India's banking sector may rise as a result of the central bank's recent steps encouraging banks to lend more to Non-Bank Financial Institutions (NBFIs) and retail borrowers, according to Fitch Ratings.

These initiatives -- an increase in the single-exposure limit to 20 per cent of Tier 1 capital (from 15 per cent); priority lending status for credit to NBFIs for on-lending to finance agriculture, small businesses and home-buyers; and a reduction in the risk weight for consumer loans (except credit cards) to 100 per cent (from 125 per cent) -- are designed to help keep credit flowing to the real economy amid signs of a slowdown.

This follows several other initiatives in recent months to boost lending, including harmonising risk weights on NBFI exposure, allowing banks to raise additional liquidity by selling excess government securities, and a partial credit guarantee from the government on banks' asset purchases from NBFIs.

The global credit rating agency said averting a significant slowdown would help borrowers and therefore the stability of the financial system, but the measures could push up banking-sector risk if they lead banks to accept higher credit risk than they previously had appetite for.

Fitch observed that India's constant nudging of banks to lend more to NBFIs is in contrast to the global trend of authorities trying to break the linkages between banks and NBFIs.

"India's overarching approach across the financial system is aimed at achieving a more inclusive financial system in which bank savings can support lending to parts of the economy that are beyond the banks' distribution network or risk appetite.

"However, it increases the potential of risks in the NBFI sector spilling over to banks, exacerbated by the limited capacity of India's capital markets to provide extra funding to NBFIs," the agency said in a statement.

The agency underscored that NBFI sector, historically an important provider of consumer loans in India, is under significant funding pressure as investors shy away following the default of Infrastructure Leasing & Financial Services in 2018 and Dewan Housing this year.

"NBFI disbursements have declined steeply as a result, with knock-on effects to other sectors, particularly consumption. Reduced availability of financing has contributed to the slowdown in India's auto sector, with vehicle sales in July falling 31 per cent year-on-year, according to the Society of Indian Automobile Manufacturers," it said.

Only strong NBFIs to benefit

Fitch felt that some of the pressure on NBFIs will be alleviated if banks now start to direct more funding to the sector, but it expects most of the benefit will go only to the strongest NBFIs. Most banks will be reluctant to lend to weaker NBFIs as they are focused on conserving their limited capital while grappling with legacy bad loans and a new wave of deteriorating asset quality.

The agency assessed that the reduction in the risk weight for consumer loans will give a small boost to banks' regulatory capital ratios (an estimated 1.3pp on average). This will enable banks to lend slightly more for each unit of capital, which would be positive for loan growth but negative for their overall credit profile if the extra lending is riskier than average.

The increase in the single-exposure limit is likely to have a more significant effect on lending as it will allow some banks to lend significantly more to NBFIs. The agency said large NBFIs, whose bank funding previously came from a handful of large banks, will be able to get additional funding from these and other banks as a result of the higher limit.

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COMMENTS