Unsecured Lending: Opportunity for Growth or Looming Risk?

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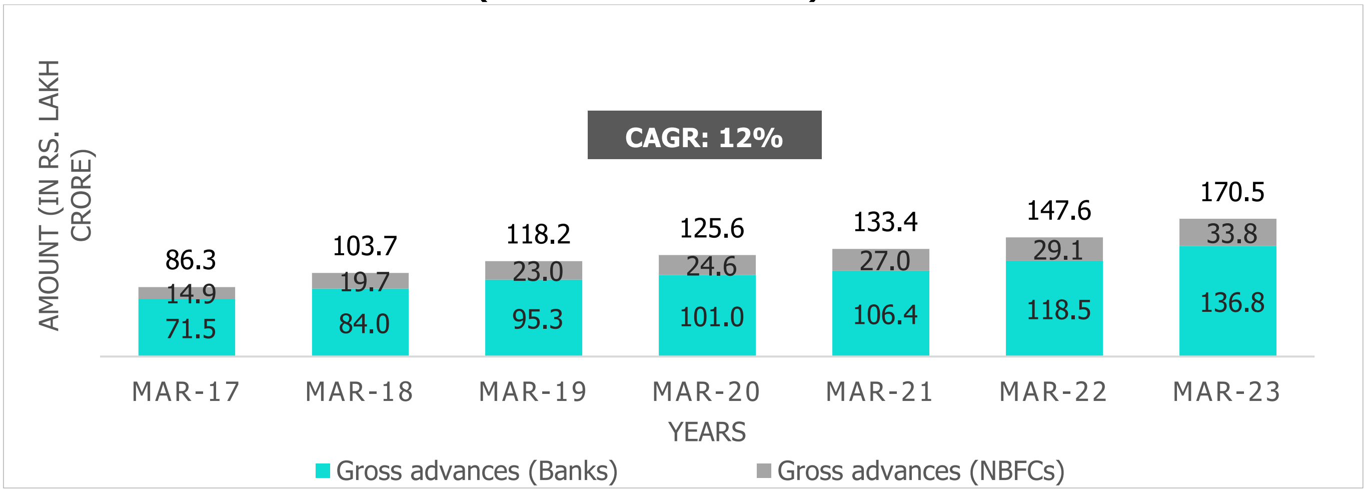
Synopsis

- During the fiscal years 2017 to 2023, personal loan credit experienced robust growth of almost 1.5 times the overall credit growth observed in both Banks and Non-Banking Financial Companies (NBFCs). Within personal credit (which typically signifies consumption loans), unsecured personal loans outpaced the overall expansion of the personal loan book and constitute nearly one-third of the total personal loan segment loans. This trend has been further facilitated by the advent of Fintech and Digital channels, contributing to increased origination volumes. The emphasis on smaller ticket-size loans by NBFCs has been a significant driver of volume growth in the unsecured personal loan segment.
- High growth in unsecured personal loans is driven by a multitude of factors with some of these factors being structural in nature, and hence, going forward, a relatively higher growth rate is likely to continue. However, the recent RBI notification, aimed at deterring high consumer credit growth, is expected to impact the momentum in growth in the immediate to near term.
- Although the asset quality has remained stable, there is a need for vigilant monitoring, particularly on small ticket size loans; furthermore, given that each player focuses on specific sub-segments, this may lead to divergent credit cost trends in the unsecured retail portfolio of these players.

Personal Credit Growing at 1.5X Overall Credit

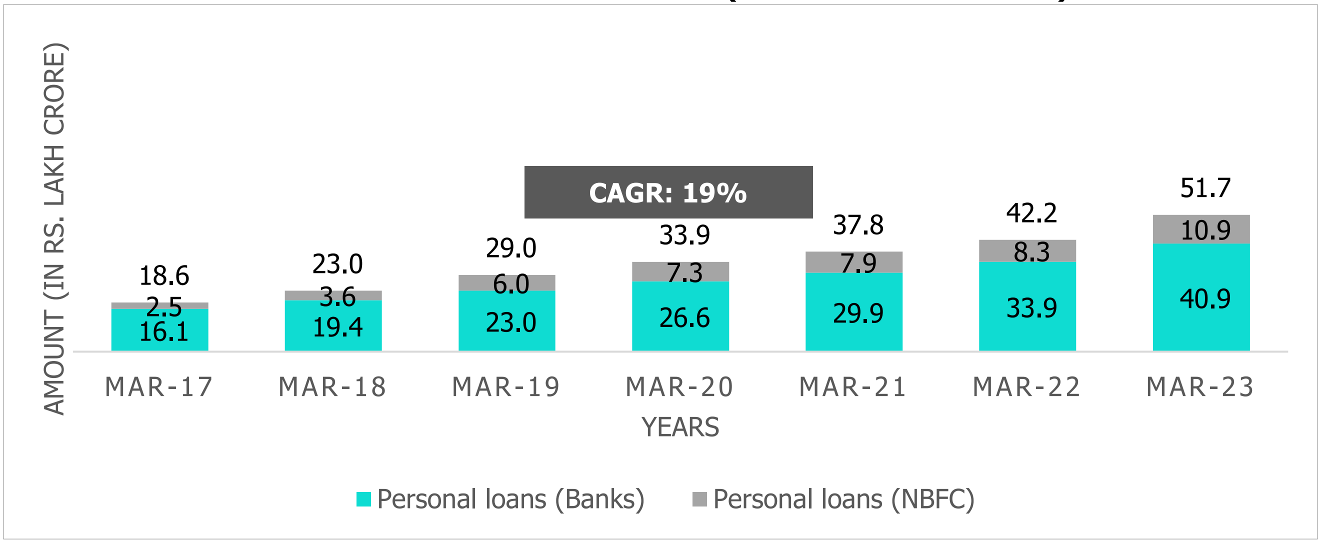
The overall credit combined for Banks and NBFCs saw a CAGR of 12% during FY17 to FY23 and stood at Rs.170.5 lakh crore as of Mar'23. During the same period, the personal loan book (including all retail for NBFCs) growth stood higher with a CAGR of 19%. In absolute terms, personal loan credit by banks and NBFCs has almost tripled in the past six years and stood at Rs.51.7 lakh crore forming 30.3% of the overall loan book as of March 31, 2023, as against Rs. 18.6 lakh crore or 21.5% of the overall loan book as on March 31, 2017. Thus, the rate of growth of personal loan books (which typically signifies consumption loans) is almost double of the rest of the banking sector lending (business lending)

Chart 1: Overall Credit Market Size (Credit of Banks+ NBFCs)



Source: Financial Stability Report: RBI

Chart 2: Overall Credit Market Size for Personal Loans (Credit of Banks+ NBFCs)

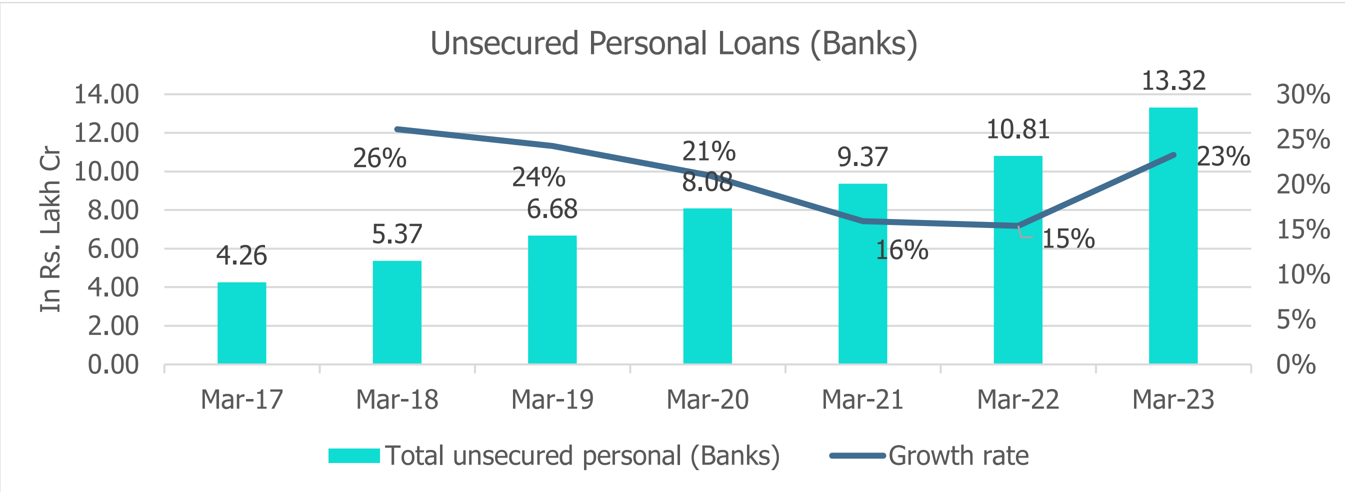


Source: Financial Stability Report: RBI

Unsecured Personal Loan Growth Outpacing Overall Retail Loan Growth

The growth of unsecured personal loans (including Credit card receivables, Consumer durable loans and Other personal loans) in banks from March 2017 to March 2023 stood at CAGR – 21.0 % outpacing the personal loan growth which exhibited a CAGR of 19% during the same period. Unsecured personal loans account for almost 1/3rd of overall bank's personal loan credit of ~Rs. 41 lakh crores as of March 31, 2023.

Chart 3: Unsecured Personal Loan (Banks)



Source: RBI

Several factors have contributed to the substantial increase in the demand for unsecured personal loans, encompassing demographic shifts, the formalization of the economy, elevated purchasing power, the evolution and prominence of FinTechs, widespread access to the Internet/broadband and feature phones, the adoption of digital payment systems, the influence of India stack and information collateral, and broader coverage of credit bureaus, etc.

The convergence of technology and finance has reshaped the lending landscape in India, making personal loans more accessible and convenient for a larger segment of the population, thereby contributing to the growth of the personal loan market. Furthermore, with higher coverage from credit bureau & availability of such data, the credit engines of the lenders are expected to work more efficiently and utilise machine learning to improve the credit performance of the pools so originated.

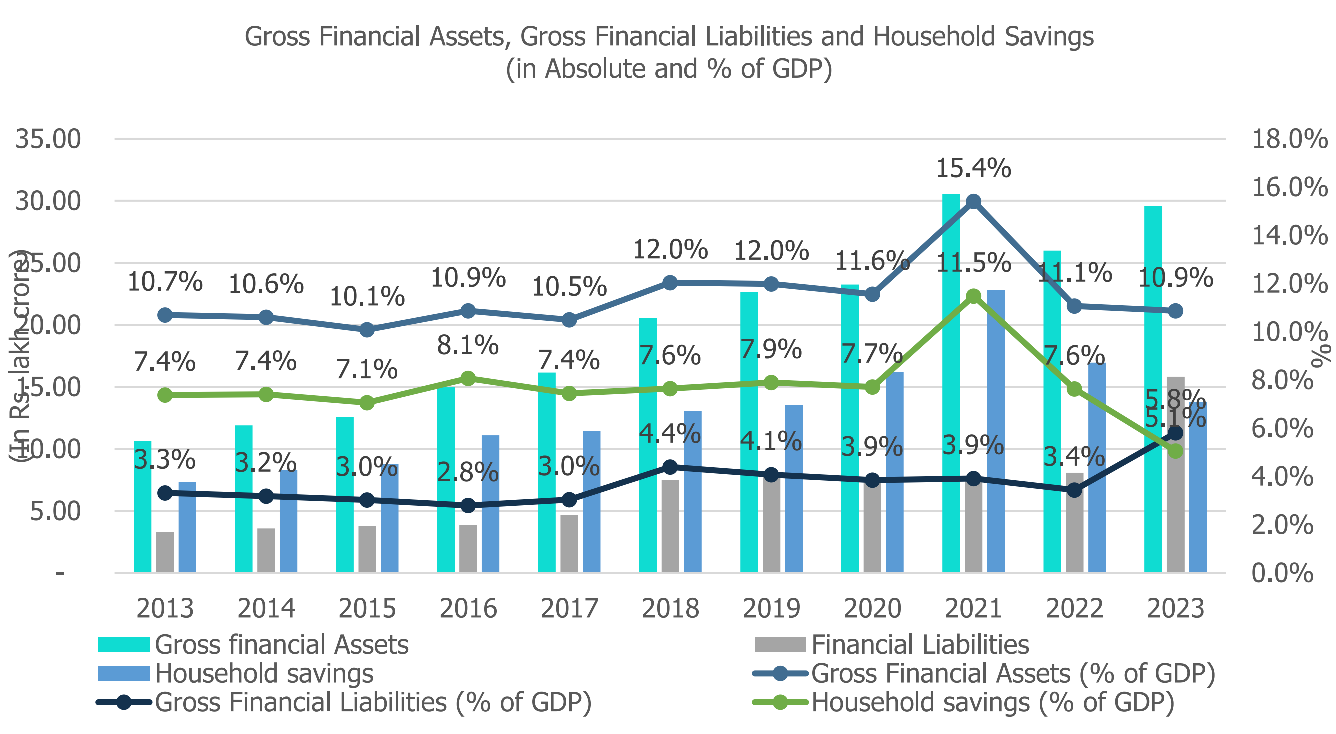
The transformation in consumer behaviour has emerged as a pivotal driver behind the upsurge in loan unsecured personal loan demand, particularly within consumption-driven growth patterns. Notably, a perceptible shift in mindset is particularly evident among the younger demographic, who now embraces the idea of borrowing for consumption, contrasting significantly with perspectives from the past decade. The significant evolution in loan processes, greatly influenced by the digital infrastructure, has significantly enhanced flexibility and convenience for consumers, especially the younger demographic. This evolution stands as a key facilitator in the consumption-driven growth witnessed today.

Further, the lending landscape has experienced a transformation, not just because of the change in the borrower mindset but also the mindset of the lenders. Over the past decade, a cultural shift has reshaped lifestyles in India, witnessing increased digital spending through payment systems, thereby generating a wealth of data. This influx of data has empowered lenders to craft robust scorecards based on customer behaviour, ultimately revolutionizing credit perspectives within the lending industry. Notably, data from sources like CIBIL, Aadhar, and Jan Dhan have substantially contributed to the development of a digitally enriched infrastructure, leading to a transition from manual paperwork to digital scorecards across the industry. Leveraging data analytics has facilitated effectively meeting the existing supply and demand for credit. The ongoing refinement of scorecards has become imperative to sustain a competitive edge.

Despite some concerns about the high growth rate, leveraging technology and employing the people with the right expertise has played a pivotal role in managing associated risks effectively. Regulatory measures such as the Digital Lending Guidelines and the Privacy Bill have strengthened the customer confidence and have provided a clear framework for all stakeholders in the market. The entire industry has undergone substantial evolution, marked by increased regulatory clarity, transforming it into a more mature and stable market.

In summary, the convergence of technology and finance has reshaped the lending landscape in India, making personal loans more accessible and convenient for a larger segment of the population, thereby contributing to the growth of the personal loan market. Further, the processes throughout the loan life cycle are greatly influenced by the digital infrastructure, which in turn significantly enhances flexibility and convenience for consumers. Moreover, given the expanded coverage by credit bureaus and the accessibility of relevant data, the credit engines of the lenders are expected to work more efficiently and utilise machine learning to improve the credit performance of the pools so originated. This, in turn, is expected to facilitate the consumption-driven growth. However, the same has led to an increase in overall household financial liabilities. As per the latest report on household savings by RBI, Household savings in India hit a 47-year low at 5.1% of GDP in FY23. This was mainly on account of the increase in household financial liabilities indicating that people are becoming more dependent on borrowing to cover their consumption demands.

Chart 4: Household Savings in India as a % of GDP



Source: RBI data

The decline in household savings was witnessed especially post FY21 with pent-up demand post covid period leading to higher consumption. Further borrowings would have gone up probably as a result of the difficulties brought on by rising inflation. However, high household debt need not necessarily be a worry if there is adequate income to back, but a rising share of loans by people with weak earning profiles could lead to loan repayment problems in the unsecured retail lending segment which has been highlighted by RBI as well.

Key Trends in the Unsecured Personal Loan Segment

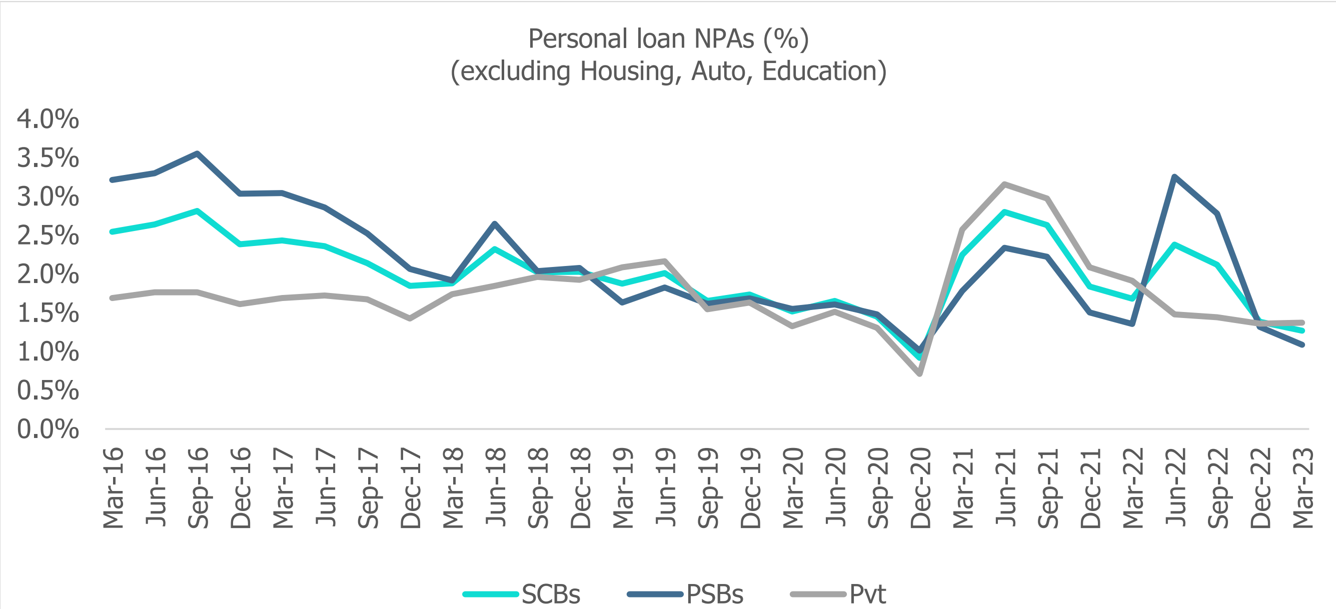
The borrower count has exhibited a pronounced rebound, experiencing a notable increase across various lender segments following a decline in the first year of the Covid-19 pandemic, with the majority of incremental volumes originating from NBFCs. The volume share of Non-Banking Financial Companies (NBFCs) has consistently risen, particularly in the post-Covid period, witnessing a significant upsurge in loan originations by volume. The advent of Fintechs targeting a younger demographic and individuals new to credit has resulted in the origination of low ticket-size loans, consequently contributing to a consistent decrease in the average ticket size of NBFC loans. Loans with a ticket size below Rs. 1 lakh constituted over 85% of loan originations by volume in FY23. Loans with ticket size below Rs. 50,000 hold the majority share in origination volume, witnessing a more than two-fold increase in origination value in this segment over the last two fiscals that ended March 2023.

However, it may be noted that despite the lower share of originations volume, originations value share is dominated by Banks owing to the higher ticket size loans catered to by them. Private sector banks have also witnessed a decline in average ticket size over the years similar to the trend witnessed in NBFCs. On the other hand, it's pertinent to note that the PSBs have witnessed growth in average origination ticket size during the same period. PSU Banks continue to lead in terms of originated loan value share.

Unsecured Retail Asset Quality Remains Robust

Lending to any category of asset comes with inherent risks in the form of asset quality. The percentage of retail non-performing assets (NPAs) excluding secured asset classes of housing, auto as well and education for both Public and Private sector banks have shown a gradual decline in the percentage of NPAs over time. Further, the percentage of below-prime borrowers (bureau score of less than 730) across the lender categories has been declining over the past 3 years. This suggests that efforts are being undertaken by the lenders to manage risk and the overall financial landscape is moving towards healthier lending practices.

Chart 5: Asset Quality Personal Unsecured - Trend (Banks)

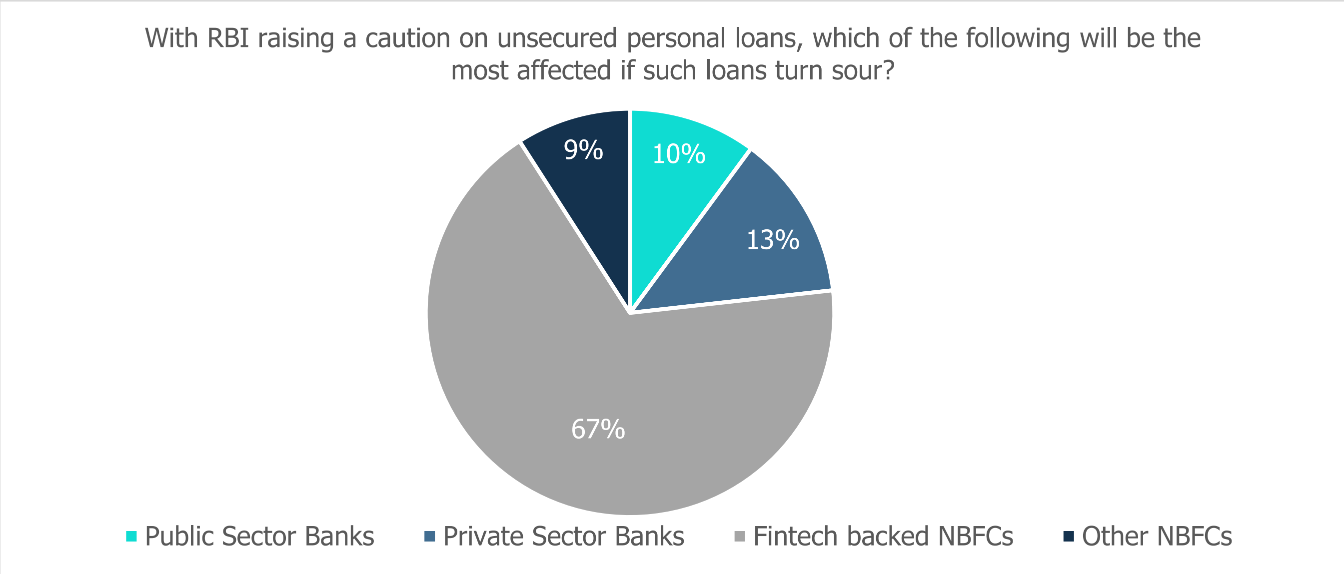


Source: RBI data

The Special Mention Account categories (SMA), i.e., SMA 0, SMA1 and SMA 2, of public sector banks stood higher with an SMA of 9.9% in unsecured personal advances as compared to 4.0% for private banks for unsecured retail loans category as on March 31, 2023. At an aggregate level, banks have ~7% of their unsecured retail loans in the SMA-0, 1 and 2 categories. Interestingly, even the SMA share of secured retail advances also lies in the range of 7% as of March 31, 2023.

Fintech NBFCs Most Vulnerable in Unsecured Personal Loans, CareEdge Ratings' Poll Reveals

CareEdge Ratings conducted a poll assessing the potential impact on various lender categories in the event of unsecured personal loans turning sour. According to the responses, Fintech NBFCs emerge as the most susceptible, with private sector banks, public sector banks, and other NBFCs following in decreasing order of potential impact. This underscores the need for a vigilant approach to risk management, especially for Fintech NBFCs, in navigating the challenges associated with the unsecured personal loan segment.



Strong signals from the Reserve Bank of India (RBI) could act as a deterrent to the growth of unsecured personal loans, potentially causing a partial slowdown in the immediate to near term. The impact on NBFCs is expected to be twofold:

The RBI's directive to increase risk weights by 25% for advances to AAA to A-rated Non-Banking Financial Companies (NBFCs) is likely to prompt banks to adjust loan pricing. This adjustment is intended to partially cover the increased capital buffers mandated by the RBI, potentially leading to a moderation in the momentum of bank lending to NBFCs not covered by Priority Sector Lending (PSL) guidelines, especially affecting entities rated A- and above.

Additionally, RBI has raised the risk weights on NBFCs' unsecured personal loan exposure by 25%. This adjustment is expected to impact the capital buffers of NBFCs. Consequently, there may be a slowdown in lending. Despite the anticipated rise in lending costs, mid and smaller-sized NBFCs are likely to have a high reliance on the banking sector for funding. CareEdge Ratings expects this situation to result in a greater-than-normal increase in funding through securitization and co-lending partnerships, serving as alternative sources of liability for NBFCs.

Outlook

Supported by a multitude of factors, some of which have led to structural changes, the growth trajectory of the Unsecured personal loan segment, particularly in the small ticket size category, with an increasing number of lenders embracing technology for loan origination. Stakeholders are progressively recognizing the importance of enhancing credit quality by avoiding the adverse selection of customers and refining collection practices. Further, regulatory clarity on essential aspects such as the business model, default loss guarantee (DLG), disclosure norms, KYC norms, and fair practices are anticipated to draw more participants and capital into the segment. Achieving attractive returns for equity capital providers will depend largely on managing credit costs and operational expenses. However, with RBI's move, aimed at deterring consumer credit growth, is expected to impact the momentum in growth in the immediate to near term.

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