JM FINANCIAL

Indian Banking Sector

A positive retreat on risk weights by the RBI

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The RBI came out with two notifications yesterday, (a) microfinance loans in the nature of consumer credit (not qualifying for regulatory retail) shall be risk weighted at 100%, (b) risk weights applicable to NBFCs rated A and above restored to pre-16th Nov'23 levels, again, cutting risk weights by 25ppts, on the book. This benefits the banks with NBFC and MFI exposure, freeing up capital for growth. Following the increased risk weights on NBFC exposure, banking credit growth to NBFCs had reduced from 22.1% YoY in Oct'23 to 6.6% YoY by Dec'24. This is likely to normalise hereon. Further, we had previously estimated the borrowing cost impact of these regulations to be 10-20bps on NBFCs, and expect the same to reverse. Amongst NBFCs, postive impact on cost of borrowings is expected to be under 0.1%, with Five-Star Business Finance and L&T Finance expected to see highest improvement. In our coverage, Bandhan Bank, Ujjivan SFB and Equitas SFB would be most benefited and should see their Tier-I capital increase by 1.7%, 5.5% and 1.0%, respectively, as a result of these notifications.

- **Context:** In his statement following the 6th Oct'23 MPC meeting, the RBI Governor had flagged high growth in components of consumer credit and advised banks and NBFCs to address the build-up of risks. Subsequently, on 16th Nov'23, the RBI issued notifications to,

  - Raise the risk weights in respect of consumer credit exposure of commercial banks and including personal loans, but excluding housing loans, education loans, vehicle loans and loans secured by gold and gold jewellery, by 25ppts to 125%. The weight on non-consumer credit exposure (qualifying for regulatory retail portfolio) was not changed.

  - Raise the risk weights applicable to NBFCs where the risk weight as per external rating of NBFCs was below 100% (NBFCs rated A and above) by 25ppts.

- **Change and impact of microfinance exposures:** Microfinance loans in the nature of consumer credit shall be subject to a risk weight of 100%. Further, no change in risk weight for microfinance loans which are not in the nature of consumer credit – they may be classified under RRP (Regulatory Retail Portfolio), and hence, carry 75% risk weight, if the banks put in place appropriate policies and standard operating procedures to ensure fulfilment of the qualifying criteria.

  - **Impact on banks:** This frees up capital for growth. With a 25% reduction in risk weights for MFI exposures, positive impact on Tier-1 capital (%) for banks is estimated in Exhibit 3.

  - **Impact on NBFCs:** In the 16th Nov'23 notification, the RBI had excluded microfinance/SHG loans of NBFCs while raising the risk weights to 125%. Hence, risk weights on MFI exposure of NBFCs remained untouched.

- **Change and impact of NBFC exposures:** The risk weights for NBFCs rated A and above are restored to pre-16th Nov'23 levels, hence, reduced by 25ppts.

  - **Impact on banks:** Following the increased risk weights on NBFC exposure, banking credit growth to NBFCs had reduced from 22.1% YoY in Oct'23 to 6.6% YoY by Dec'24. This is likely to normalise going ahead.

  - **Impact on NBFCs:** Amongst NBFCs, benefit on blended on cost of borrowings is expected to be under 0.1%, with Five-Star Business Finance and L&T Finance expected to see highest improvement (tabulated in Exhibit 2).

- **Bandhan Bank and Ujjivan SFB to benefit the most:** Benefit to banks under coverage is tabulated in Exhibit 3. Ujjivan SFB, Bandhan Bank and Equitas SFB will be most positively impacted. We estimate Tier- I capital for Bandhan Bank to rise by 1.7% to 15.5% while Ujjivan and Equitas SFB should see their Tier- I capital rise by 5.5% and 1.0%, respectively.

- View: The reversal of increased risk weights for NBFCs is a positive for sector growth. Similarly, clarity on risk weights for MFI exposure for banks releases capital for growth. We refrain from concluding that the RBI is now satisfied with credit discipline in these segments. However, this would be sentimentally positive for the MFI segment. Basis the impact of these regulations, Bandhan Bank and Ujjivan Small Finance Bank would be most benefited. Amongst NBFCs, positive impact on cost of borrowings is expected to be under 0.1%, with Five-Star Business Finance and L&T Finance expected to see highest improvement.

Exhibit 1. Risk weights corresponding to external credit ratings of NBFCs

External credit rating	Risk weights
AAA	20%
AA	30%
A	50%
BBB	100%
BB & below	150%
Unrated	100%

Source: Industry, JM Financial

Exhibit 2. Impact of a 15bps impact on cost of bank borrowings

	Bank Term Loans (as a % of total borrowings)	CoF Impact (bps)*
Bajaj Finance	29%	4.4
Poonawalla Fincorp	43%	6.5
L&T Finance	54%	8.1
Aditya Birla Finance	51%	7.7
Cholamandalam Inv & Fin Co.	46%	6.9
Piramal	47%	7.1
Shriram Finance	21%	3.2
Five-Star	56%	8.4

Source: Company, JM Financial

*assuming 15bps impact on cost of bank borrowings

Exhibit 3. Expect Bandhan Bank and SFBs to gain the most in Tier- I capital

Banks	NBFC exposure	MFI exp	NBFC+MFI (% of Loans)	Tier- I Capital, %	% Gain in Tier -I
HDFC Bank	5.9%	1.0%	6.9%	18.0%	0.3%
Axis Bank	4.8%	1.3%	6.1%	15.0%	0.2%
ICICI Bank	6.1%	NA	6.1%	15.9%	0.2%
KMB	5.5%	2.0%	7.5%	22.5%	0.3%
IndusInd Bank	5.8%	8.9%	14.6%	15.2%	0.5%
Bandhan Bank	**10.9%**	**42.5%**	**53.4%**	**13.7%**	**1.7%**
SBI	17.7%	0.3%	18.0%	11.3%	0.1%
BOB	13.0%	0.5%	13.5%	13.4%	0.7%
Canara Bank	15.2%	0.0%	15.3%	14.6%	0.8%
PNB	10.7%	NA	10.7%	10.7%	0.4%
AU SFB	3.2%	6.6%	9.8%	16.9%	0.6%
Equitas SFB	**2.8%**	**14.4%**	**17.2%**	**17.5%**	**1.0%**
Ujjivan SFB	**6.7%**	**59.4%**	**66.1%**	**22.1%**	**5.5%**

Source: Company, JM Financial *assuming 90% of NBFC exposure is A and above

APPENDIX I

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* REITs refers to Real Estate Investment Trusts.

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