



TM

## India Economy & Strategy

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### INDIA ECONOMY

#### RBI confounded in its incrementalism maze!!

The RBI's latest move to relax the risk weightage of bank lending to NBFC and microfinance companies (MFIs) by revoking the Nov'23 order does not come as a surprise. In its last monetary policy announcement, the RBI hinted at easing the regulatory stringency that has built up since 2023, as the central bank saw the cost of regulation outweighing the objectives of efficiency.

In the latest order, effective April 1<sup>st</sup>, the risk weights for banks on lending to NBFCs and MFIs will be restored to the pre-Nov '23 situation. Banks can now revert to weight determined as per the ratings assigned by accredited external credit assessment institutions (ECAI). In Nov'23, given the exuberant retail lending, accentuated by aggressive lending to NBFCs and MFIs, RBI had sought to tighten the norm by increasing the risk weight by 25% for lending to such entities assigned based on the external risk assessment.

The relaxation is a fallout from the latest RBI's assessment, as communicated in the post-policy Q&A that the purpose of the earlier tightening has lived its merit and the desired tapering in credit excesses has been achieved.

Growth in bank lending to NBFCs has slowed from 19% to 6.7% in Dec'24. However, for NBFCs excluding housing finance companies, constituting 80% of NBFC lending, the slowdown has been more severe; from 30% to 9.3%.

Consequently, credit growth of NBFCs (excluding HFCs, and core investment companies) slowed down to 16.0% in 2QFY25 from 22.1% a year ago, due to the high base effect and the increased risk weight for consumer lending prescribed by the Nov'23 circular (RBI Stability Report, Dec'24). Likewise lending growth of MFIs has slowed to 21.8% in Dec'24 from 29% in Sep'23.

Thus, the latest easing comes as a respite for NBFCs and MFIs as it would increase their access to bank lending.

However, some pertinent questions need to be addressed.

The Nov'23 notification included other components as well, viz higher risk weights for consumer credit exposure of banks, and NBFCs along with tightening sub-sector credit limits on various types of retail lending, including top-up loans. Why is the relaxation restricted to bank lending to NBFCs and MFIs? Will the latest easing be extended to other components as well? Is the central bank satisfied with the track record of the retail credit cost cycle?

It is difficult to surmise RBI's intent. Purportedly, the objective is to resurrect growth backed by leverage spending resurgence. But the most proximate reason appears to be the renewed sharp weakening of the rupee against the US dollar to 87 levels and the prospects of further weakening.

Bank credit tightening due to increased risk weightage prompted NBFCs to rely on external commercial borrowings (ECBs), in anticipation of easing US rates and were encouraged by RBI's currency inflexibility.

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ECBs by finance companies rose to a nine-month average of USD 2bn, 129% higher than the Nov'23 levels; the number of average issuances also doubled to 18. Importantly, there has been a reduction in average maturity to 4 years from 5 years at the onset of the COVID crisis, along with the possibility of a third of ECBs now funding rollovers.

Things have rapidly changed over recent months with the accelerated rupee depreciation. The rising debt servicing burden on ECBs has impacted the margins of finance companies even as the AUM growth slowed, thereby impacting their return ratios and valuations. Relative to Sep'23 the NIMs of NBFCs have fallen by 50-100bp by Dec'24.

Given the recent sharp depreciation in rupee, the situation may have further worsened, thereby making it imperative for NBFCs to switch back to rupee borrowings from Indian banks. But with the higher risk weights, this option may also have been stifling. Thus, the possibility of tightening funding costs may have compelled RBI to relax the NBFC exposure limit for banks.

But will this help? Given the lagging bank deposit growth and credit-deposit ratio at a historical peak of 80.4%, the switch from ECB lending to domestic lending by NBFCs has tightened the liquidity scenario further. A reduced risk weight on NBFC lending will only incentivize this switch further. The situation gets complicated as it also makes RBI's dollar-selling interventions to defend the rupee counterproductive, as it aggravates the liquidity tightening. Consequently, despite the 25bp rate cut by the RBI to 6.25%, money market rates have retained the hardening bias notwithstanding RBI's liquidity infusion worth INR 3.76tn to balance the market (OMO, bond purchases, USD-INR swap and long-term repo).

Extending the sequence of the newfound admission that regulatory tightness is burdensome, RBI ceding to rate easing demands and the subsequent relaxation of the risk weights for NBFCs and MFIs, there is a fair possibility that the central bank may further relax the stringency. Seen along with the latest proposal to remove pre-payment charges on retail lending, it is increasingly evident that RBI's latest actions, combined with income tax sops, are attempts to shore up leveraged consumption again, particularly in the urban areas that face shrinking income.

However, these are still countercyclical responses to deeper structural growth constraints and are liable to be ineffective; the entire framework is pivoted on the assumption that the concurrent slowdown is temporarily below that perceived potential growth of 7%+. However, multiple variables testify that the potential growth is much lower.

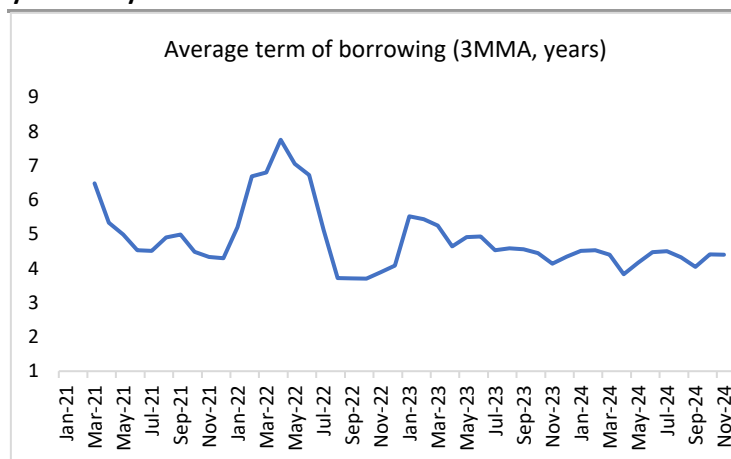
Over the past decade, bank deposit growth has aligned with the decelerating household income and wage growth. Hence, RBI's onboarding accommodative policy rate and regulatory stance along with currency inflexibility are creating incessant friction. Liquidity infusion only addresses the residual imbalances, it does little to address the employment problem. Inducement to shore up retail lending amid declining wages and peak level of household leverage will perpetuate default risk, even as it camouflages the underlying infirmness. And to the extent that monetary accommodation flares up inflation, such attempts can be self-effacing.

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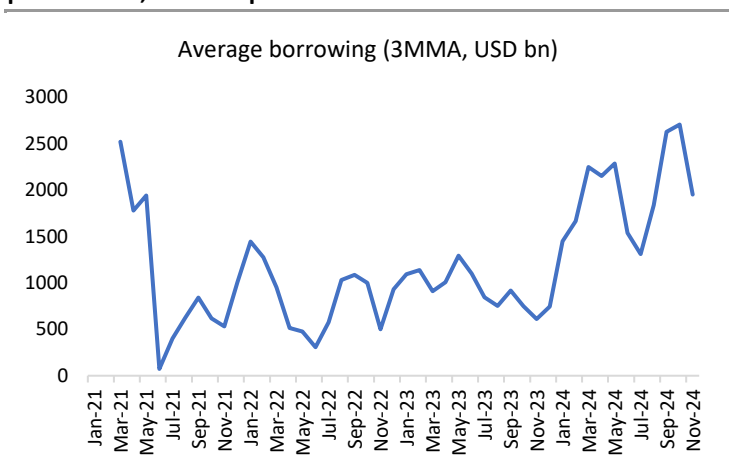
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**Market impact:**

- The fact the bond yield at the short end has remained mostly invariant and long end has hardened indicates that RBI's rate cut, and large liquidity infusion have been ineffective.
- The switch from ECBs to domestic credit by NBFCs and MFIs can increase the demand for funds in the banking system, thereby intensifying the scamper for deposits even further. Their dependence on non-deposit liabilities can rise again. All these will sustain margin pressure for banks along with aggravation of asset-liability mismatch.
- While the reduction in risk weight for bank lending to NBFCs and MFIs would help them from further erosion of margins, banks would stand to lose the opportunity to charge higher lending rates.
- Credit risk on retail lending can get camouflaged and aggravated.
- INR-USD can see quicker depreciation towards our target of 90-92.

**Exhibit 1: Average term of ECB borrowing has reduced from 5 years to 4 years**

Source: RBI, Systematix Research

**Exhibit 2: NBFC's substituted their borrowing from banks to ECB's post Nov'23; this is expected to reverse now**

Source: RBI, Systematix Research

**Exhibit 3: Relative to Sep'23 the NIMs have fallen by 50-100bp by Dec'24 for major NBFCs**

NBFCs	Deviation (2QFY24-3QFY25, ppt)			Deviation (2QFY24-3QFY25, ppt)		
	Yield on net loans	Cost of borrowings	Spreads	Yield on Avg AUM	Cost of Funds	NIMs
Cholamandalam Finance	0.40	0.31	0.09	0.40	0.34	0.06
M&M Finance	-0.07	0.23	-0.30	-0.07	0.25	-0.32
Shriram Finance	0.03	-0.04	0.07	0.02	0.32	-0.30
Sundaram Finance	0.67	0.74	-0.07	0.67	0.46	0.22
Manappuram Finance	0.77	0.73	0.04	0.77	0.98	-0.21
Muthoot Finance	0.97	0.05	0.92	0.97	0.25	0.72
Bajaj Finance	0.08	0.52	-0.44	-0.41	0.14	-0.55
IIFL Finance	-0.88	0.20	-1.08	-0.88	-0.09	-0.13
Aavas	-0.36	0.50	-0.86	-0.49	0.06	-0.55
Aptus	0.30	0.67	-0.36	-0.21	0.52	-0.73
Canfin	-0.02	0.17	-0.19	0.13	0.23	-0.11
Homefirst	-0.13	0.47	-0.60	-0.07	0.85	-0.92
LIC HF	-0.30	0.08	-0.37	-0.31	0.03	-0.34
Bajaj Housing	-0.05	-1.12	1.06	-0.37	-0.18	-0.19
Credit access	-0.38	-0.18	-0.19	-0.02	-0.05	0.03
Fusion	-2.70	0.33	-2.20	-4.32	-0.03	-3.78
Spandana	-1.47	-0.33	-1.15	-2.68	-0.37	-2.31
Ugro	0.00	0.97	-0.97	0.02	0.44	-0.12
Capri	0.28	0.19	0.09	-1.55	0.01	-1.56
<b>Average</b>	<b>-0.15</b>	<b>0.24</b>	<b>-0.34</b>	<b>-0.44</b>	<b>0.22</b>	<b>-0.58</b>

Source: RBI, Systematix Research, calculated figures

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