Rise of Unsecured loans in banking sector

What is the issue?

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Share of unsecured loans are increasing in the economy which can expose banks to sudden risks.

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What is the status of unsecured loans?

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- An unsecured loan is a loan that is issued and supported only by the borrower's creditworthiness, rather than by any type of collateral.
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- According to a Crisil Research, as of March 2018, outstanding unsecured loans stood at about Rs 5 lakh crore.
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- It accounts for 26% of retail lending, compared with 21% three years ago.
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- This is not altogether surprising since Indian banks are increasingly getting affected by wilful defaults on project loans to some of the largest industrial groups.
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- This made them to turn to the borrowers at the other end of the spectrum in the form of retail loans to drive their growth.
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- Thus, unsecured credit card debt and personal loans have become the fastest growing segments for banks in the last three years.
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- It is expanding at a 30-31% annually while overall system credit has increased at just 8-9%.
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- Also, unsecured retail loans, which make up less than 8% of outstanding bank credit, are growing at higher rates than before.

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- This scenario warrant attention from bank risk managers and the regulator.
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What are the concerns?

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- Indian banks have had a bitter experience with indiscriminate retail lending during the previous boom.
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- In the event of defaults, such loans offer negligible prospects for recovery.
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- However, this shift in bank lending has no doubt served a felt need for the economy.
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- In recent years, with a stagnated private capital expenditure, private consumption has been the key engine of India's growth.
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- Given that India is still a lower middle-income country, retail access to credit is imperative to sustain this consumption momentum.
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- Hence, banks too are keen to push unsecured loans because they allow them to showcase strong credit growth while earning a return on assets as high as 3-4%.
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- This has been witnessed with a quantum improvement in the quality of data backing credit card and personal lending in this economic cycle, compared to the previous one which went bust in 2008-09.
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- This is also made possible with the advent of credit bureaus, data repositories on credit history and social media analytics.
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- These technical interventions created the ability for lenders in monitoring their retail borrowers and to extend loans only to prime ones.
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- But there are multiple lenders in the form of universal banks, small finance banks, NBFCs and microfinance institutions catering to the same retail segment.
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- This intense competition will force a dilution of credit standards, leading to poor risk pricing and trigger a race to the bottom.
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What should be done?

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- To avoid this, public sector banks may need to increase the pace of technology adoption and build capacity in alternative credit scoring and data analytics.
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- Acquiring retail exposures indirectly through securitisation or assignment deals with NBFCs or small finance banks is another option.
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- Securitization is a process by which a company clubs its different financial assets/debts to form a consolidated financial instrument which is issued to investors.
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- This enables the firm to raise capital and provide more loans to its customers.
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- In return, the investors in such securities get interest.
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- Traditionally, such niche lenders have managed low credit costs by concentrating in areas where they have last-mile reach.
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- They can also hire local staff there and leverage on local communities to ensure good credit behaviour.
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- But they have still proved vulnerable to liquidity risks and exogenous shocks, suffering a sharp spike in defaults during the economic downturn and demonetisation.
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- Banks must thus be conservative with their exposure limits to unsecured retail loans, no matter how attractive their growth rates or yields may seem right now.
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Source: Business Line

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