Household Debt Stress: Fear in the "good times"*

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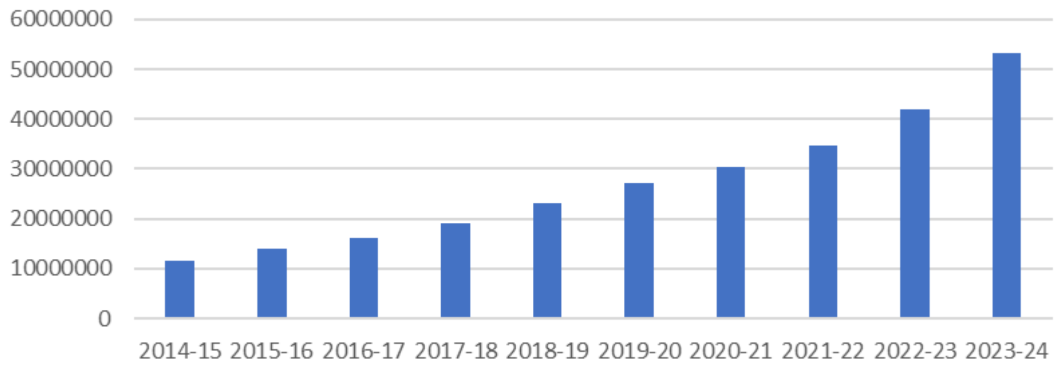
The financial media in India and abroad are flagging the likelihood of a meltdown in India's financial sector, resulting from large scale defaults on personal loans. Even the Financial Times of London has chosen to devote considerable column space to an article focusing on a potential problem in a country that ranks among the globe's fastest growing.

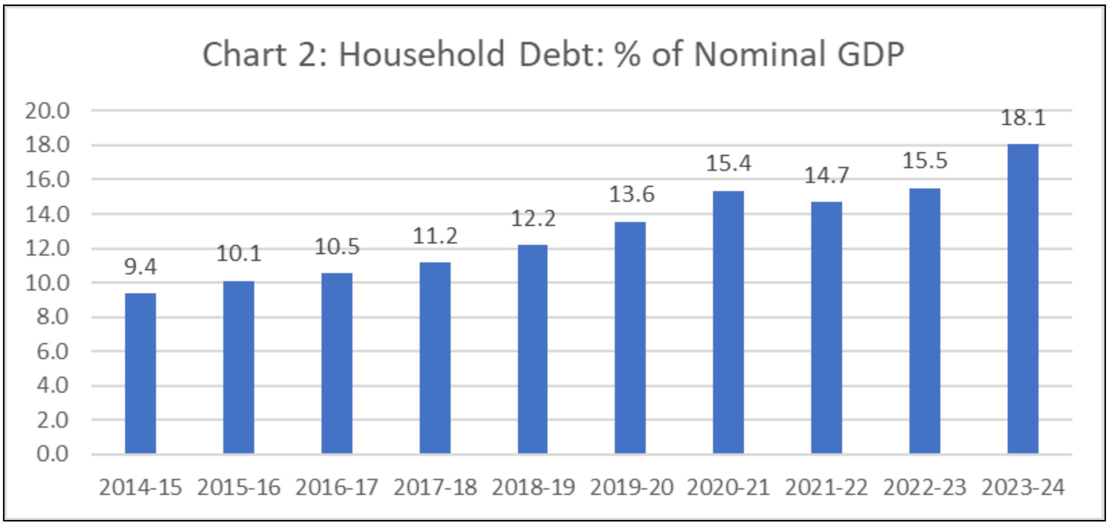
Three developments have triggered this concern. First, a statement from the Governor of the Reserve Bank of India that "excessive" retail lending by Indian banks, "mostly for consumption purposes", needed to be closely scrutinized from a "macro-prudential point of view", or simply put, for likely systemic risks.

The second is a now well-publicised November 2023 decision of the central bank to rein in unsecured retail lending by banks and non-bank financial companies, by raising the risk weight on such loans by 25 percentage points. That decision suggests that the RBI is indeed concerned about the trend in default rates. It would require banks to hold more costly regulatory capital against these loans, so as to discourage such lending. Unsecured loans are those that have no collateral against them. The effort at tightening excludes housing, education and vehicle loans as well as loans secured by gold and gold jewellery.

The third source of concern comes from estimates from private sources that place household debt at levels much higher than the official figures suggest. According to RBI figures, personal loans outstanding or the volume of retail lending (Chart 1) has risen sharply in recent years, and stood at 18.1 per cent of GDP at the end of financial year 2023-24, having risen from half of that level or 9 per cent in 2014 (Chart 2). But a widely-quoted figure estimated by securities trading firm Motilal Oswal places the ratio of household debt to GDP at 40 per cent at the end of March 2024.

Chart 1: Outstanding Retail Loans of Indian Scheduled Commercial Banks (Rs million)





The turn to retail lending by Indian banks began in the middle of the last decade, when they could no longer conceal bad debt advanced to the corporate sector (especially infrastructural projects) that had been restructured through the corporate debt restricting mechanism. New guidelines for recognizing non-performing assets issued by the RBI under Governor Raghuram Rajan put paid to that practice.

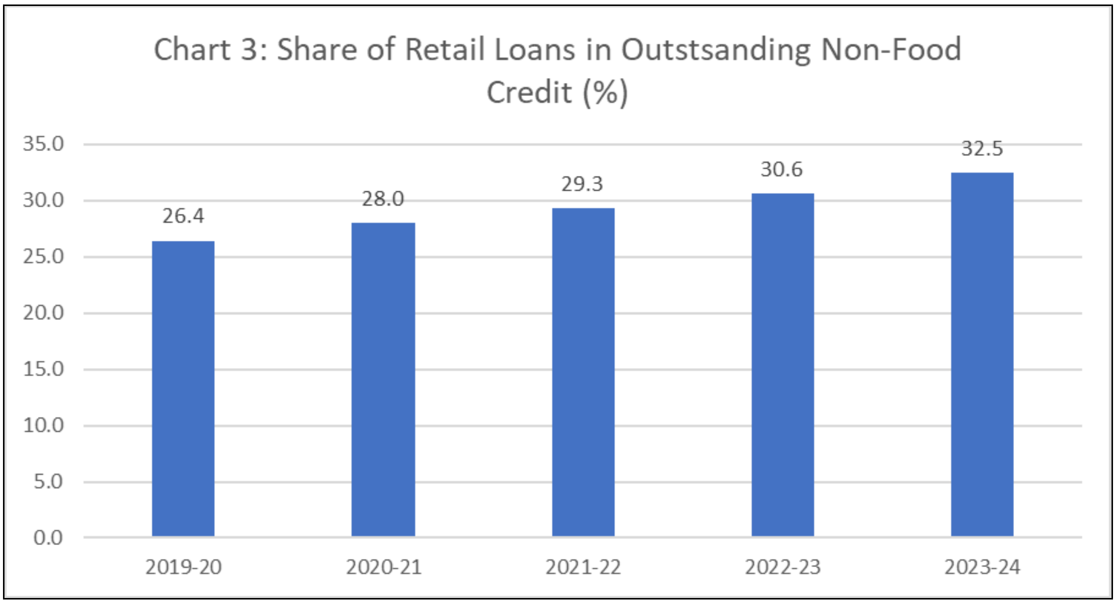
The boom in lending to the corporate sector began after 2004 when a buildup of liquidity in the financial system forced banks to look to new areas to deploy their resources. With that search coinciding with the government's effort to get the private sector to take up capital-intensive infrastructural undertakings, which it had largely stayed away from, nationalized banks saw in these projects a relatively 'safe' opportunity. They took to lending to projects they had stayed away from in the past because of the maturity and liquidity mismatches between the shorter term capital they mobilized and the longer term exposure involved. In practice, many of the projects failed to do well or even take-off, resulting in defaults on their debt that had to be restructured. That helped to conceal bad debts and avoid provisioning for them, since restructured debt could be categorized as standard assets under then prevailing rules.

Rajan's intervention changed that. Banks took a hit since they had to make provisions for a bunch of bad loans, and that soon showed on their bottom lines and balance sheets. Although recapitalization with government support (including the use of the dubious practice of issuing recapitalization bonds) paid for part of the process, banks realized they could not return to the same game. But there was a larger macroeconomic concern. Since growth had been riding on debt-financed housing and corporate investment, the cutback there could depress aggregate demand with implications for overall economic performance.

Interestingly, this did not happen to the expected degree, after allowing for the effects of shocks like the Covid-19 pandemic. This was because credit growth did not slow. But the pattern of lending had to change, and retail lending with its low default rates was the chosen alternative. The result was an increase in exposure to retail loans, including in recent times to retail lending without recourse to collateral. The share of retail loans in outstanding non-food credit rose from 26.4 per cent in pre-pandemic year 2019-20 to 30.6 per cent in 2022-23 and 32.5 per cent in 2023-24 (Chart 3).

As the proportion of retail loans in the total rose, so did defaults. The Financial Times cites a Nomura estimate that personal loans in India overdue by more than 90 days have increased from 3.9 per cent to 5.1 per cent in the last financial year. It is this trend that possibly explains the RBI's decision to hike risk weights on unsecured retail loans and the note of caution for banks from its leadership.

The central bank faced a dilemma here, since debt-financed housing investments and vehicle and consumer durable purchases have been an important stimulus for growth in recent times. This explains the exclusion of such lending from the restriction, where the asset bought with credit provides the collateral for the loan. The justification also was that default rates on loans in these categories was low, so enhanced lending in those silos may not be disruptive.



There are two reasons why that may not work. First, during the years when retail lending was rising, the share of non-secured retail loans was close to a third of the total, and even registered an increase in 2022-23 (Table). That implies that the value of outstanding unsecured loans is large enough to be disruptive if defaults rise. Second, there is no reason to believe that there would not be an increase in defaults on housing and vehicle loans, equated monthly instalments on which are known to account for a significant share of incomes of the "new" upper middle class. If growth slows, the incomes of these sections may be squeezed and defaults on their borrowing may rise, triggering ripple effects that can be damaging both for the banks and the economy.

This explains the concern being expressed by the leadership of the central bank. At issue is not just the health of individual banks but of the banking system, and, therefore, of the sustainability of the growth that India's statistical system has been reporting.

Table: Shares in Personal Loans of Principal Categories (%)					
	2019-20	2020-21	2021-22	2022-23	2023-24
Housing	49.9	49.6	50.2	47.6	51.0
Vehicle Loans	12.5	12.1	11.7	12.0	11.1
Education	2.9	2.6	2.4	2.3	2.2
Other with collateral	3.1	2.7	2.6	3.1	2.5
Credit Card Outstanding	4.4	4.5	4.5	4.9	4.8
Other without collateral	25.5	25.4	26.0	27.4	26.0

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