ICRA

Indian Banking Sector
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Covid-19: Asset quality issues likely to resurface amidst credit squeeze in a slowing economy

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COVID-19 impact on banks; Outlook: Negative

The spread of the Coronavirus (Covid-19) has injected a lot of uncertainty into the global and domestic economic outlook. ICRA expects a sharp downturn in various manufacturing and services sectors, particularly those catering to domestic discretionary activities, such as travel, tourism and recreation, labour intensive sectors such construction and transport, as well as exports from March 2020 onwards. Depending on the duration of the lockdowns that have been imposed in several districts, ICRA expects Indian GDP growth to range from 4.7% to 5.2% in FY2021 (4.7%E for FY2020).

With some large companies involved in production of discretionary items announcing shutdowns, the SME sector as well as unorganized sector are likely to be adversely impacted. In addition to a severe demand slowdown, many sectors could witness disruptions in payments and an elongation of the receivables cycle, along with the emergence of contractual disputes, all of which would strain the liquidity situation, and may lead to a rise in delays in servicing debt obligations unless forbearance is extended. Moreover, job losses, especially of contractual employees in manufacturing as well as retail sectors may rise. Additionally, the loss of incomes may result in constrained consumption, some rise in defaults on personal loans, and could emerge as a risk for microfinance institutions, especially in the urban areas. We expect serious impact on cash-flows of individual as well as corporate entities and the impact of Covid-19 as under:

- ***Business and economic activity to slow down significantly as lockdown conditions may extend for a few weeks.***
- ***Self-employed segment to be affected as lockdown to impact discretionary economic activity.***
- ***Salaried individuals may face salary cuts/delays.***
- ***Lease rental discounting exposures to get impacted by social distancing and lockdowns, which will reduce sales.***
- ***Lower road traffic will impact toll collections and repayments, as well as EMI payments of taxi operators.***
- ***Slowdown in real estate sales and leasing activity to curtail developers cash flows and impact cement/steel/labour demand.***
- ***Lower car sales to impact dealerships, loan demand, auto ancillaries and steel demand.***
- ***Impact to be felt by large industries as well as MSME as entire manufacturing chains could get impacted.***
- ***Stretched cash flows of large corporates to impact MSMEs' cash flows and asset quality of both segments.***
- ***Slowdown in exports amid lockdowns by various nations.***
- ***Lower economic activity to compress freight volumes, and impact asset quality of CV financers, as well as CV OEMs.***
- ***Collections in cash in MFI segments (less than 20% are estimated to be cashless) could also get impacted.***
- ***Discretionary spends to be curtailed amid social distancing and lower confidence levels, impact retail credit demand also.***
- ***Other retail asset segments such as auto loans, consumer durables and home loans to be impacted as personal connect is higher in such loans.***

Asset quality woes to rise amid slowing credit growth

- *Collections could get impacted across the board.*
- *Repayment moratorium, if provided by the Reserve Bank of India (RBI), could assuage reported asset quality indicators even as inherent stress will build up. Bank repayment schedule can get extended, however debt capital market instruments unlikely to be rescheduled.*
- *SBI's announcement of additional working capital limits on temporary basis to tide over liquidity crisis positive for its borrowers. However, will other banks follow suit is not yet clear.*
- *Borrower's leverage likely to go up with additional working capital requirements and profitability pressures*
- *Credit growth to remain slow amid muted economic activity, likely to remain below 6% in FY2021*
- *Slow credit growth will add to profitability pressures for banks amid likely increase in credit provisions as asset quality stress likely to go up.*
- *Government of India has relaxed the conditions for Initiation of bankruptcy proceedings; and the bankruptcy invocation may get suspended if the challenging conditions continue beyond April 30, 2020.*
- *Interest rate cuts may be forthcoming, but credit supply issues need to be addressed.*
- *Direct transfer of benefits to weaker sections of society, which face complete income loss, may be announced.*
- *Lower risk appetite of debt capital markets to push borrowers towards banks.*

Incremental credit growth eases considerably, while deposit accretion remains steady

EXHIBIT 1: Incremental Non-food credit growth

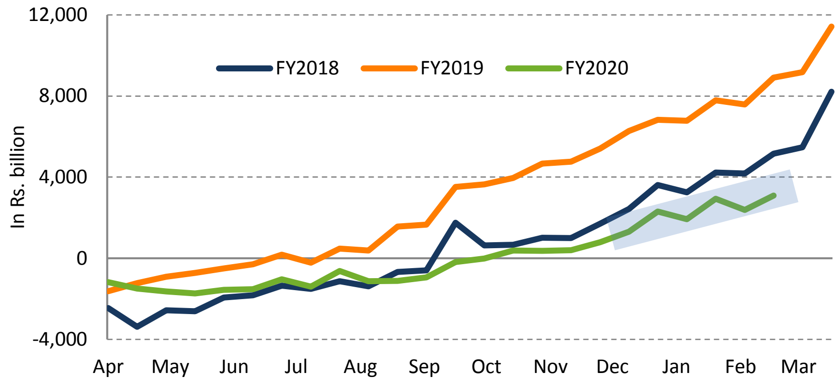
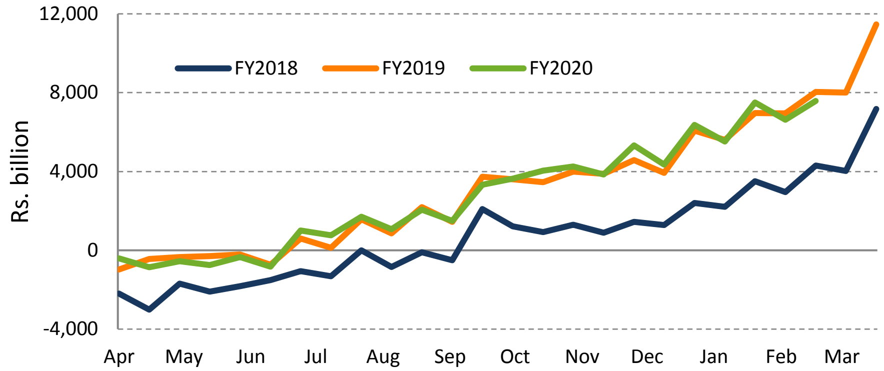


EXHIBIT 2: Incremental Deposit growth



Source: RBI, ICRA research

- Incremental credit offtake in FY2020 (till February 28, 2020) stands at just Rs. 3.1 trillion (Rs. 8.9 trillion till March 1, 2019)
- Deposit growth remains steady at Rs 7.6 trillion in 11 M FY2020 vs. Rs 8.0 trillion over the corresponding period in FY2019
- Incremental credit growth negative for industrial segment (large), while the MSME credit outstanding remains flat on year on year (YoY) basis
- Credit to the services segment declined, driven primarily by portfolio sales by the housing finance companies (HFCs) segment, because of portfolio sales to banks, even though credit to NBFCs recorded a growth.
- Supported by retail portfolio buyouts, credit growth to the retail segment was strong at 16.9% (YoY) as on Jan 2020
- Slowing economic growth, risk aversion among lenders and subdued confidence among borrowers are the key reasons for slower credit growth
- Temporary increase in working capital limits and shift of corporates from debt capital markets to banks is likely to increase the credit demand from banking channel
- Ad hoc credit limits are however likely to increase the indebtedness of the borrowers amid stress on their earnings and cash flows; need to suitably structure such credit limits to ease the repayment burden on borrowers

Credit growth to touch multi-decade lows; outlook remains weak for FY2021

EXHIBIT 3: YoY Credit and deposit growth

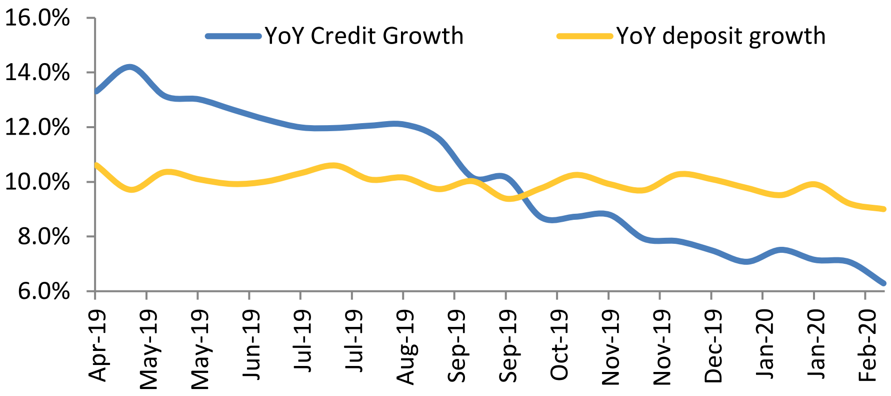
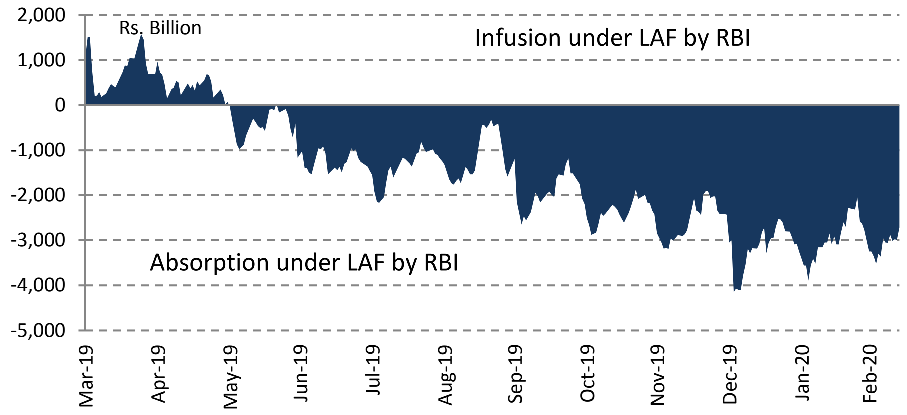


Exhibit 4: Liquidity infusion / (absorption) under LAF by RBI



Source: RBI, ICRA research

- YoY credit growth estimated at 5-6% for FY2020, which will be a multi-decadal low.
- Slower credit growth and steady deposit growth drive liquidity in the banking system, with over Rs. 3 trillion parked under reverse repo with the RBI for the last six months.
- Credit deposit ratio declined to 75.8% as on Feb 28, 2020 from 77.7% as on March 29, 2019.
- Even assuming a high case scenario of Rs. 6-lakh crore of incremental credit during FY2021, the YoY growth is likely to remain weak at less than 6%.
- Deposit rates likely to see further cuts of up to 50-75 bps over the next year (70 bps median cut in 1-year fixed deposit rates during FY2020) if the credit demand remains muted. However, this will require a similar cut in various small saving schemes of Government of India.
- Likely increase in redemptions from debt mutual funds, as higher risk aversion may prompt investors to shift surplus funds to banks, will boost the deposit growth of the latter. With Rs 8.0-9.0 trillion of incremental deposit accretion, the YoY deposit growth is estimated at 6.0-7.0% for banks during FY2021.
- Slower credit growth and higher pace of deposit build-up will adversely impact net interest margins as banks will have to park excess liquidity in reverse repo at much lower rates.
- Ability to control operating expenses will drive the ability of banks to cushion the impact on their operating profitability.
- Pressures on operating profitability amid expectations of rising asset quality pressures and credit provisions to adversely impact internal capital generation.

Credit growth of Private banks (PVBs) slowing down; Public sector banks (PSBs) continue to record muted growth

EXHIBIT 5: YoY credit growth and deposit growth - PSBs

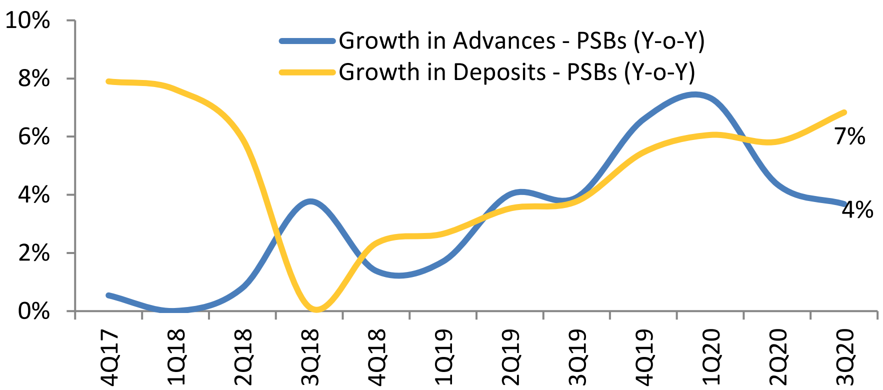
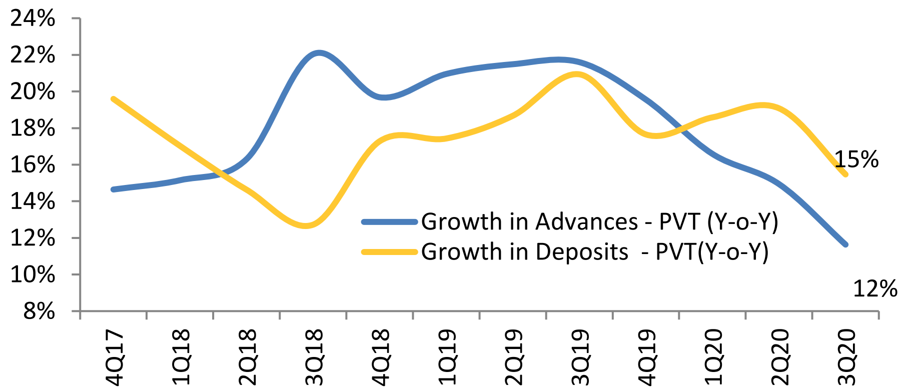


Exhibit 6: YoY credit growth and deposit growth – PVBs



Source: Aggregate of Public sector banks (including IDBI) and 18 large private sector banks, ICRA Research

- Aggregate YoY deposit and credit growth of 37 banks in ICRA's sample set at 9.2% and 6.4%, respectively, as on December 31, 2019.
- Ability of PSBs to support credit growth will remain weak because of near-term integration issues among 10 PSBs undergoing merger that account for ~23% of the banking system advances.
- PSBs, which account for ~64% of bank credit outstanding, continue to have a relatively weaker capital position; no capital infusion has been budgeted by the GoI for PSBs for FY2021.
- Despite offering higher interest rates, the deposit/liability franchise could be a challenge for PVBs in the near term amid Covid-19 issues and the recent Yes Bank event.
- PVBs are likely to adopt a cautious approach on growth amid slowing economic expansion and build-up of liquidity cushions amid the liability mobilization issues.
- Market share gain for PVBs in advances to be less than 2% for FY2020 (2.5% for FY2019 and 3.5% for FY2018), with further slowdown likely in near term.
- YoY credit growth for PVBs stood at 11.6% as on December 31, 2019 (21.6% as on December 31, 2018).
- Overall, credit availability in FY2021 is likely to be constrained because of the above issues.

Corporate Bond yields rise, and Spreads widen

- Sharp decline in stock prices of financial sector entities driven by increasing asset quality concerns and liability pressures amid tightening funding conditions
- Secondary market yields for Corporate bond have shot up since the first week of March 2020, as investors look to preserve liquidity. Sell off by FPIs has added to the negative sentiments.
- Pressures felt on primary bond issuances as well, with lower issuances recorded in this period.
- The RBI has infused liquidity with open market purchase of G-secs (2-5 year tenure) of over Rs. 400 billion in multiple tranches in March 2020. This would contribute to some softening of yields of G-Sec, and possibly of Corporate Bonds as well, but risk aversion could limit the gains.

EXHIBIT 7: Bond yields comparison March 20, 2020 vs March 4, 2020

Yields in %	As on March 4th 2020				As on March 20 2020				Change		
	3Yr	5Yr	10Yr		3Yr	5Yr	10Yr		3Yr	5Yr	10Yr
G-sec	5.54	5.76	6.35		5.97	6.29	6.49		+0.43	+0.53	+0.14
NBFC Excl HFC	6.94	8.14	8.20		8.10	8.28	8.33		+1.16	+0.14	+0.13
HFC	6.90	7.15	7.19		8.20	8.27	8.13		+1.30	+1.12	+0.94
Corporate	6.60	7.66	7.19		7.59	7.48	8.00		+0.99	-0.18	+0.81

Source: Aimin, ICRA research

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ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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