SMALL FINANCE BANKS
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Good progress; enhancement of retail deposit franchise key success factor

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CONTENTS

Executive Summary

HIGHLIGHTS

- SFBs reported a sharper annualised growth of 41% in FY2019 (5% growth in FY2018) in assets under management, which crossed Rs. 67,000 crore in FY2019, supported by product and geographical diversification
- Asset quality indicators of SFBs improved with gross NPA at 2.5% as on March 31, 2019 (9.5% as on March 31, 2018), primarily supported by write-offs of legacy demonetisation-related slippages and NPAs
- Good progress on deposit mobilisation with deposits, mostly bulk, accounting for 63% of the borrowings, as on March 31, 2019
- Reduction in blended cost of funds on conversion to SFB even though the deposit rates offered are 100-150 bps higher than other full-service banks
- Good liquidity profile supported by shorter-tenor assets and high share of non-callable long-term deposits from FIs like NABARD, SIDBI and MUDRA
- Regulatory capital adequacy supported by lower risk weights; need to raise capital and list to meet growth objectives and regulatory guidelines
- Profitability improvement seen with RoE improving to 11.9% in FY2019 from 3.9% in FY2018 for all SFBs excluding one player where impact of demonetisation-related slippages was high
- Setting up and upgradation of existing branches, systems upgradation, and hiring of manpower has kept the operating expense ratios high

OVERVIEW

Despite a tough operating environment, the total asset base for small finance banks (SFBs) crossed Rs. 90,000 crore as on March 31, 2019 while managed advances growth crossed Rs. 67,000 crore with a growth of 41% in FY2019 (5% growth in FY2018). The pace of growth has picked up as operations are stabilising and bulk resource mobilisation has been managed well. SFBs are emerging as an important market intermediary targeting the retail underserved segments and ICRA expects overall SFBs to grow by 25-30% with the total asset base expected to cross Rs. 1.2 lakh crore by March 2020.

The asset quality indicators of SFBs improved with the gross NPA at 2.5% as on March 31, 2019 (9.5% as on March 31, 2018), supported by write-offs of legacy demonetisation-related slippages. The overall capitalisation levels of SFBs remained comfortable, supported by capital infusions of approximately Rs. 2,700 crore in FY2019 (Rs. 890 crore in FY2018). Going forward, SFBs would need external capital not only to meet growth aspirations but also to manage the regulations related to mandatory listing after reaching a net worth of Rs. 500 crore and reducing promoter shareholding. As of March 2019, 8 of the 10 SFBs had crossed a net worth of Rs. 500 crore and only 1 SFB is listed at present.

SFBs have made good progress on deposit mobilisation with deposits accounting for 63% of the borrowings (including off-balance sheet borrowings), as on March 31, 2019. Nevertheless, most of these are bulk deposits, as developing the retail franchise will take longer. The cost of funds for SFBs declined, supported by the higher share of funding from financial institutions (FIs) and deposits, despite the rate offered on deposits being 100-150 bps higher than that offered by other full-service banks.

On the liquidity front, SFBs have been able to maintain a favourable asset liability maturity profile supported by shorter-tenor assets and the high share of non-callable deposits raised by them. Further, like other scheduled commercial banks (SCBs), SFBs are eligible for additional liquidity support including interbank limits and have access to the call money market as well. While these factors support the near-term liquidity position, the ability to develop a strong franchise and hence, a retail deposit base, is critical from a long-term perspective. All SFBs are eligible for deposit insurance, which enhances their ability to mobilise retail deposits as this provides more confidence to retail depositors and can help maintain stability of retail deposits.

Owing to the focus of SFBs on higher-yielding asset classes, portfolio yields and net interest margins (NIMs) continue to be higher than that of SCBs. The NIMs have improved due to high lending yields and reduction in the cost of funds as the share of deposits in overall borrowings has increased. The setting up and upgradation of existing branches, systems upgradation, and the hiring of manpower have kept the operating expense ratios high. The overall profitability of SFBs improved (except for one player), supported by higher NIMs and lower credit costs.

OUTLOOK

- ICRA expects SFBs to grow by 25-30% in FY2020, supported by product and geographical expansion
- FIs and bulk deposits are expected to remain key sources of funding over the medium term; developing the retail deposit franchise will be critical for the long-term sustainability of SFBs
- The asset quality indicators of SFBs improved with gross NPA at 2.5% as on March 31, 2019 (9.5% as on March 31, 2018) owing to write-offs of legacy NPAs related to demonetisation-related slippages. While retail assets dominate the asset mix of SFBs, credit costs could be volatile as most of the SFBs are focussed on riskier asset classes and have a high share of unsecured/difficult to repossess asset classes. ICRA expects credit costs to be in the range of 1.5-2.5% over the medium term
- Profitability indicators are expected to improve, supported by lower operating expense ratios and credit costs. ICRA expects SFBs (excluding one player) to report RoE of 12-14% in FY2020.

ICRA

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