SMALL FINANCE BANKS
September 2020

Regular capital infusions and deposit stability to help weather Covid-19 disruptions

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HIGHLIGHTS

ICRA's Estimates

- ICRA expects small finance banks (SFBs) to witness a slowdown in growth in FY2021, given the limited disbursements in H1 FY2021 and the subdued outlook for H2 FY2021.
- The asset quality is expected to weaken in FY2021, which would impact the profitability of the industry. The ability to contain the credit costs will differentiate SFBs from one another.
- ICRA expects the industry to need around Rs. 5,000-6,000 crore of equity infusion till FY2023 to maintain the leverage at 7-8 times.

FY2020 Performance

- The assets under management (AUM) of SFBs crossed Rs. 90,000 crore in FY2020 on the back of a 30% growth in FY2020 (41% growth in FY2019), supported by geographical diversification.
- The asset quality indicators of SFBs improved with the gross non-performing assets (GNPAs) at 1.7% as on March 31, 2020 (2.4% as on March 31, 2019), primarily supported by the write-off of legacy demonetisation-related slippages and NPAs.
- SFBs made good progress on deposit mobilisation with deposits accounting for 70% of the borrowings, as on March 31, 2020 (64% as on March 31, 2019).
- The liquidity profile was good, supported by shorter-tenor assets and a high share of non-callable long-term deposits from financial institutions (FIs) like NABARD, SIDBI and MUDRA.
- The improvement in the profitability indicators was supported by higher net interest margins (NIMs) and lower credit costs.
- Geographical and product mix expansion kept the operating expense ratios high.
- The regulatory capital adequacy was supported by lower risk weights and regular equity infusions.
- SFBs would need external capital to not only manage the Covid-19-related credit costs and medium-term growth but also to manage the regulations related to reducing the promoter shareholding. Some SFBs are approaching the three-year timeline for mandatory listing in FY2021.

OVERVIEW

Despite the tough operating environment, the total asset base of SFBs crossed Rs. 1,30,000 crore as on March 31, 2020 and managed advances crossed Rs. 90,000 crore, reflecting a growth of 30% in FY2020 (41% growth in FY2019). The pace of growth remained good as the traction on resource mobilisation remained good. Microfinance dominates the asset mix of SFBs as 8 of the 10 SFB licensees were originally microfinance institutions (MFIs). However, with a focus on product diversification, SFBs have forayed into retail asset classes such as vehicle loans, business loans, loan against property (LAP) and housing finance over the last two years. Nevertheless, the share of unsecured asset classes remains high for SFBs as a large proportion of the business loans were also unsecured, leading to a moderate risk profile for the overall portfolio. Further, for the MFI-focussed SFBs, the share of microfinance remains high at 71% and meaningful product diversification has not been achieved by most of the players.

The asset quality indicators of SFBs improved with the GNPA at 1.7% as on March 31, 2020 (2.4% as on March 31, 2019), supported by the growth in the portfolio and the write-off of legacy demonetisation-related slippages.

As far as the regulatory capital adequacy is concerned, the credit risk of SFBs is measured by the Basel II standardised approach and is supported by lower risk weights on retail assets (75% risk weight as against 100% for a non-banking financial company; NBFC). The capitalisation levels of SFBs were also supported by total capital infusion of approximately Rs. 2,853 crore in FY2020 (Rs. 2,989 crore in FY2019). Going forward, SFBs would need external capital to not only manage the Covid-19-related credit costs and medium-term growth but also to manage the regulations related to reducing promoter shareholding. Additionally, SFBs are required to list themselves on the stock exchanges within 3 years of reaching a net worth of Rs. 500 crore. This would have to be worked out as some SFBs are approaching the 3-year timeline in FY2021. As of March 2020, 8 of the 10 SFBs had crossed a net worth of Rs. 500 crore and only 2 are listed at present.

SFBs have made good progress on deposit mobilisation with 70% of their borrowings, as on March 31, 2020, being through deposits. However, a large portion of these are bulk deposits as the retail franchise will be developed over time. While the deposit growth and stability have been good, SFBs need to develop a low-cost deposit base as the share of current account and savings account (CASA) deposits remained low at 16% as on March 31, 2020. Further, funding from refinancing institutions like SIDBI, NABARD and MUDRA accounted for 24% of the borrowings, supporting the interim funding requirements of SFBs as they develop and stabilise their retail franchise.

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. 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 the stability of retail deposits.

The portfolio yields and NIMs of SFBs remain higher than that of SCBs, given their focus on higher-yielding asset classes. The yield on advances and NIMs improved with an improvement in the lending yields. This was due to the improved asset quality and lower interest reversals on delinquent portfolios. 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, supported by higher NIMs and lower credit costs. The profitability indicators improved with the return on equity (RoE) increasing to 14.1% in FY2020 from -6.8% in FY2019.

Covid-19 to impact SFBs' performance

The Covid-19 pandemic is likely to impact the performance of SFBs in FY2021 on the growth, asset quality as well as profitability front. The asset quality is likely to get impacted adversely as the product segment for SFBs is largely unsecured with a focus on the self-employed segment, which is more vulnerable to income shocks.

Microfinance, which was the largest product segment for SFBs in terms of AUM (accounted for 41% of the portfolio) as on March 31, 2020, continues to face challenges following the spread of the pandemic throughout the country. The challenges for the industry include concerns regarding the continuity of business operations on the field, given the people-centric model with most of the collections being made in cash, the likely adverse impact on the asset quality as the borrowers' cash flows and economic activity have undergone a slowdown, as well as the impact on incremental business growth. The Reserve Bank of India (RBI) had allowed a moratorium on term loans for March 1, 2020 to August 31, 2020. This provided much-needed relief to the borrowers, especially at the retail level. Considering the expected impact on the income levels of these borrowers during the lockdown period, the revival trajectory and income stabilisation would be fairly long-drawn. Further, the impact could be higher for SFBs which have a higher share in the urban microfinance portfolio as urban areas have been more impacted by the lockdowns and rising infections vis-à-vis rural areas.

While the asset-side risk for SFBs and NBFC-MFIs would be similar, SFBs are better placed in terms of liquidity to withstand the crisis owing to their access to deposits and their better refinancing ability given their access to the call money market.

ICRA

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