ICRA
A MOODY'S INVESTORS SERVICE COMPANY

INDIAN BANKING SECTOR

Insulated against Covid-19; Expect improvement in profitability even as asset quality remains monitorable

Outlook: Stable

October 2021

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EXECUTIVE SUMMARY

INDIAN BANKING SECTOR - INSULATED AGAINST COVID-19; EXPECT IMPROVEMENT IN PROFITABILITY EVEN AS ASSET QUALITY REMAINS MONITORABLE

Incremental credit growth better in H1 FY2022 despite second wave: The second wave of Covid-19 was more severe and widespread. It did raise concerns on the nascent revival in the credit growth and asset quality that was witnessed in Q4 FY2021. However, both lenders and borrowers were better equipped with the experience gained during the first wave and were able to contain the impact of the second wave. This was also aided by the less-restrictive lockdowns, improved pace of vaccination and fewer regulatory interventions such as moratorium or standstill on asset classification. The incremental credit growth in H1 FY2022 remained better than the corresponding period last year, though it remained at sub-optimal levels.

We retain our credit growth estimates for FY2022: On an incremental basis, the credit growth as higher by Rs. 1.1 trillion in H1 FY2022, and even in a scenario of growth similar to that of H2FY2021, i.e. Rs. 6.8 trillion during H2 FY2022, the incremental credit growth is likely to touch Rs. 8.0 trillion in FY2022. If demand remains strong, as the absolute size of the economy could grow beyond the pre-Covid level, and incremental demand improves, we can touch incremental credit growth of 9.0 trillion in FY2022, which will translate into a credit growth of 7.3-8.3% in FY2022 compared to 5.5% in FY2021. Both public and private banks largely remain well capitalised and supply is not a constraining factor for growth, given the abundant liquidity in the banking system and the record low interest rates. Two key elements, i.e. revival of corporate credit demand and higher growth by public banks, will remain critical for the overall growth.

Headline asset quality will continue to improve, though contingent upon the performance of overdue/restructured loans: The overall restructuring by banks is estimated at Rs. 2.0 trillion till June 30, 2021 or ~2% of the loan book and is likely to increase by 20-30 bps in the coming months despite the impact of the second wave. The restructuring numbers are much lower than our initial estimates of 5-6% solely due to the first wave. While regulatory measures like the moratorium and Emergency Credit Line Guarantee Scheme (ECLGS) loans did provide relief to borrowers and reduced the need for restructuring, the impact of the pandemic was relatively well contained if we compare to 30-40% of the loan books of the banks undergoing moratorium in Q1 FY2021.

Notwithstanding the above positives, Covid did impact the cash flows of borrowers and the overdue loan book for lenders in the retail and micro, small and medium enterprise (MSME) segments remains high even as the overdue loans in the corporate segment have remained stable or declined. Unlike corporate loans, where lenders suffered huge losses upon defaults, the likelihood of losses shall be low with better recovery prospects for small ticket and granular loans, especially in secured segments. Hence, unlike the previous NPA cycle, the credit losses should be manageable even as slippages remain elevated in FY2022.

Banks have done well in maintaining operating profitability despite huge build-up of liquidity: The liquidity surpluses in the banking system continued to increase every quarter since the onset of the pandemic and crossed Rs. 8 trillion by the end of September 30, 2021. With a steep cut in reverse repo rates, this surplus liquidity has been a drag on the earnings of banks. But banks have been able to contain the impact of the same by sharply cutting the deposit rates and were able to maintain their interest spreads and the net interest income (NII). Additionally, recoveries from NPAs aided the operating profitability and treasury gains on bonds, which were phenomenal in FY2021 and continued in H1 FY2022 driven by bond purchases by the RBI. With steady operating profits and declining legacy asset provisioning, the return on assets (RoA) has been on an improving trend with the same likely to continue in the coming quarters.

Banks well placed to meet higher regulatory capital requirements: With improved confidence about the likely impact of Covid and the outlook on the asset quality, profitability and capital position, the RBI phased in the last tranche of the CCB (0.625% of risk-weighted assets; RWAs) to increase the core equity capital requirements of banks to 8.0% and Tier I to 9.5% from October 1, 2021. This phase-in was deferred multiple times during the last three years and the RBI's action reflects its improved confidence in banks. As per our estimates, most public banks are well placed on their capital position while some private banks may need to raise capital to maintain the capital cushion amid some uncertainty on the asset quality.

Largely positive rating actions in H1 FY2022: With the improving outlook on profitability and internal capital generation, improved capital and solvency position supported by the large capital raise by both public and private banks and reduction in net stressed assets, the rating actions have largely been on the positive side with no negative rating actions (including downgrade or outlook revision) in H1 FY2022. However, we remain watchful on banks with a high level of overdue loans or restructured loans as these loans could remain vulnerable from an asset quality perspective.

Outlook on Credit and Deposit Growth

Asset Quality Trends and Outlook

Capital Position and Requirements

Profitability Trends and Outlook

Credit Ratings and Outlook

Quarterly Financials

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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.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

Alliance with Moody's Investors Service

The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. The agreement also envisages Moody's conducting regular training and business seminars for ICRA analysts on various subjects to help them better understand and manage concepts and issues relating to the development of the capital markets in India. Besides this formal training programme, the agreement provides for Moody's advising ICRA on Rating-products strategy, and the Ratings business in general.

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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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