



Indian Banking Sector: Challenges unlikely to derail the progress made

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Indian banks, the dominant financial intermediaries in India, have made good progress over the last five years, as is evident from several parameters, including annual credit growth, profitability, and trend in gross non-performing assets (NPAs). While the annual rate of credit growth clocked 23% during the last five years, profitability (average Return on Net Worth) was maintained at around 15% during the same period, and gross NPAs fell from 3.3% as on March 31, 2006 to 2.3% as on March 31, 2011.

Good internal capital generation, reasonably active capital markets, and governmental support ensured good capitalisation for most banks during the period under study, with overall capital adequacy touching 14% as on March 31, 2011. At the same time, high levels of public deposit ensured most banks had a comfortable liquidity profile.

While banks have benefited from an overall good economic growth over the last decade, implementation of SARFAESI¹, setting up of credit information bureaus, internal improvements such as upgrade of technology infrastructure, tightening of the appraisal and monitoring processes, and strengthening of the risk management platform have also contributed to the improvement. Significantly, the improvement in performance has been achieved despite several hurdles appearing on the way, such as temporary slowdown in economic activity (in the second half of 2008-09), a tightening liquidity situation, increases in wages following revision, and changes in regulations by the Reserve Bank of India (RBI), some of which prescribed higher credit provisions or higher capital allocations.

Currently, Indian banks face several challenges, such as increase in interest rates on saving deposits, possible deregulation of interest rates on saving deposits, a tighter monetary policy, a large government deficit, increased stress in some sectors (such as, State utilities, airlines, and microfinance), restructured loan accounts, unamortised pension/gratuity liabilities, increasing infrastructure loans, and implementation of Basel III.

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¹ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

Background

The Indian financial sector (including banks, non-banking financial companies, or NBFCs, and housing finance companies, or HFCs) reported a compounded annual growth rate (CAGR) of 19% over the last three years and their credit portfolio stood at close to Rs. 49 trillion (around 62% of 2010-11 GDP) as on March 31, 2011. Banks accounted for nearly 86% of the total credit, NBFCs for around 10%, and HFCs for around 4%. Within banks, public sector banks (PSBs), on the strength of their country-wide presence, continued to be the leader, accounting for around 76% of the total credit portfolio, while within the NBFC sector, large infrastructure financing institutions² accounted for more than half the total NBFC credit portfolio; NBFCs that are into retail financing took up the rest.

Chart 1: Credit Composition of Financial Sector Entities



Source: RBI, ICRA Research

Within banks, public sector banks (PSBs), on the strength of their country-wide presence, continued to be the leader, accounting for around 76% of the total credit portfolio, while within the NBFC sector, large infrastructure financing institutions² accounted for more than half the total NBFC credit portfolio; NBFCs that are into retail financing took up the rest.

While the Indian banking sector features a large number of players competing against each other, the top 10 banks accounted for a significant 57% share of the total credit as on March 31, 2011.

Table 1: Key Players in Indian Banking Sector

Name of Bank	Credit Portfolio as in March 2011 (Rs. billion)	Market Share (%)	NIMs (2010-11)	Tier I Capital % as in March 2011	Return on Net Worth (2010-11)	Gross NPA % as in March 2011
State Bank of India	7,567	18%	2.9%	7.8%	13%	3.3%
Punjab National Bank	2,421	6%	3.5%	8.4%	24%	1.8%
Bank of Baroda	2,287	5%	2.8%	10.0%	24%	1.4%
ICICI Bank	2,164	5%	2.3%	13.2%	10%	4.5%
Bank of India	2,131	5%	2.5%	8.3%	17%	2.2%
Canara Bank	2,125	5%	2.6%	10.9%	26%	1.5%
HDFC Bank	1,600	4%	4.2%	12.2%	17%	1.1%
IDBI Bank	1,571	4%	1.8%	8.1%	16%	1.8%
Axis Bank	1,424	3%	3.1%	9.4%	19%	1.1%
Central Bank of India	1,297	3%	2.7%	6.4%	18%	2.2%
Total banking sector³	42,874	100%	2.9%	9.7%	17%	2.3%

NIM: net interest margin

Source: Annual Reports, Results of banks, ICRA Research

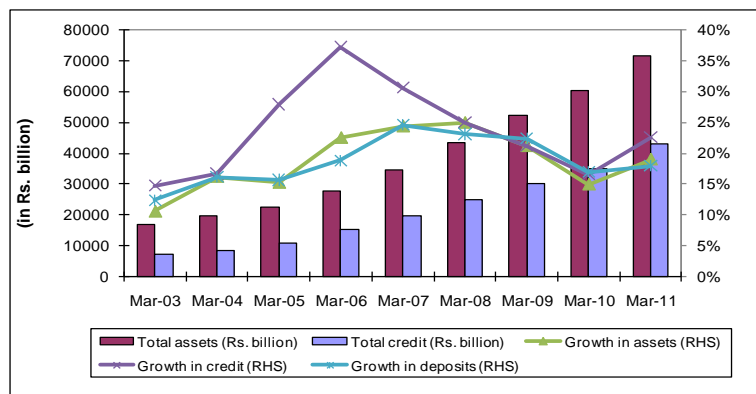
² Such as Power Finance Corporation, Rural Electrification Corporation, and other infrastructure NBFCs

³ The data pertains to SCBs, except for NIMs and Returns on Net Worth, which are for select Public Sector Banks + Private Sector Banks covering more than 90% of the universe

Strong growth in infrastructure credit drives credit growth in 2010-11; pace of deposit growth slows

Total banking credit⁴ stood at close to Rs. 39 trillion as on March 25, 2011 and reported a strong 21.4% growth in 2010-11, led by credit to the

Chart 2: Trend in Growth of Banking Assets



Source: RBI, ICRA Research

Historically, the banking sector's credit portfolio has been growing at over 20% per annum over the last several years (except in 2009-10, when the growth rate moderated to 17% mainly because of the decline in ICICI Bank's credit portfolio). Over the years, credit growth has outpaced deposits growth; the credit portfolio reported a CAGR of 24% over the last eight years, while deposits achieved a CAGR of 19% and the investment portfolio of 14% over the same period. The higher growth in credit could be achieved because of the slower growth in investments and the increase in capital. In 2010-11, while deposits growth for SCBs slowed down to 17%, credit growth was maintained at 21% with the growth in investments being just 13%. The higher credit growth versus deposits growth led to an increase in the credit deposits ratio (CD ratio) from 72.2% as in March 2010 to 75.7% as in March 2011, although the CD ratio moderated to 74.2% as on May 27, 2011, largely because of the slow credit growth in comparison with deposits during the first two months of 2011-12.

Table 2: Domestic Credit Portfolio Composition of SCBs

Credit portfolio composition	Mar 25, 2010	Mar 25, 2011	As % of Total Credit as in March 2011	Growth (y-o-y)
Agriculture and Allied Activities loans	4,161	4,603	13%	11%
Non-Agri Corporate Loans				
Commercial Real Estate loans	921	1,118	3%	21%
Loans to NBFCs	1,134	1,756	5%	55%
Power Sector Loans	1,878	2,692	7%	43%
Other Infrastructure Loans	1,920	2,575	7%	34%
Other Corporate Loans	14,528	17,076	47%	18%
Retail Loans				
Housing loans	3,009	3,461	9%	15%
Credit Card Outstanding	201	181	0%	-10%
Vehicle Loans	638	793	2%	24%
Other Retail Loans	2,008	2,419	7%	20%
Total Non-Food Credit	30,400	36,674	100%	21%

y-o-y: year-on-year

Note: Amounts in Rs. billion

Source: RBI, ICRA Research

⁴ SCBs business in India

During 2010-11, the infrastructure sector, particularly power, and NBFCs were the key drivers of the credit growth achieved by the banking sector. Credit to the power sector reported a growth of 43%, while other infrastructure credit grew by 34% during 2010-11, against an overall credit growth of 21%. As in March 2011, the infrastructure sector (including power) accounted for 14% of the total credit portfolio of banks.

Within the power sector, historically banks have been taking exposure to State power utilities as well as independent power producers (IPPs). Going forward, with many banks approaching the exposure cap on lending to the power sector and given the concerns hovering over the prospects of the sector itself, the pace of growth of credit to this segment could slow down. However, in the short to medium term, the undisbursed sanctions to power projects are likely to provide for a moderate growth.

As for bank credit to NBFCs, the same increased by 55% in 2010-11 and accounted for around 5% of the banks' total credit portfolio as in March 2011. Moreover, around half of this went to infrastructure related entities, and the rest mainly to NBFCs engaged in retail financing. Most of the NBFCs are focused on secured assets classes, have reported low NPA percentages, and are well-capitalised.

As for banks' retail lending, this continued to lag overall credit growth during 2010-11. Retail credit grew by 17% in 2010-11 against the overall credit growth of 21%, although the 17% figure marked a significant increase over the 4.1% reported in 2009-10. Credit to commercial real estate also increased in 2010-11, reporting a 21% growth that year as against nil in 2009-10.

Large government borrowings may allow for just 17-18% credit growth in 2011-12

Since March 2010, the RBI has raised the repo rate by 275 basis points (bps), which in turn has been transmitted by the banking system via increases in the base and prime lending rates, besides deposit rates. Going forward, while the RBI's tight monetary stance may exert a downward pressure on the demand for credit, considering the anticipated GDP growth (around 8%), investments in infrastructure and lower funds flow from the capital markets, credit demand could still remain high. However, banks' capacity to meet credit demand could get constrained by the volume of deposits they are able to mobilise and by the large amount of funds they would need to keep aside to fund the government deficit.

In case the government deficit is in line with the Budget numbers, the net borrowing of the Government of India (GOI) and the State governments via bonds would reach an estimated Rs. 4.7 trillion in 2011-12 (Rs. 4.1 trillion in 2010-11). As banks fund around 40% of these bonds, they would need to set aside Rs. 1.9 trillion for the purpose. If deposits were to grow by 17%, the balance funds (incremental deposits + internal capital generation + fresh external capital – increase in investments in government bonds) would support only 17-18% credit growth. Any higher growth would require intervention from the RBI. Further, in case the government deficit is higher because of lower tax collection and underprovided fuel & food subsidies, the maximum possible credit growth would be still lower. At the same time, a higher-than-expected deposit growth could allow banks expand their credit base.

On asset quality, PSBs report some deterioration while private banks show improvement

The Gross NPA percentage of SCBs did not increase by the extent that the stress in the Indian market during 2008-09 would warrant because of large loan restructuring over last 2-3 years (4-5% of total advances); Gross NPAs declined marginally from 2.4% as in March 2010 to 2.3% as in March 2011. However, higher provisioning led to a reduction in Net NPAs from 1.1% as in March 2010 to 0.9% as in March 2011.

Table 3: Trend in Asset Quality Indicators of SCBs

SCBs	FY06	FY07	FY08	FY09	FY10	FY11⁵
Gross NPAs (%)	3.3	2.5	2.3	2.3	2.4	2.3
Net NPAs (%)	1.2	1.0	1.0	1.1	1.1	0.9
Fresh NPA Generation Rate (%)	2.0	1.7	1.8	2.1	2.2	2.0
Net NPAs/Net Worth (%)	10.1	9.2	7.8	8.6	9.1	10.0
PSBs	FY06	FY07	FY08	FY09	FY10	FY11
Gross NPA (%)	3.6	2.7	2.2	2.0	2.2	2.3
Net NPA (%)	1.3	1.1	1.0	0.9	1.1	1.1
Net NPAs/Net Worth (%)	13.1	12.1	11.2	11.4	13.5	13.4
Private banks	FY06	FY07	FY08	FY09	FY10	FY11
Gross NPAs (%)	2.1	2.1	2.4	2.9	2.7	2.3
Net NPAs (%)	0.9	0.9	1.1	1.3	1.0	0.6
Net NPAs/Net Worth (%)	6.3	7.8	6.1	7.5	5.3	3.2

Source: Annual reports of banks, RBI, ICRA Research

- Over the last two years, PSBs' Gross NPAs rose from 2% to 2.3%, while private banks' NPAs declined from 2.9% to 2.3%. The Gross NPA percentage of the PSBs got impacted by slippages from restructured accounts, "agri debt relief", and slippages because of automation of asset classification.
- Better provisioning coverage and a stronger capitalisation profile allowed private banks report better solvency (Net NPA/Net Worth) than PSBs during last few years.

Asset quality related challenges ahead

➤ Spill-over from restructuring window not over yet

In 2008-09, the RBI allowed a second time restructuring of corporate advances (excluding commercial real estate advances) and a one-time restructuring of commercial real estate advances. As part of this exercise, banks mostly allowed deferment of principal repayment by eligible borrowers by allowing a moratorium of six to 12 months. From ICRA's discussions with bankers it has emerged that some of the restructured corporate borrowers needed loan restructuring because of genuine liquidity issues, while some others merely took advantage of the scheme and did not necessarily have weak credit profiles.

Restructured advances accounted for around 4% of SCBs' total advances as on March 31, 2011. For PSBs, restructured advances were higher at 4.5% as in March 2011 because of their higher lending to the corporate sector, while for private banks, such advances were lower at around 1% of their credit portfolio as in March 2011. Some of these restructured accounts have slipped into the NPA category over the last two years (in the range 8-20% for various banks), and with the operating environment deteriorating, slippages from restructured advances could continue into 2011-12 as well.

➤ Exposure to State utilities remains an area of concern

The exposure of banks to the power sector increased from Rs. 602 billion as in March 2006 (around 4% of total banking credit) to Rs. 2,692 billion as in March 2011 (around 7% of total banking credit). Banking credit to the power sector as a percentage of banks' total net worth also increased from 33% as in March 2006 to 56% as in March 2011. The exposure to the power sector includes that to State power utilities and IPPs. Within these, loans given to fund the cash losses of State utilities are estimated at 30-40% of the total power-sector exposures. Since the financial health of the State power utilities remains poor, it is likely that they will find it difficult to service debt on time, and this could be a problem for banks unless power-sector reforms gain pace. Further, any reduction in credit flow from the banking system to such entities, with some banks hitting the exposure caps for the entities/sector, could also trigger defaults, although State government guarantees for some of the exposures would mitigate the eventual credit loss to an extent. In the context of power-sector reforms, the GOI has set up a committee to assess the total losses of State power utilities. Timely assessment of such losses and speedy initiation of steps to lower them (via technical

⁵ Estimated by ICRA for public sector banks and private banks; data not available for foreign banks

and commercial loss reduction measures, tariff revisions, etc.) would be critical for improving the financial viability of State utilities and also for reducing the counter-party credit risks of entities serving the power sector.

➤ ***Credit loss from exposure to micro lending institutions in AP likely***

SCBs' exposure to micro lending institutions, viz. microfinance institutions (MFIs) and self-help groups (SHGs), accounted for 1.3% of their gross credit portfolio as in March 2010. Andhra Pradesh (AP) alone accounted for 42% of the total SHG loans and 28% of the total MFI loans. In October 2010, the Government of AP issued an Ordinance, imposing several restrictions on MFI operations in the State. The promulgation of the Ordinance has led to:

- A substantial drop in the collection efficiency in AP; and
- A move by banks and other investor to freeze credit to MFIs across the country, which has impacted disbursements in non-AP States as well. Nevertheless, collection efficiency in the non-AP States has remained comfortable so far.

Overall, SCBs' exposure to micro lending institutions (including SHGs) in AP is likely to lead to credit losses of 7-12 basis points (bps) in various scenarios of collection efficiency.

Gross NPA percentage could rise to 2.3-2.7% by end-year 2011-12

Exposure to State power utilities (2-3% of total exposures), a large number of which are incurring losses, airlines (1.5-2%), and AP-based micro lending institutions has increased the vulnerability of banks of late. However, given the importance of State utilities, there may be some regulatory respite for asset classification, and therefore, such exposures may not slip into the NPA category in the short term. As for the on-lending to AP-based micro lending institutions by SCBs, these exposures are not very significant, and therefore, the overall credit profile of the SCBs may not suffer much even if the current stress on collections continues. As for the exposure to airlines, a large part of it is to the GOI-owned carrier and here, government guarantees mitigate the risk to an extent.

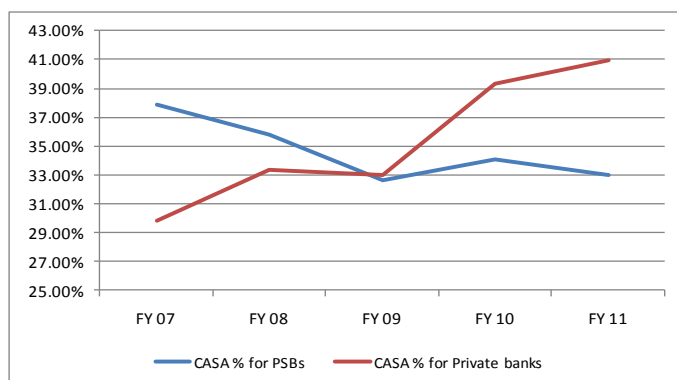
Overall, the credit profiles of borrowers could weaken in 2011-12 because of the following factors, among others:

- Moderation/slowdown in demand conditions;
- Compression of operating profitability because of cost pressures, and inability of companies to pass on the higher costs in a scenario of increasing competitive intensity;
- Higher interest rates;
- Lacklustre capital markets, which would constrain access to equity;
- Project implementation related delays;
- Reduced profitability of new projects (because of competitive pressures, higher feedstock prices and higher interest costs) funded with relatively higher leveraging; and
- Increase in counterparty risks and increasing concerns over fuel linkages in the power sector.

Despite some deterioration in the operating environment vis-à-vis the previous year, fresh slippages in 2011-12 may not be significantly higher than in 2010-11 since the previous year's numbers had included slippages because of adjustment issues (restructured accounts, Agri Debt Relief, and automation of asset classification). The Gross NPA percentage (for public and private sector banks) could increase to 2.3-2.7% as on March 31, 2012 from 2.3% the previous year. Further, if interest rates continue to rise, it could negatively impact asset quality.

Higher interest rates could ensure better deposits growth in 2011-12

Chart 3: Trend in Low-Cost Deposits of Banks



Source: RBI, Annual Reports/Results of banks, ICRA Research

increased by 18%. Within deposits, low cost deposits (CASA, current and saving accounts) increased by 27% for private sector banks, and by 15% for PSBs. CASA deposits represented 41% of the total deposits for private banks, and for a lower 33% for PSBs. For banks, having significant low cost deposits (CASA) as a proportion of total deposits could help them keep their cost of funds under control even in a scenario of rising interest rates in the system.

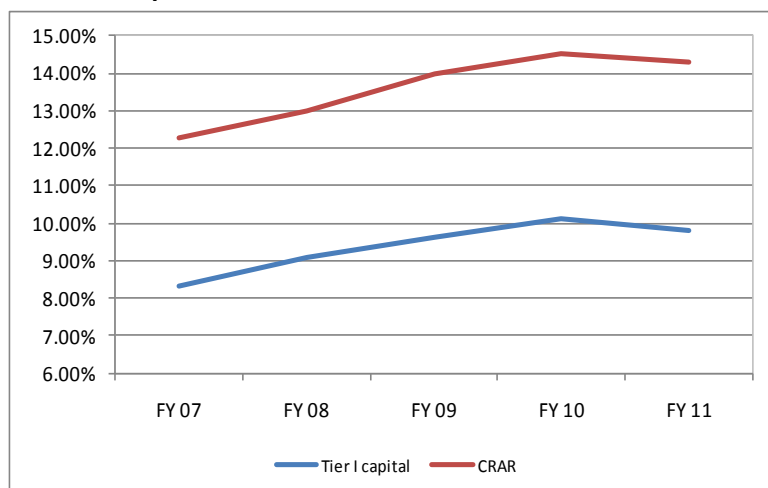
High proportion of certificates of deposits could impact NIM and liquidity negatively

ICRA's analysis of the current liquidity situation shows that Indian banks have been raising bulk funds in the form of certificates of deposit (CDs) and high-cost deposits from corporate entities mostly for short tenures. The share of CDs outstanding increased to 8.2% as in March 2011 from 7.2% as in September 2010 and 7.6% as in March 2010, with the total CDs outstanding increasing from Rs. 3.4 trillion to Rs. 4.2 trillion during this period. The high proportion of CDs (instead of retail deposits) could adversely impact the liquidity profile of banks and their NIMs in a scenario of rising interest rates.

Comfortable capitalisation against current norms

The capitalisation profile of SCBs remains comfortable and much above the minimum regulatory requirements of 6% and 9% for Tier

Chart 4: Capitalisation Profile of SCBs



Source: RBI, ICRA Research

government support (via capital infusion) to enable PSBs maintain a minimum Tier I capital of 8% is likely to result in these banks being able to maintain a comfortable capitalisation profile over short to medium term.

In the banking system, historically, there has been a positive correlation between growth in deposits base and increase in interest rates; periods with high interest rates have seen relatively high deposits growth, as in a high interest rate regime bank fixed deposits become more attractive than many other instruments. At present, it appears that given the outlook on interest rates, banks may be able to mobilise retail deposits at a higher pace in 2011-12 than in the previous year.

In 2010-11, according to ICRA's estimates, the overall deposits of private banks increased by 22%, while that of PSBs

requirements of 6% and 9% for Tier

I capital and Capital to Risk-weighted Assets Ratio (CRAR), respectively, although the CRAR and Tier I capital of SCBs declined in 2010-11. The decline is attributable largely to strong credit growth and the fall in the capitalisation level of the country's largest bank, State Bank of India (SBI).

The capitalisation profile of private banks continues to be better than that of PSBs, with the private banks' CRAR at around 16% and that of PSBs at around 13%, as in March 2011. However, continuous

Unamortised pension/gratuity liability could lower Tier I of PSBs (excluding SBI) by 30-35 bps

In 2010-11, PSBs reopened the pension option for employees who had not opted for pension earlier (including retired employees) and also enhanced the gratuity limits from Rs. 3.5 lakh to Rs. 10 lakh following the amendment to the Payment of Gratuity Act, 1972. The RBI allowed banks to amortise these liabilities over a maximum five years, beginning the financial year ended March 31, 2011, subject to minimum amortisation of 1/5th of the total liability every year. However, with the likely switch to International Financial Reporting Standards (IFRS) from April 1, 2013 (as scheduled for the Indian banking industry), the full unamortised liability would be knocked off from the opening balance of reserves, and consequently, banks may have to absorb the entire liability over the next two to three financial years.

For the 24 PSBs⁶ analysed by ICRA, as on March 31, 2011, the total unamortised pension and gratuity liabilities were around Rs. 203 billion (11% of their net worth). If the unamortised liability is adjusted against the Tier I capital of PSBs as on March 2011, then the Tier I capital declines by 30-35 bps from the 9% level of March 2011. While unamortised liability is moderate for PSBs as a whole, it is relatively high for a few banks (bank-wise unamortised liability as on March 31, 2011 at *Annexure 1*).

Most banks may not require significant capital now

During 2010-11, the GOI infused Rs. 165 billion in PSBs to improve their Tier I capital to 8% and take up its stake in the PSBs to at least 58%. After this, the Tier I capital of most of the PSBs has improved. Therefore, these banks (apart from SBI) may not require significant Tier I capital in the short term. The GOI has budgeted for Rs. 60 billion capital for PSBs in 2011-12. As for SBI, it plans to raise significant capital through a rights issue, and therefore, under the current regulations and market valuations, the GOI may need to infuse substantial capital into it to maintain its stake in the bank at 58%. As for private banks, these are well capitalised, although some may need equity to fund their growth plans.

Some banks may require capital to meet Basel III norms

As can be seen in *table 4* below, banks will need to maintain higher regulatory capital under BASEL-III norms versus the existing RBI norms.

Table 4: Capital Adequacy under Basel III vs. Existing Norms

	Basel III Norm	Existing RBI Norm
Common equity (after deductions)	4.50%	3.6% (9.2%)
Conservation buffer	2.50%	Nil
Countercyclical buffer	0-2.5%	Nil
Common equity + Conservation buffer + Countercyclical buffer	7-9.5%	3.6% (9.2%)
Tier I (including the buffers)	8.5-11%	6% (10%)
Total capital (including the buffers)	10.5-13%	9% (14.6%)

Note: Figures within parentheses pertain to aggregated capital adequacy of banks covering over 95% of the total banking assets as on March 31, 2010.

Source: Basel committee documents, RBI, Basel II disclosure by various banks

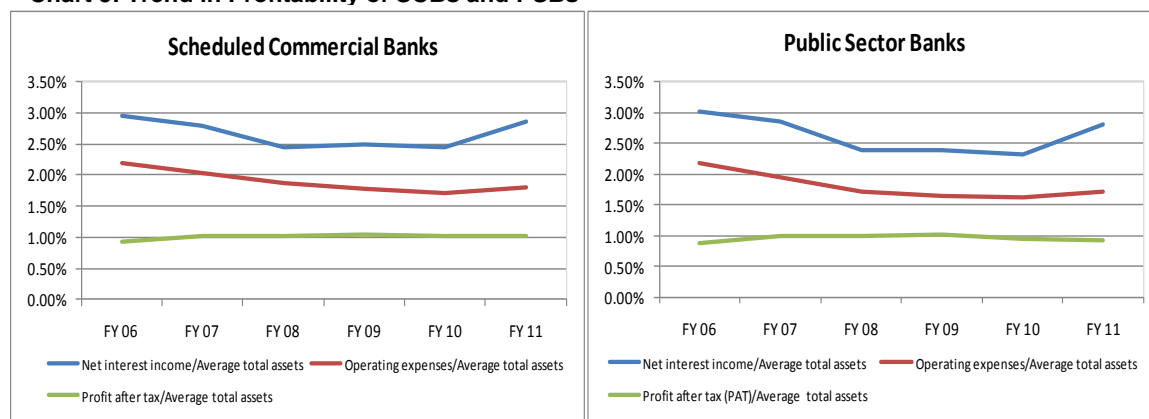
At an aggregate level, Indian banks fare well against the Basel III requirement for capital. However, some may appear inferior on comparison; for instance, nine banks had Tier I capital of less than 8.5% as on March 31, 2011. Considering the stricter deductions from Tier I and the fact that some of the existing perpetual debt (around Rs. 250 billion) would become ineligible for inclusion under Tier I, some banks may need to infuse superior or core capital (equity capital or Tier I). Additional capital may also be required to support a growth rate that exceeds the internal capital generation rate, which is likely.

⁶ Excluding SBI

Profitability profile stable; higher operating expenses, credit provisions offset increase in NIMs

The profitability profile of SCBs has remained steady over the years with the ratio of Profit after Tax to Average Total Assets (PAT/ATA) being in the 0.9-1.1% range. In 2010-11, while the profitability of SCBs benefited from the improvement in NIMs, the benefit was partly offset by the increase in their operating expenses and in credit provisioning, with banks rushing to raise the provisioning cover to 70%⁷. The rise in operating expenses largely followed the increase in the liability for pension & gratuity expenses⁸.

Chart 5: Trend in Profitability of SCBs and PSBs



Source: RBI, Annual Report Results of banks and ICRA Research

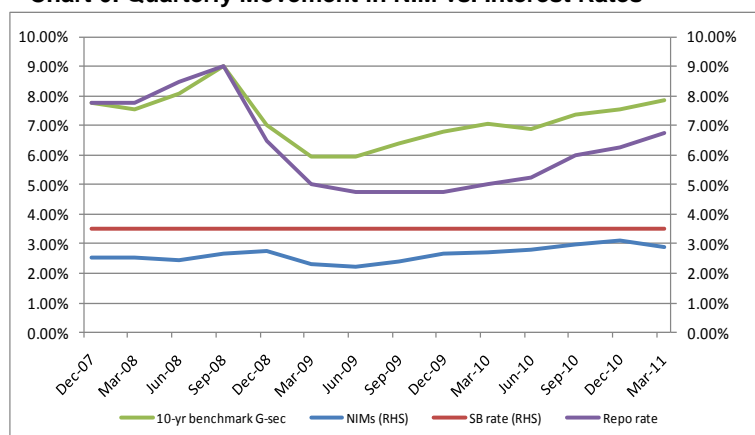
Increase in interest rate on savings deposits could reduce NIM by 5-15 bps

In recent periods, the spread between the savings bank (SB) deposit and term deposit rates has widened significantly. In May 2011, the RBI decided to raise the SB deposit interest rate from 3.5% to 4.0%. At the systemic level, SB deposits are estimated to account for 22-23% of total bank deposits (as of March 31, 2011). The increase in interest rate on SB deposits could raise the cost of deposits by around 13 bps at the systemic level. If banks do not pass on this additional cost to borrowers, their NIMs could be diluted by 10 bps, even as the post-tax impact would be lower at 6-7 bps; therefore, the return on equity could get diluted by less than 1%. The impact would be higher for banks with a large proportion of SB deposits (SBI, Punjab National Bank, ICICI and HDFC Bank) than for those with a smaller share of such deposits (UCO Bank, Oriental Bank of Commerce or OBC). Overall, the impact on NIMs for various banks ranges from 5 to 15 bps, which even if not very significant *per se*, would add to the pressures on profitability.

Interest rate sensitivity may rise; ability to pass on increase in cost of funds to influence trend in NIMs

As Chart 6 shows, banks have historically reported an increase in NIM in a rising interest rate scenario, although the trend was broken in

Chart 6: Quarterly Movement in NIM vs. Interest Rates



Source: RBI, ICRA Research

the fourth quarter (Q4) of 2010-11 by a higher rise in the cost of funds versus yield in advances. This positive correlation could be partly explained by the lag effect in term deposit re-pricing and partly by CASA deposits (34% of deposits or 28% of total liabilities), which are not interest rate sensitive; that is, interest rates are not linked to market rates. Going forward, the interest rate sensitivity of banks could increase as the proportion of infrastructure loans

⁷ Banks were asked by the RBI to achieve and maintain a provision cover ratio of 70%

⁸ Operating expenses as percentage of ATA rose in 2010-11 after having been on a declining trend for several years

(which are not as dynamically aligned to variable benchmark rates as loans to other sectors) increases and also if interest rates on SB deposits are deregulated.

Overall, a temporary slack in credit growth (as is typically seen in the first half of a financial year) and adjustments in the lending rate to incorporate a higher rate on SB deposits (and such other factors) may lead to a dip in the NIM in the first half of 2011-12, but the margin could recover subsequently, depending on the credit off-take.

Operating expenses may remain at an elevated level in the short term

The operating expenses of SCBs, after reporting a declining trend over the years, rose from 1.7% of ATA in 2009-10 to 1.8% of ATA in 2010-11 largely because of a rise in the PSBs' employee expenses following an increase in their pension and gratuity liability. Going forward, with the PSBs continuing to amortise these liabilities, their operating expenses are unlikely to decline.

As for expenses related to pension/increase in gratuity, during 2010-11, PSBs made a total provision of Rs. 89 billion for the same. Going ahead, if PSBs amortise only 20% (minimum required) of the total liability, they will have to make a provision of around Rs. 50 billion both in 2011-12 and 2012-13. However, if IFRS is implemented from April 1, 2013, as is scheduled, any unamortised liability would have to be knocked off from the opening net worth as on that date. So, it is expected that PSBs would want to accelerate the amortisation rate in 2011-12 and 2012-13. If a 40% amortisation rate (each year) for these liabilities is assumed for 2011-12 and 2012-13, the amortisation sum works out to around Rs. 100 billion each year (as against the total provision of around Rs. 89 billion made in 2010-11).

Given the concern about having an adequate cushion against unexpected losses, in October 2009, the RBI asked banks to increase the provisioning coverage ratio (including technical write-offs) to 70% by September 2010 and maintain the same subsequently. Most banks achieved a provisioning coverage ratio of 70% by September 2010 while a few obtained extension of the deadline (ranging from March to September 2011) from the RBI. As Table 5 shows, credit provisioning for PSBs increased significantly over the last two years (from 0.30% of ATA in 2008-09 to 0.62% of ATA in 2010-11) with the banks accelerating their provisioning to achieve a provision cover ratio of 70%. For private banks, their credit provisioning declined in 2010-11, largely because of lower fresh slippages. As for slippages, PSBs reported fresh slippages of 2.2% of opening standard assets and private banks of 1.3% in 2010-11.

Table 5: Trend in Credit Provisioning of PSBs and Private banks

	2008-09		2009-10		2010-11	
	PSBs	Private banks	PSBs	Private banks	PSBs	Private banks
Credit provision ⁹ as % of average credit	0.49%	1.46%	0.76%	1.62%	1.00%	0.79%
Credit provision as % of average total assets (ATA)	0.30%	0.81%	0.46%	0.90%	0.62%	0.44%

Source: Annual Report/Results of banks, ICRA Research

Credit costs may decline from 2010-11 levels

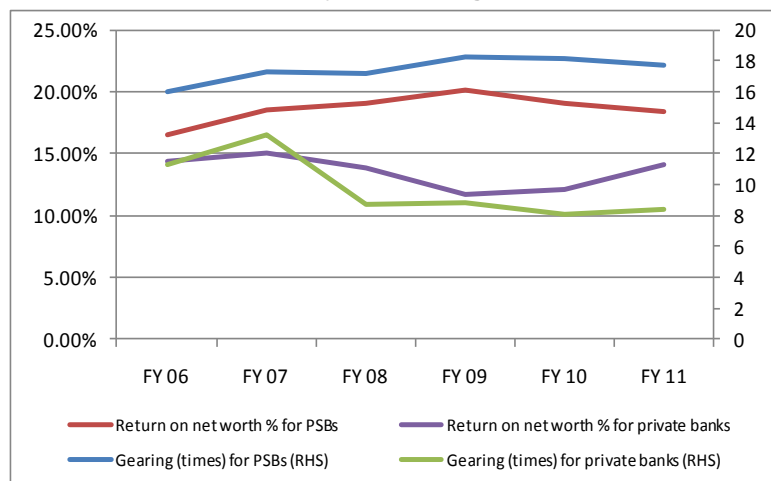
Credit provisioning for 2011-12 would be impacted positively by changes in the RBI norms, despite fresh slippages. A recent RBI guideline, according to which banks are no longer required to maintain a provision cover ratio (PCR) of 70% on new NPAs (although they need to maintain a PCR of 70% on NPAs as on September 30, 2010), could reduce the incremental credit provisioning requirement. However, another guideline, issued by the RBI in May 2011, has enhanced the provisioning requirement for certain categories of NPAs by 5-10% and asked banks to create a 2% provision on standard restructured assets. The latter guideline could absorb a part of the reduction in incremental credit provisioning resulting from the earlier relaxation. Overall, these guidelines could lead to credit provisioning of 0.35-0.45% (as percentage of assets) in 2011-12, depending on fresh slippages; the figure had stood at 0.6% in 2010-11.

⁹ Including standard asset provisioning

Profitability may remain in line with long-term trends

The profitability (PAT as a percentage of Total Assets) of SCBs has been stable at 0.9-1.1% over the last five years. Further, the profitability (PAT/Average Total Assets) of the PSBs has been lower (at around 0.9%) than that of private banks (at

Chart 7: Trend in Profitability and Gearing



Source: RBI, Annual Report/Results of banks, ICRA Research

around 1.4%) over the same period. However, despite lower profitability, the return indicators (Return on Net Worth) of the PSBs remain higher than those of private banks primarily because of higher leveraging. During 2010-11, PSBs reported a Return on Net Worth of around 18%, and private banks of around 14%.

Going forward, a temporary slack in credit growth (typical in the first half) and adjustments in lending rates (to incorporate a higher rate on saving deposits, etc.) may lead to a dip in

the NIM in the first half of 2011-12. Subsequently, the NIM could recover, depending on the credit off-take. Overall, despite the high levels of operating expense, banks are expected to report good core profitability, given their reasonable NIMs and lower credit provisions. At the same time however, depreciation on investments because of rising yields (50-75 bps from the March 31, 2011 levels) could pull down profitability by 5-10 bps.

Summing up

- For SCBs, the cost of funds could go up partly because of the increase in the saving bank rate (by 5-15 bps) and partly because of higher incremental costs. A temporary slack in credit growth (as is typically seen in the first half of financial year) and adjustment in the lending rate (to incorporate the higher rate on saving deposits, etc.) may lead to a dip in the NIM in the first half of 2011-12, which could however recover subsequently, depending on the credit off-take.
- The credit profiles of borrowers could weaken in 2011-12 because of a tight liquidity situation, higher interest rates, and moderation in GDP growth rate. The vulnerability of banks because of their increasing exposure to State power utilities is likely to increase, unless tariffs are revised upwards. However, these may not reflect in the Gross NPA percentage as there may be some regulatory respite. The Gross NPA percentage (for PSBs and private sector banks) may remain in the 2.3-2.7% range, as against 2.3% as on March 31, 2011. However, following regulatory relaxations, incremental credit provisions for 2011-12 could reduce to 0.35-0.45% of Average Total Assets as against 0.6% in 2010-11.
- An increase in the proportion of infrastructure loans (from the current 14% of domestic credit) and deregulation of saving rates could worsen the asset-liability management (ALM) profile and increase the interest rate sensitivity of banks.
- Indian banks continue to enjoy a comfortable capitalisation as compared with existing RBI norms with their Tier I capital close to 9%. Thus, apart from SBI, none of the PSBs may need significant Tier I capital in the short term. However, some of the fast-growing small private sector banks may need Tier I capital over short to medium term.

Annexure 1: Unamortised pension/ gratuity liability as on March 31, 2011

S No.	Name of the bank	Un-amortised pension and gratuity as on Mar-11 (Rs. billion)	Unamortised liability as % net worth
1	Allahabad bank	5.98	7%
2	Andhra Bank	5.06	8%
3	Bank of Baroda	14.64	7%
4	Bank of India	21.13	13%
5	Bank of Maharashtra	4.10	12%
6	Canara Bank	20.28	11%
7	Central Bank of India	11.82	13%
8	Corporation Bank	4.42	6%
9	Dena Bank	3.47	9%
10	Indian Bank	7.83	10%
11	Indian Overseas Bank	8.04	10%
12	Oriental Bank of Commerce	6.84	7%
13	Punjab National Bank	26.59	13%
14	Punjab & Sind Bank	7.61	21%
15	State Bank of Hyderabad	2.89	5%
16	State Bank of Patiala	6.47	16%
17	State Bank of Bikaner & Jaipur	3.08	11%
18	State Bank of Mysore	1.07	3%
19	State Bank of Travancore	5.38	16%
20	Syndicate Bank	5.82	9%
21	UCO Bank	6.40	11%
22	Union Bank of India	16.12	15%
23	United Bank of India	3.58	10%
24	Vijaya Bank	4.76	14%
	Total of 24 PSBs	203.37	11%

Source: Annual Report/Results of banks, ICRA Research



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