PRESS RELEASE

April 10, 2024

ICRA revises banking sector outlook to Stable from Positive

- *Incremental credit growth expected to moderate to Rs. 19.0-20.5 trillion in FY2025 (+11.7-12.5%) as credit to deposit ratios are at all-time high since December 2018*
- *Banks' net interest margins expected to compress, though benign credit costs and lower operating expenses would provide support*

ICRA has revised the banking sector outlook to Stable from Positive on the expectation of moderation in credit growth and profitability metrics, though the same would continue to remain healthy. While the compression in the interest margins over the last 18 months has been driven by rising deposit cost, the expectations of a rate cut in H2 FY2025 could lead to margin pressure, driven by a likely downward repricing of advances. Notwithstanding the margin compression, the growth in loan book shall translate into steady operating profits, aided by benign credit costs. ICRA expects this to drive healthy earnings, that will largely be sufficient for most banks to meet their regulatory as well as growth capital requirements.

Commenting further, **Mr. Sachin Sachdeva, Vice President & Sector Head, ICRA** said*: "The challenges in deposit mobilisation, and regulatory measures to slow down credit growth towards loans extended to consumer credit and non-banking finance companies (NBFCs) are expected to temper expansion modestly to Rs. 19.0-20.5 trillion in FY2025 (year-on-year growth at 11.7%-12.5%). This would be next only to the highest ever credit expansion of over Rs. 22.2 trillion (16.3%) in FY2024."*

The credit to deposit ratio (CD ratio) for the banks is estimated to have increased to 78% (excluding the merger of HDFC Limited) as on March 22, 2024, the highest since December 21, 2018 (77.9%) and much higher compared to 75.7% as on March 24, 2023, and 71.9% as on March 25, 2022. This will pose significant challenges for the banks to pursue credit growth as their on-balance sheet liquidity has been deployed towards strong credit growth during the last two years. The CD ratio is likely to remain elevated at 77-78% (excluding HDFC merger) and over 80% (including HDFC merger) at the sector level in FY2025, even though some of the private banks may see a decline, while some of the public banks may see an increase in their CD ratio.

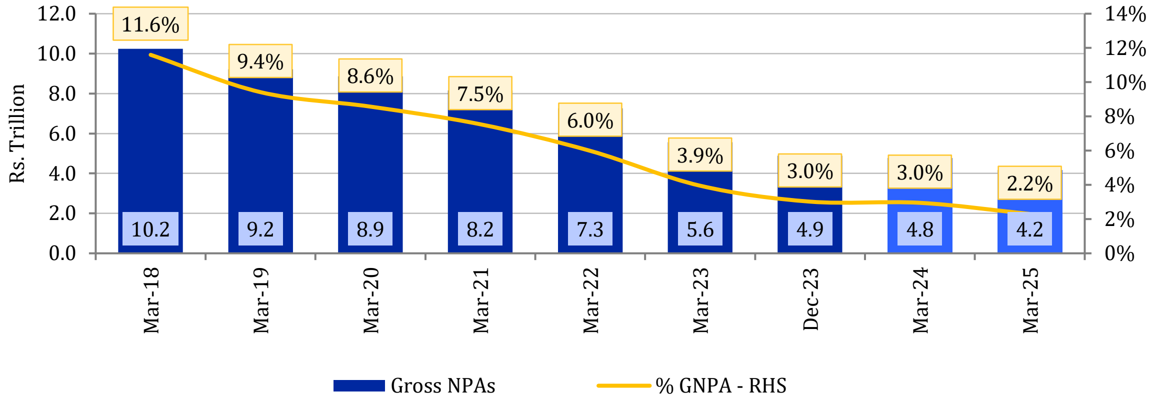
Mr. Sachdeva added: *"With elevated CD ratio, the competition for deposit mobilisation is likely to remain high even during FY2025, which will limit the banks' ability to cut their deposit and lending rates. Amid this, if the policy rates are cut, it will pose significant challenges to banks' net interest margins (NIMs)."*

ICRA expects the headline asset quality metrics of the banking sector to remain on an improving trajectory. Gross and net additions to non-performing advances (NPAs) are likely to increase amid seasoning of recently originated book and slower recoveries and upgrades as low hanging resolutions and recoveries are largely completed. However, continued growth in the loan book would lead to an improvement in the headline asset quality metrics. ICRA expects the gross NPAs (GNPAs) and net NPAs (NNPAs) to decline to 2.1-2.3% and 0.5-0.6%, respectively, by March 2025 from 3.0% and 0.7%, respectively, estimated for March 31, 2024, which would remain the best in more than a decade. Notwithstanding this, ICRA remains cautious about the impact of macro-economic shocks such as slowdown in credit growth, and high interest rates locally as well as in developed markets on the asset quality, if these were to materialise.

Credit costs are estimated to remain steady at 0.8% of advances in FY2025, in line with FY2024. This should allow banks to comfortably withstand a compression in the interest margins, which would lead to a mild moderation in the return on assets (RoA) to 1.0-1.1% in FY2025 from an estimated 1.2% in FY2024. At these levels, the return on equity (RoE) would remain healthy at 11.5-12.7% in FY2025 against estimated 14.6% in FY2024.

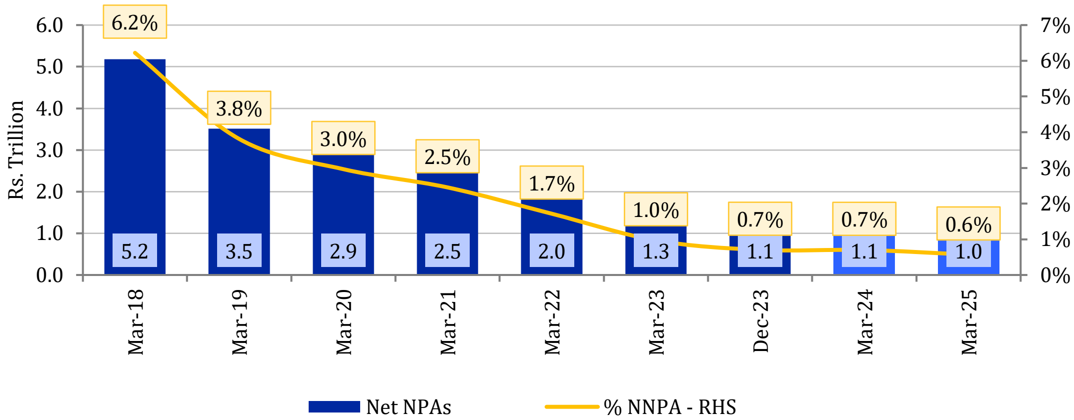
Furthermore, supported by internal capital generation and lower NNPA levels, the capitalisation and solvency profiles of private and public sector banks would remain comfortable. ICRA projects the Tier-I capital of the banking sector at 14.5-14.9% (~14.5% as of March 2024) and an improvement in the solvency levels to ~5% (~6% as of March 2024) by March 2025.

Exhibit: Gross NPAs to decline – Public + Private sector banks



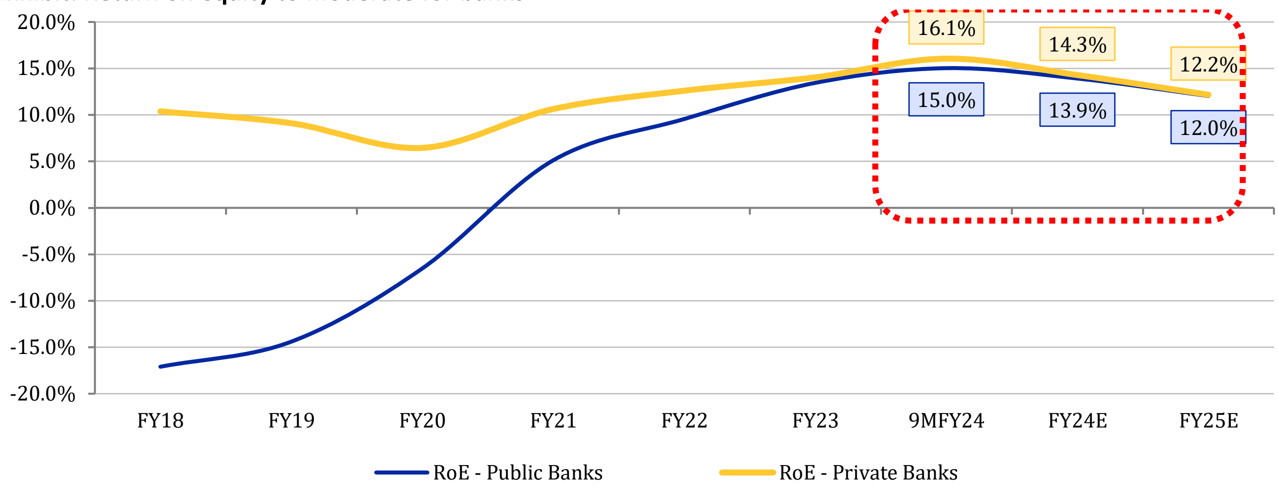
Source: Aggregate of 13 PSBs (including IDBI Bank) and 19 private banks, ICRA Research

Exhibit: Net NPAs to remain steady – Public + Private sector banks



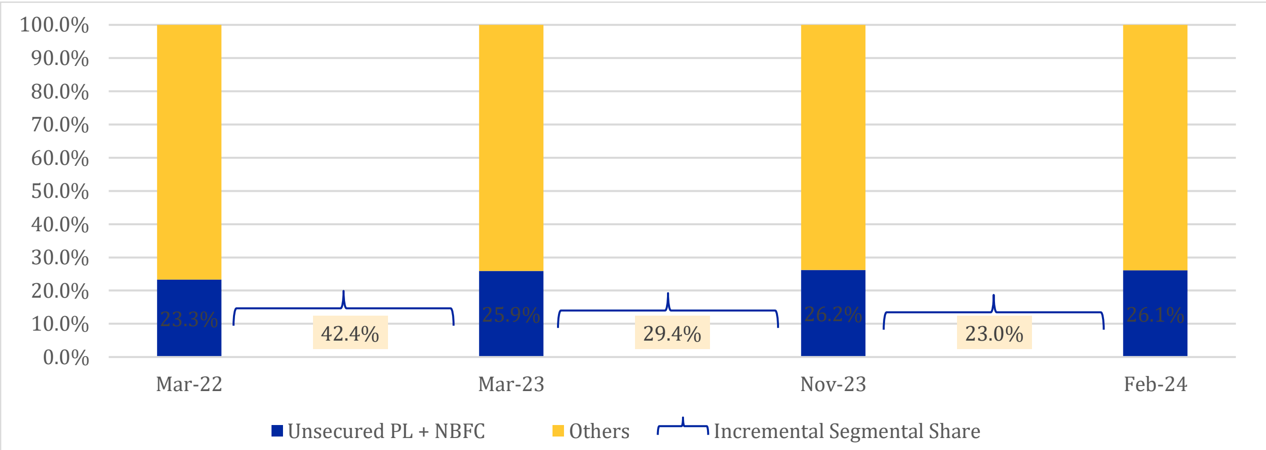
Source: Aggregate of 13 PSBs (including IDBI Bank) and 19 private banks, ICRA Research

Exhibit: Return on equity to moderate for banks



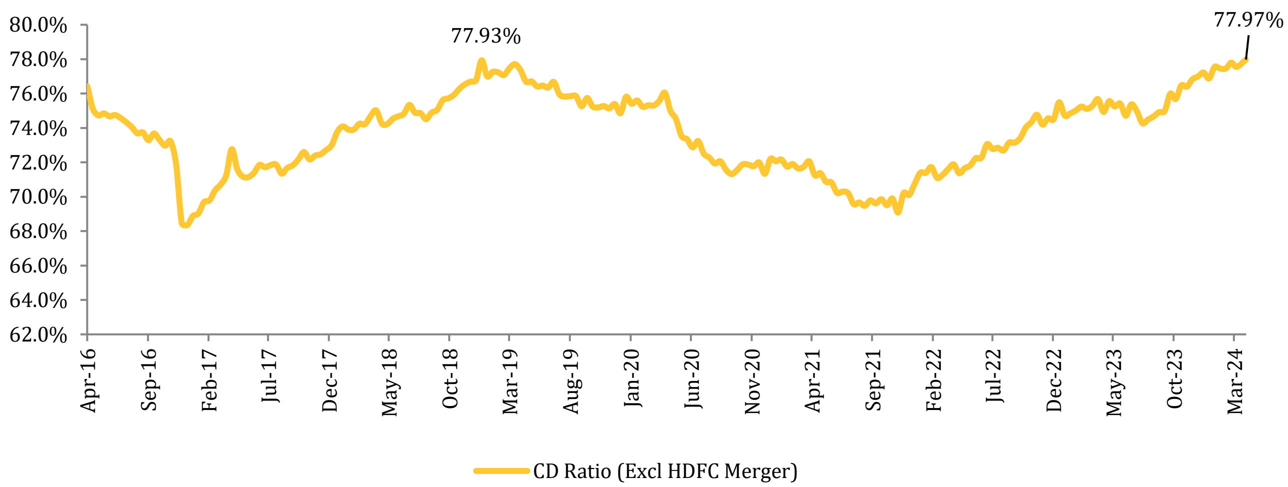
Source: Aggregate of 13 PSBs (including IDBI Bank) and 19 private banks, ICRA Research

Exhibit: Incremental share of unsecured PL & NBFC in non-food bank credit slows down post November 2023



Source: RBI, ICRA Research

Exhibit: Credit to Deposit ratio at all-time high in the last five years



Source: RBI, ICRA Research

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