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INDIAN BANKING SECTOR

Threat of third wave poses risk to asset quality, especially the restructured loan book

Outlook: Stable

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Table of Contents

EXECUTIVE SUMMARY	6
Outlook - Stable	7
Indian Banking Sector – Threat of Third Wave of Covid-19 Poses Risk to Asset Quality, Especially The Restructured Loan book	7
Outlook on Credit and Deposit Growth	9
Credit Growth Improves; Momentum Likely To Sustain But Double-digit YoY Growth Could Remain Elusive In FY2023 As Well	10
Retail And Agriculture Continue To Drive YoY Loan Growth; Credit Growth To Services And Industrial Segments Remains Muted	11
Bank Credit Growth Expectations Maintained At 7.3-8.3% For FY2022; Expected To Improve To 7.7-8.6% In FY2023	12
Short-term Rates Harden Despite Increasing Liquidity Surplus As RBI Absorbs Surplus Liquidity At Higher Rates	13
Improved Vaccination Levels And Experience Gained From Past Covid Waves Would Continue To Support Credit Growth Even If Third Wave Hits	14
Market Share Gains Continue For Private Banks; Private Banks Expected To Account For ~40% Of Bank Credit By CY2023	16
Lending Rates Start Going Up In December 2021	17
Asset Quality Trends and Outlook	18
Slippages Of SREI Group Exposure Drive Up Corporate Slippages In Q2 FY2022; Retail Segment Slippages Remain Elevated	19
Gross Fresh Slippages Likely To Be Higher In FY2022 Compared To FY2021; However, Net Slippages To Be Lower Than Previous Year	20
Tail Impact Of Second Wave Drove Elevated Slippage Rate For Lenders In Unsecured Retail Segments In Q2 FY2022 As Well	21
Retail And MSME Restructuring During Second wave Was Almost 3x The First Wave	22
PSBs Report Higher Restructuring; Overall Restructuring For The Sector At 2.9% Of Loans Of The Banking Sector	23
Stressed Exposures Including Restructured Loans Are Higher Than Pre-Covid Level Even As Headline Numbers Improve	24
NNPAs Of Banks Continue To Decline; Legacy NPA Provisions To Remain Low And Hence Support Ability To Absorb Incremental Stress	25
GNPAs And NNPAs Of Banks – September 30, 2021; NNPAs Rise For Many Private Sector Banks	26
Bounce Rates Continue To Decline As Economic Activity Improves And Impact Of Second Wave Wanes	27
Loan Restructuring, Improving Collections And DHFL Recovery Drive Recoveries And Upgrades To Highest Level Since June 2018	28
Sequential Decline In Overdue Loan Books (or SMA Accounts) Of Most Banks In Q2 FY2022	29
Outlook On Asset Quality – Declining Trend Of GNPAs And NNPAs Expected To Continue	30

Credit Provisions Will Continue To Decline For Public As Well As Private Banks, Thereby Driving Improvement In Earnings	31
Summing Up – Headline Asset Quality Numbers Improve; Performance Of Restructured Loans Is Monitorable Amid Threat Of Third Wave	32
Capital Position and Requirements	33
Capitalisation – Peak Capital Requirements With CCB Of 2.5% Kicked In From October 1, 2021	34
Public Banks’ Capital Position Is Adequate With Improved Solvency Profile Driven By Internal Capital Generation As Well As Capital Raisings	35
Public Sector Banks Successfully Roll Over AT-I Bonds Due For Call Option In FY2022	36
Large Private Banks On Strong Footing On Capital Position; However, A Few Mid-Sized Banks Will Need To Raise Capital	38
Capital Requirements Of Public Banks – GoI Unlikely To Announce Capital Infusion For Public Banks For First Time In Last Decade	39
Capital Requirements Remain Limited To A Few Mid-Sized Private Banks	40
Profitability Trends and Outlook	41
Rising Interest Rates To Improve NII Growth In Coming Quarters; Treasury Gains Unlikely To Continue From Q3 FY2022	42
Credit And Other Provisions Remained Steady Despite Second Wave	43
Most Banks Report Sequential Growth In Profitability In Q2 FY2022	44
Outlook – Upward Revision In Earnings Estimates Driven By Further Moderation In Credit Costs	45
Credit Ratings and Outlook	46
Rating Actions Have Been On Positive Side	47
Quarterly Financials	49
Summary Quarterly Financials – Public Sector Banks (Aggregate Of 13 Public Banks – Including IDBI)	50
Summary Quarterly Financials – Private Sector Banks (Aggregate Of 18 banks In ICRA’s Sample Set)	54
Summary Quarterly Financials – All Banks (Aggregate Of 31 Public And Private Banks)	58

Table of EXHIBIT

EXHIBIT 1: Incremental Non-food Credit Growth of Banks.....	10
EXHIBIT 2: Incremental Bank Deposit Growth	10
EXHIBIT 3: Sectoral Deployment of Bank Credit	11
EXHIBIT 4: Credit Growth Likely to Improve Further in FY2023.....	12
EXHIBIT 5: Non-food Credit Outstanding and Incremental Credit Growth.....	12
EXHIBIT 6: YoY Credit and Deposit Growth.....	13
EXHIBIT 7: Liquidity Infusion/(absorption) under LAF	13
EXHIBIT 8: Credit and Deposit Growth Trends for Public Banks	14
EXHIBIT 9: Credit and Deposit Growth Trends for Private Banks.....	14
EXHIBIT 10: Bank-wise YoY Credit Growth September 2021 – Public Banks	15
EXHIBIT 11: Bank-wise YoY Credit Growth September 2021 – Private Banks.....	15
EXHIBIT 12: Market Share of Private Banks	16
EXHIBIT 13: TTM Market Share of Banks in Advances	16
EXHIBIT 14: Weighted Average Lending Rate and Term Deposit Rate for Banks	17
EXHIBIT 15: Decline in Various Rates during January 2020 – December 2021	17
EXHIBIT 16: Quarterly Trend in Gross Fresh Slippages – Public Banks	19
EXHIBIT 17: Quarterly Trend in Gross Fresh Slippages – Private Banks.....	19
EXHIBIT 18: Break-up of Slippages for H1 FY2022	19
EXHIBIT 19: Annual Trend in Gross Fresh Slippages – Public Banks.....	20
EXHIBIT 20: Annual Trend in Gross Fresh Slippages – Private Banks.....	20
EXHIBIT 21: Bank-wise Gross Fresh Slippages – Public Banks.....	21
EXHIBIT 22: Bank-wise Gross Fresh Slippages – Private Banks	21
EXHIBIT 23: Slippages, Repayments and Restructured Book – Public Banks	22
EXHIBIT 24: Slippages, Repayments and Restructured Book – Private Banks	22
EXHIBIT 25: Mix of Restructuring – Covid 1.0, Covid 2.0 and MSME till September 30, 2021	22
EXHIBIT 26: Bank-wise Standard Restructured Advances – Public Banks.....	23
EXHIBIT 27: Bank-wise Standard Restructured Advances – Private Banks	23
EXHIBIT 28: GNPA's + Std. Restructured – Public Banks	24
EXHIBIT 29: GNPA's + Std. Restructured – Private Banks	24
EXHIBIT 30: NNPA's – Public Banks	25
EXHIBIT 31: NNPA's – Private Banks	25

EXHIBIT 32: Reported GNPA and NNPA – Public Banks	26
EXHIBIT 33: Reported GNPA and NNPA – Private Banks	26
EXHIBIT 34: Trends in Bounce Rates	27
EXHIBIT 35: Trend in Recovery + Upgrade (% of opening GNPA of preceding quarter)	28
EXHIBIT 36: Trend in Recovery/Upgrades and Write-offs.....	28
EXHIBIT 37: SMA Level Across Key Banks	29
EXHIBIT 38: GNPA Outlook – Public + Private Banks	30
EXHIBIT 39: NNPA Outlook – Public + Private banks	30
EXHIBIT 40: Credit and Other Provisions Outlook – Public Banks.....	31
EXHIBIT 41: Credit and Other Provisions Outlook - Private Banks	31
EXHIBIT 42: Outlook on Asset Quality Indicators for FY2022 and FY2023 – Public Banks, Private Banks and All Banks	32
EXHIBIT 43: Capital Ratio Requirement for Banks	34
EXHIBIT 44: Step-up Schedule for Minimum Regulatory Capital Requirements^	34
EXHIBIT 45: Reported Tier I Capital – Public Banks as on September 30, 2021	35
EXHIBIT 46: Solvency – (NNPA/Core Capital) – Public Banks as on September 30, 2021	35
EXHIBIT 47: AT-I Bonds Due for Call Option (FY2022 and FY2023) and Bonds Raised in FY2022 (YTD)	36
EXHIBIT 48: Reported Tier I Capital – Private Banks as on September 30, 2021	38
EXHIBIT 49: Solvency – (NNPA/Core Capital) – Private Banks as on September 30, 2021	38
EXHIBIT 50: Bank-wise Tier I Capital Requirement for Public Banks – FY2022 and FY2023	39
EXHIBIT 51: Overall Tier I Capital Requirement for Public Banks – FY2022 and FY2023	39
EXHIBIT 52: Bank-wise Tier I Capital Requirement for Private Banks – FY2022-23	40
EXHIBIT 53: Overall Tier I Capital Requirement for Private Banks – FY2022-23	40
EXHIBIT 54: Growth in Net Interest Income.....	42
EXHIBIT 55: Return on Assets.....	42
EXHIBIT 56: Key Profitability Indicators – Public Banks	43
EXHIBIT 57: Key Profitability Indicators – Private Banks.....	43
EXHIBIT 58: Bank-wise RoA in Q1 FY2022 and Q2 FY2022 – Public Banks.....	44
EXHIBIT 59: Bank-wise RoA in Q1 FY2022 and Q2 FY2022 – Private Banks	44
EXHIBIT 60: Profitability Estimates for Public and Private Banks for FY2022 and FY2023	45
EXHIBIT 61: Rating Distribution – Public Banks (Tier II Bonds)	47
EXHIBIT 62: Rating Distribution – Private Banks (Tier II Bonds).....	47



EXECUTIVE SUMMARY

OUTLOOK - STABLE

Incremental restructuring under Covid 2.0 pushes up the standard restructured loan book of banks to 2.9% as on September 30, 2021 from 2.0% as on June 30, 2021

Gross slippages remained elevated in H1 FY2022; however, improved recoveries moderate the net slippages

Banks have implemented ~83% of the restructuring requests received under Covid 2.0 till September 30, 2021; hence, incremental restructuring to remain limited in Q3 FY2022

Lower net slippages and recovery from DHFL drive down credit provisions and improvement in profitability

INDIAN BANKING SECTOR – THREAT OF THIRD WAVE OF COVID-19 POSES RISK TO ASSET QUALITY, ESPECIALLY THE RESTRUCTURED LOAN BOOK

The standard restructured loans of banks are estimated at 2.9% of standard advances. This largely includes the borrowers that were impacted by the first and second waves of the Covid-19 pandemic. The threat of a third wave poses high risk to the performance of the restructured loan book and remains a key monitorable for the near term.

Headline numbers for banks remain on improving trend: The performance of banks in Q2 FY2022 continued its improving trend despite the impact of the second wave in the preceding quarter. Improving collections, recovery from Dewan Housing Finance Corporation Ltd (DHFL) and incremental restructuring of Rs. 0.8 trillion under Covid 2.0 led to better recoveries and upgrades, which were the highest ever during the last three years. The moderation of slippages on a sequential basis (despite large slippage from SREI) also resulted in lower net slippages and a sharp decline in the credit provisions of banks. Overall, the improvement in the headline asset quality numbers continued, which supported a further improvement in the bottom line of banks.

Standard restructured loans increased: Notwithstanding the above positives, with incremental restructuring under Covid 2.0, the overall restructured loan book for banks increased and is estimated at 2.9% of standard advances of the sector as on September 30, 2021 (2.0% as on June 30, 2021). Most of this restructuring includes borrowers impacted by Covid 1.0 and 2.0. With the increased spread of the new Covid-19 variant, i.e. Omicron, the possibility of a third wave cannot be ruled out. As banks restructured most of these loans with a moratorium of up to 12 months, this book is likely to start exiting the moratorium from Q4 FY2022 and Q1 FY2023. Therefore, a third wave poses high risk to the performance of the borrowers that were impacted in the previous waves and hence poses a risk to the improving trend of profitability and solvency.

Stable Outlook maintained on the sector: The level of restructured loans varies significantly across lenders with a relatively high restructured book for public banks and a few mid-sized private banks. The credit profile of some of these banks, especially those with weak capital cushions or solvency position, will remain a monitorable. Overall, given the broader improvement in headline numbers and improved outlook on the earnings, capital, and solvency position, we maintain a Stable outlook for the sector even though there could be a temporary setback if the third wave materialises.

Limited capital requirements for public banks: With the overall improvement in the headline numbers on profitability and capital, the fresh equity capital raise was relatively limited in 9M FY2022 compared to FY2021 despite the second wave. However, on the positive side, public banks were largely able to roll over their additional tier-I (AT-I bonds) as there was a sizeable amount of bonds with call option due in FY2022. This will preserve their Tier-I capital ratios even as the Reserve Bank of India (RBI) increased the minimum regulatory capital requirements from October 1, 2021. With the improved position of public banks, we maintain that the regulatory and growth capital requirements of banks will remain limited for the next couple of years. With capital and asset quality issues no longer a challenge, the ability of public banks, which account for a ~62% share in bank loans, to meet the increased credit demand does not appear to be a constraint. Nevertheless, the revival of credit demand and the willingness of banks to push growth will be key drivers of the overall credit growth in the economy.

Incremental equity capital raising remained limited in 9M FY2022 with public banks raising most of the capital from markets

Public banks also rolled over the AT-I bonds scheduled for call option in FY2022 and preserve their Tier-I ratios, reducing their dependence on GoI for recapitalisation

Credit growth likely to remain within our estimates of 7.3-8.3% for FY2022; double-digit growth unlikely in FY2023 unless corporate demand revives

Interest rates to remain on upward trend in FY2023 as RBI is expected to hike policy rates

Outlook remains Stable driven by expectations of improvement in asset quality, profitability and capital cushions; high level of restructured loans and overdue loans for some banks remains key challenge, especially amid threat of a third wave

Key highlights:

- Bank credit growth has shown signs of further improvement in Q3 FY2022 with the YoY growth improving to 7.4% as on December 4, 2021 from 5.5% for FY2021. We retain our credit growth estimate of 7.3-8.3% for FY2022 and expect the trend of improving growth to continue in FY2023 as well, though this is unlikely to touch double-digits till the growth in corporate credit demand revives. We expect YoY credit growth of 7.7-8.6% for FY2023 with potential for higher growth if corporate demand revives in the second half of the next financial year.
- The surplus liquidity in the banking system continues to rise. However, the short-term rates have increased gradually despite this as the RBI has increased the liquidity absorption under variable rate reverse repo or longer tenure, which is higher than the overnight reverse repo rates. This will pave the path for a gradual hike in policy rates next year, thereby leading to higher borrowing costs in FY2023.
- Gross fresh slippages are likely to be higher in FY2022 compared to FY2021. However, net slippages are likely to remain lower than FY2021, given the improving collections trend, restructuring implemented during H1FY2022 and the ability of lenders to enforce recovery actions, leading to a continued decline in the gross and net non-performing advances (NPAs). Nevertheless, the stressed book of banks (including standard restructured book) has increased above the pre-Covid level and remains a key monitorable for future asset quality.
- Banks have implemented ~83% of the restructuring requests received under Covid-19 till September 30, 2021. With the implementation window available till December 31, 2021, the restructuring levels could increase marginally by 15-20 bps from 2.9% as on September 30, 2021. Retail and micro, small & medium enterprise (MSME) restructuring under Covid 2.0 was almost 3x of Covid 1.0 in the absence of the moratorium that was announced by the RBI during Covid 1.0. With further restructuring and improving collections in Q2 FY2022, the overdue loan book across most banks declined on a sequential basis.
- The core operating profitability remained steady for private banks, even though family pension provisioning impacted the core operating profitability of public banks. Despite a moderation in the gains on bond portfolios amid rising bond yields, the moderation in the credit provisions resulted in a broad-based improvement in profitability across most banks.
- With improved profitability and asset quality, the regulatory and growth capital requirements for public banks are negligible and the Government of India (GoI) is unlikely to budget capital allocation for FY2023. The allocation of the budgeted capital for FY2022 remains to be seen as most banks do not require capital after they successfully rolled over their AT-I bonds in Q3 FY2022.
- Rating actions largely remained on the positive side in 9M FY2022 as the outlook on the asset quality, capital and solvency profile remains on the positive side, even as the threat of a third wave and the impact on the restructured book remain monitorable.

ABOUT ICRA

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