ICRA
A MOODY'S INVESTORS SERVICE COMPANY

INDIAN BANKING SECTOR

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

Outlook: Stable

December 2021

Karthik Srinivasan
+91 22 6114 3114
karthiks@icraindia.com

Anil Gupta
+91 124 4545314
anilg@craindia.com

Aashay Choksey
+91 22 61143430
aashay.choksey@craindia.com

Table of Contents

Table of EXHIBIT

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.

ICRA
A MOODY'S INVESTORS SERVICE COMPANY

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.

The ICRA Factor

Our services are designed to

- Provide information and guidance to institutional and individual investors/creditors;
- Enhance the ability of borrowers/issuers to access the money market and the capital market for tapping a larger volume of resources from a wider range of the investing public;
- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

ICRA

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
+91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: Jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: Communications@icraindia.com
Tel: +91 124 4545 860

Registered Office

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg, New Delhi - 110 001
Tel: + 91 11 2335 7940-50

Corporate Office

Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,
Gurgaon - 122 002
Tel: +91-124-4545300

Ahmedabad

1809-1811, Shapath V,
Opp: Karnavati Club,
S.G.Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/501

Bengaluru 1

'The Millenia', Tower B Unit No. 1004,
10th Floor, 1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

4th Floor, 'Shoban'
6-3-927/A&B. Somajiguda
Raj Bhavan Road,
Hyderabad - 500 082
Tel: +91 40 4067 6500

Hyderabad 2

No. 7-1-58, 301, 3rd Floor, 'Concourse',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road,
Shivajinagar, Pune - 411 020
Tel: +91 20 2556 1194

Email: Info@icraindia.com
Helpdesk: 9354738909
Website: www.icra.in/ www.Icraresearch.in