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Will a second COVID wave, fresh state-level restrictions add to banks' NPA woes?

Just when the Indian economy was trying to get its second wind after braving the onslaught of lockdown 2020, comes the unexpected but severe second round of the pandemic.

On Tuesday, Maharashtra announced a 15-day curfew in the state to control the spread of COVID-19 infections. There is a likelihood of more states following suit. How will the fresh round of restrictions impact the economy and, more specifically, the banking sector asset quality?

Logically, banks, non-banking finance companies (NBFCs) and microlenders may witness continued stress on their asset quality front due to the second wave of COVID and fresh restrictions, but the general consensus among analysts is that the incremental stress in the banking sector may not be as huge as compared to the last round of the pandemic in 2020.

Last year, when the Centre announced a nationwide lockdown to fight COVID-19, banks had faced major pressure on their asset quality and fresh business acquisition. But the actual impact on asset quality wasn't much due to the timely intervention of the central bank to avert an immediate shock.

The RBI announced a six-month moratorium and a subsequent one-time restructuring facility for banks. This helped to escape from a huge spike in their non-performing assets (NPAs). A loan becomes an NPA if there is no repayment of interest or principal for a period of 90 days. Once a loan becomes NPA, banks need to set aside money to cover the potential losses from such accounts. High provisions hurt banks' profitability.

If the second wave of infections continue to force more restrictions on business activities, banks face headwinds on their asset quality but the impact will not be severe as restrictions are likely to be partial, said Siddharth Purohit, senior research analyst at SMC Global Securities.

"There might be more restrictions. But even last time, the impact was not very big. So, one shouldn't worry too much with regards to the stress in assets," said Purohit.

Rating agency Moody's held similar views. It, too, flagged the risks to the economy on account of fresh COVID infections. "The second wave of infections presents a risk to our growth forecast as the reimposition of virus management measures will curb economic activity and could dampen market and consumer sentiment," the rating agency said.

It cited google mobility data to show that retail and recreation activity across India had dropped by 25 per cent as of April 7 compared to February 24. "This was mirrored in the Reserve Bank of India's March Consumer Confidence Survey, which showed a deterioration in perceptions of the economic situation and expectations of decreased spending on nonessential items," Moody's said.

However, given the focus on `micro-containment zones' to deal with the current wave of infections, as opposed to a nationwide lockdown, we expect that the impact on economic activity will be less severe than that seen in 2020, the rating agency pointed out.

Last year, the COVID-19 outbreak added to the worries of an already slowing economy. This fiscal year, the Indian economy is projected to bounce back on a lower base of last year. In FY21, the growth is projected to contract by 7.7 percent.

On Monday, agency S&P Global Ratings (a division of Standard and Poor Global) said systemic risk in Indian banks is likely to remain high in the wake of the second wave of COVID-19 and high proportion of weak loans.

S&P estimates the weak loans in banks at 11-12 percent of gross loans. "We forecast credit losses will decline to 2.2 percent of total loans in the year ending March 31, 2022, and 1.8 percent in fiscal 2023, after staying elevated at an average of 2.8 percent in fiscals 2016-2021," S&P predicted.

In the last round, banks had reported fewer requests for loan recasts as most companies had applied for loan moratorium. The government had put a freeze on fresh Insolvency and Bankruptcy Code (IBC) cases last year for a period of 12 months to help stressed borrowers hit by the Covid-19 pandemic. This meant a sharp decline in the fresh IBC cases, but that deadline expired on March 25.

According to a recent report from CARE rating agency, banks have already managed to recover around 40 percent of their dues in 12 large cases, of which ten have reached the resolution stage.

"Since the last two years, NPA levels have reduced (partly due to loan write-offs) and the challenge for banks continue in the current year due to pandemic and nationwide lockdown, which has resulted in muted economic activities across the country," the CARE report said.

Indian banks have seen a significant spike in NPAs after the RBI initiated early identification of stressed assets and Asset Quality Review (AQR) for banks. This forced banks to dig out the hidden dirt in their balance sheets.

The exercise caused a sharp spike in reported NPAs. But NPAs started declining in the last two years due to significant loan write-offs and high provisioning. Provisions refer to the money set aside against NPA losses.

In absolute terms, the Gross NPAs of scheduled commercial banks improved in FY19 and FY20 to Rs.9.4 lakh crore and Rs.8.9 lakh crore respectively, after reaching a peak in FY18 (Rs.10.4 lakh crore), CARE said.

MFIs may see more pain

Compared to the big banks, microfinance institutions (MFIs) or smaller microlenders may face more trouble on the ground on account of fresh restrictions due to the nature of their business, said rating agency Crisil.

Microlenders, as the name suggests, give small loans to low-income borrowers. MFIs typically borrow from banks and lend to their borrowers at a margin of 10-12 per cent over their borrowing costs.

According to the agency, Maharashtra is also among the top five states in terms of microfinance loans, with assets under management (AUM) of around Rs 16,700 crore as on December 2020, tantamount to around 7 per cent of all microfinance loans.

Non-banking finance company microfinanciers (NBFC-MFIs) account for 40 per cent, or around Rs 6,700 crore, of this pie.

Crisil said collection efficiency in Maharashtra has been relatively lower at around 85-90 per cent even before the latest curbs because of previous extended lockdowns. The all-India average collection efficiency was 90-94 per cent in December 2020.

Said Krishnan Sitaraman, Senior Director & Deputy Chief Ratings Officer, CRISIL Ratings: “The sector’s collection efficiency has stalled at 90-94 per cent in the past few months compared with the pre-pandemic level of 98-99 percent. These mini-lockdowns can restrict improvement in the coming months."

However, NBFC-MFIs have been allowed to continue operations in Maharashtra, unlike the most stringent lockdown phase early last fiscal. Since microfinance requires high personal connect, this comes as a big relief, he said.