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Indian Banking Sector: Update FY17 & Outlook

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Background

FY17 *(refers to period from April 01 to March 31)* was yet another challenging year for Indian banks with decline in credit growth, continued stress on asset quality, high provisioning costs resulting in declining profits and high requirement of capital for growth and compliance with stringent regulatory requirements. The performance of the banks was also impacted by the subdued economic backdrop as well as dynamic regulatory environment.

As per the revised estimates of CSO, the GDP growth during FY17 is expected to be 7.1% which was lower than 8.0% during FY16. The decline in GDP growth was largely lower due to impact on sectors like manufacturing, mining and services, whereas agriculture showed improvement in growth on the back of good monsoon. Another key factor impacting the economy during the year was the demonetisation of high value currency notes in the second half of the financial year which had a temporary impact on the economic growth in the second half of the year resulting in lower growth during FY17 as compared to the previous year.

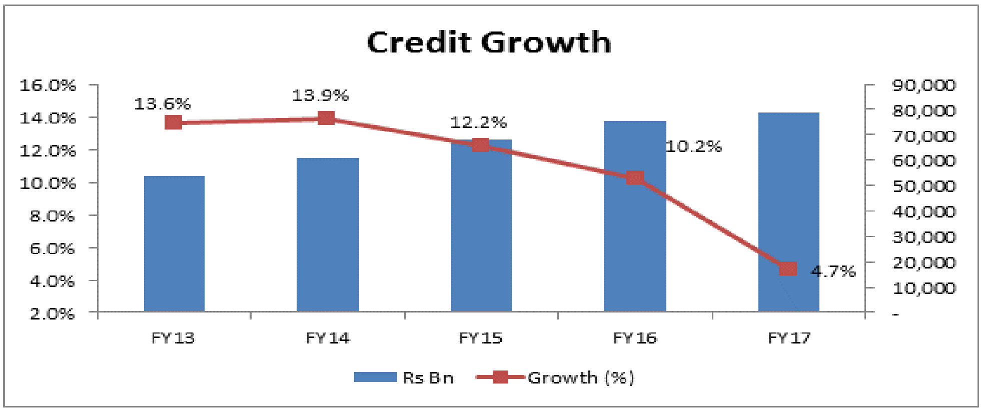
Over the last three years, RBI which is the regulator for the sector has been focusing on cleaning of the balance sheets of banks and emphasised on adequate provisioning for stressed assets. The regulator has time and again provided banks with several schemes like Joint Lending Forum (JLF), 5/25 scheme, Strategic Debt Structuring (SDR), Scheme for Sustainable Structuring of Stressed Assets (S4A), and has also directed banks to file for Insolvency proceedings with National Company Law Tribunal (NCLT) against 12 borrowers under the Banking Regulation (Amendment) Ordinance 2017 to resolve the issue of Non Performing Assets (NPA) and manage the risk on the banks' books. RBI also revised the Prompt Correcting Action (PCA) framework for banks and has put 6 banks under the same.

Business Growth

Credit growth was at record low due to decline in demand and asset quality pressures

Credit growth in India has seen a declining trend over the last three years due to decline in economic activity leading to moderation in industrial output, leveraged corporate balance sheets and low capital expenditure (capex) plans resulting in decline in credit demand and asset quality overhang making banks cautious in lending. During FY17 (refers to period from April 01 to March 31, 2017), credit growth was at 4.7% which was lowest in growth rate in over a decade.

Chart 1: Credit Growth



Source: RBI

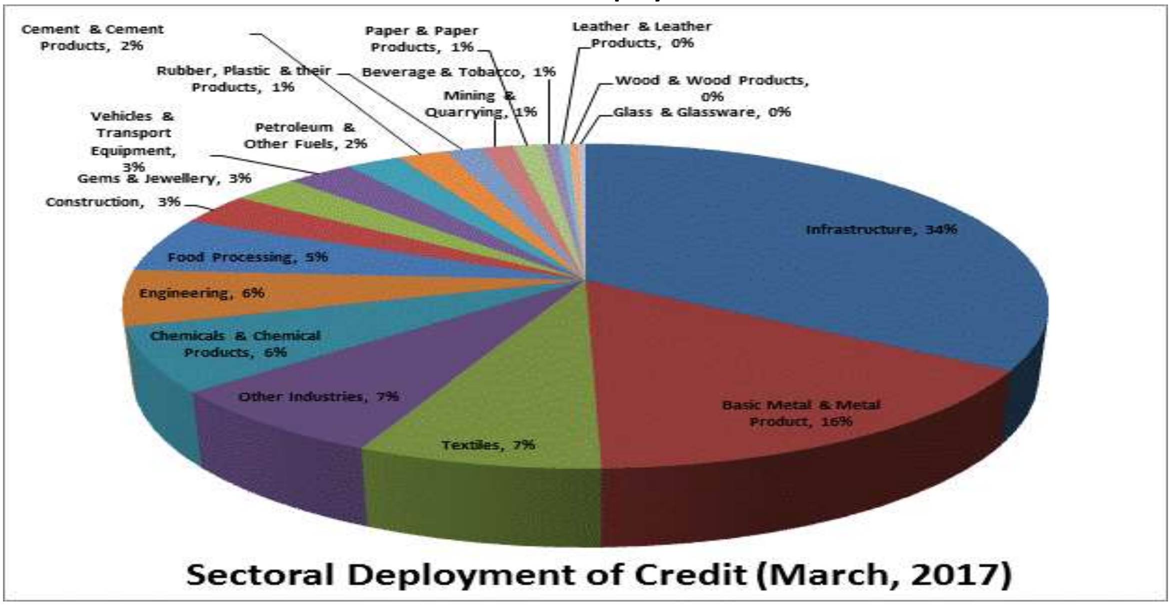
The shift in incremental growth has been towards services and retail segments while the incremental credit to industry has been negative during FY17. The retail segment has become lucrative due to diversification of risk over a large number of borrowers, development of credit bureaus over the last decade leading to increasing awareness about credit history among retail borrowers and technology helping lenders to rely upon analytics to estimate losses in retail segments.

Table 1: Incremental Credit Growth

Incremental Credit	2014	2015	2016	2017
TOTAL	**100%**	**100%**	**100%**	**100%**
Agriculture & Allied Activities	12%	21%	22%	19%
Industry	43%	30%	13%	-9%
Services	28%	16%	24%	51%
Retail	17%	33%	42%	39%
Housing (Incl. Priority Sector Housing)	*12%*	*19%*	*22%*	*19%*

Source: RBI

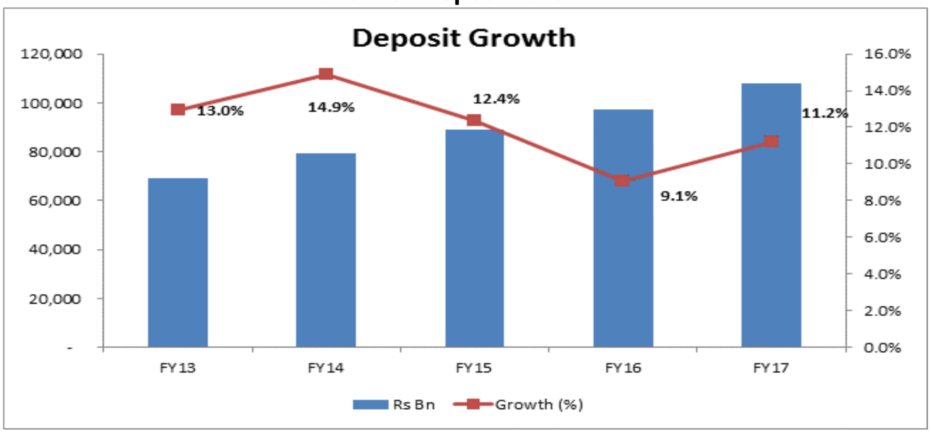
Chart 2: Sector-wise Deployment of Credit



Source: RBI

The major sector for non-food credit deployment was infrastructure, followed by metal and metal products (including iron & steel), textiles, chemicals & chemical products, engineering and food processing.

Chart 3: Deposit Growth

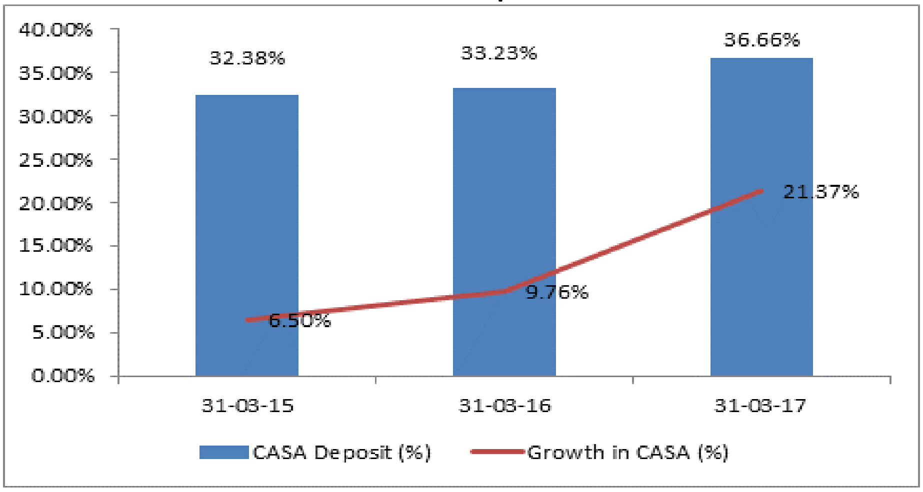


Source: RBI

In line with the trend in credit growth, deposit growth had seen a declining trend over the three years ending FY16. However, during FY17, deposit growth increased to 11.2% largely supported by demonetization of high value currency notes during November and December, 2016 which increased the deposit levels of the banks in spite of declining interest rate scenario. The low cost Current Account

Saving Account (CASA) deposits witnessed a growth 21.4% during FY17 as against growth 9.8% during FY16.

Chart 4: CASA Deposit Trend



Source: CARE Ratings and Banks

Asset Quality

Deterioration in asset quality continued but pace of stressed assets addition declined

The asset quality of the Indian banks saw a sharp deterioration in the last three years with sharp increase in NPAs in the last two years. The Gross NPAs of the banks studied by CARE Ratings* increased from around Rs.3 lakh crore as on March 31, 2015 to nearly Rs.6 lakh crore as on March 31, 2016 which jumped to over Rs.7 lakh crore as on March 31, 2017. The overall Gross NPAs ratio increased from 4.36% as on March 31, 2015 to 9.20% as on March 31, 2017.

Public Sector Banks (PSBs) have witnessed a higher deterioration in asset quality as compared to the private sector players. The Gross NPA ratio for the PSBs studied by CARE Ratings increased from 4.97% as on March 31, 2015 to 11.03% as on March 31, 2017. Within the PSB space, 16 of the 21 banks studied reported Gross NPA ratio in excess of 10%.

The private sector banks which historically have shown better asset quality as compared to PSBs, continued to report relatively better asset quality numbers as compared to their public sector peers. However, the private sector banks also witnessed deterioration in asset quality with Gross NPA ratio of private sector banks near doubling from 2.11% as on March 31, 2015 to 4.19% as on March 31, 2017.

As compared to PSBs, the private sector banks continued to have strong net worth coverage to Net NPA with Net NPA to Net worth ratio of 13.03% as on March 31, 2017 as compared to high 77.52% for PSBs.

**CARE Ratings' study has been based on performance of 35 banks (21 public sector banks and 14 private sector banks).*

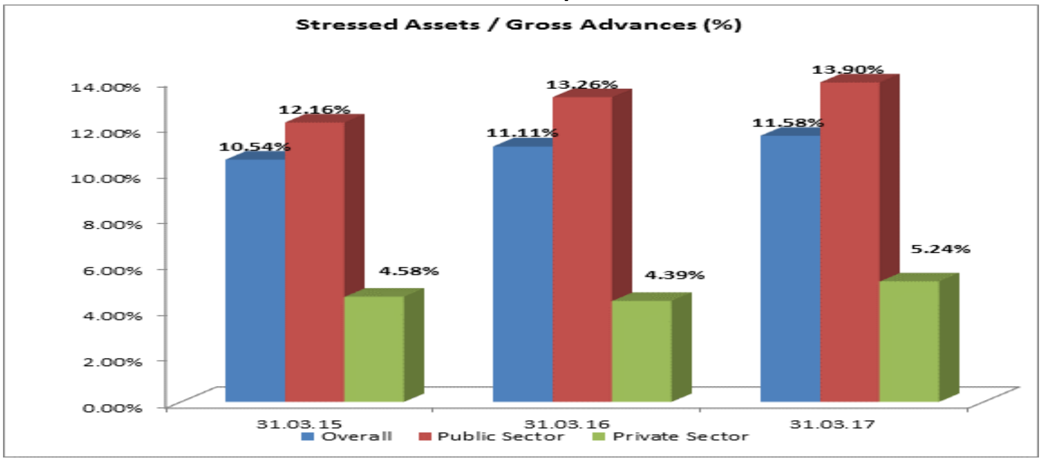
Table 2: Trend in Asset Quality

Parameters	Overall			Public Sector			Private Sector		
As on March 31	2015	2016	2017	2015	2016	2017	2015	2016	2017
Gross NPA / Gross Advances	4.36%	7.71%	9.20%	4.97%	9.29%	11.03%	2.11%	2.79%	4.19%
Net NPA / Net Advances	2.50%	4.65%	5.30%	2.92%	5.73%	6.47%	0.94%	1.35%	2.19%
Net NPA / Net worth	23.95%	44.52%	49.72%	84.69%	66.70%	77.52%	5.60%	8.39%	13.03%
Std. Rest. Advances / Net Advances	6.27%	4.65%	2.49%	7.35%	4.13%	3.02%	2.30%	1.63%	1.08%
Stressed Assets^ / Gross Advances	10.54%	11.11%	11.58%	12.16%	13.26%	13.90%	4.58%	4.39%	5.24%

Source: CARE Ratings & Banks ^Stressed assets = Gross NPA + Standard Restructured Assets

Though, the Gross NPAs of the banks have seen sharp rise over the last two years, the amount of stressed assets (Gross NPA + standard restructured assets) has remained range bound at 10% to 12% of gross advances over the three years. This indicates that the banks had exposure to the stressed assets in its books prior to FY15 and the increase in NPAs has largely been on account of slippages from the restructured assets.

Chart 5: Stressed Assets / Gross Advances



Source: CARE Ratings & Banks

An industry-wise analysis of NPAs shows that the major industries that have contributed to NPAs are metals (including iron & steel), infrastructure, engineering, textiles, construction, chemicals and gems & jewellery.

Table 3: Top Sectors Contributing to NPA

Top NPA Sectors	
Metals (Largely Iron & Steel)	Construction
Infrastructure (including power)	Chemicals
Engineering	Gems & Jewellery
Textiles	

Source: Disclosure by Banks (Top 10 banks comprising 51% of NPAs)

CARE Ratings' study has been based on performance of 35 banks (21 public sector banks and 14 private sector banks).

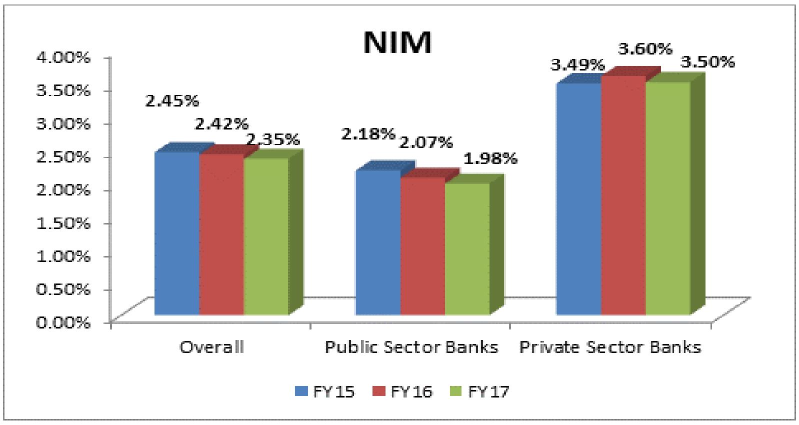
Earnings and Profitability

Profitability of the banks saw declining trend due to worsening of asset quality

Slow credit growth and deterioration in asset quality impacted the income growth of banks as well as profitability during FY17. The 35 banks studied by CARE Ratings showed moderate growth of 6% due to interest reversals on NPA accounts as well as a low credit growth. Though, fee based income and treasury gains in a declining interest scenario helped non-interest income increase by 32% during FY17. PSBs reported growth of 3% in total income while private banks reported growth of 13% during FY17.

The Net Interest Margin (NIM) has seen a declining trend over the last three years largely on account of decline in margins of PSBs. The private sector banks have been able to maintain their NIM in the range of 3.40% to 3.60% over the last three years.

Chart 6: Net Interest Margin (NIM)



Source: CARE Ratings & Banks

In addition to decline in margins, rise in NPAs led to banks especially PSBs saw significant rise in provisioning which severely impacted the profits of the banks. During FY16, 12 out of the 21 PSBs reported loss and during FY17, 10 PSBs reported loss. In the private sector, only one bank each reported loss during F16 and FY17 respectively. The overall Return on Total Assets (ROTA) for public sector banks was negative for FY16 while it was near zero for FY17.

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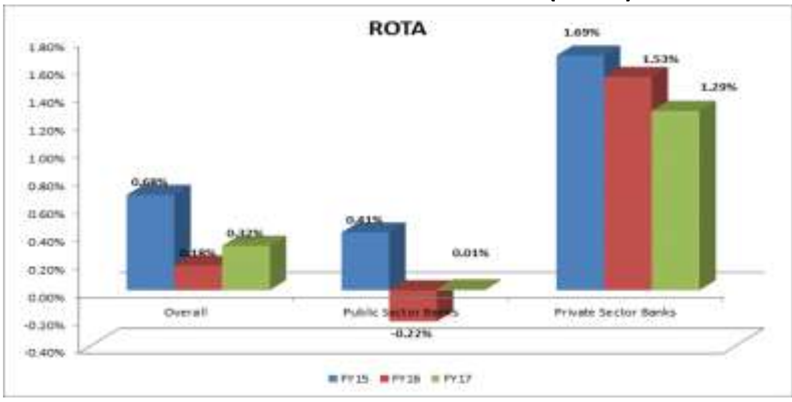
Chart 7: Return on Total Assets (ROTA)



Source: CARE Ratings & Banks

Capital Adequacy

Sector remained moderately capitalized with high requirement of capital

The overall sector remained moderately capitalized with overall Capital Adequacy Ratio (CAR) of 13.74%, Tier I CAR of 10.76% and Common Equity Tier I (CET I) Ratio of 9.97% as on March 31, 2017. Most of the private sector banks have been maintaining adequate cushion over the minimum regulatory requirement to support growth in near future. As a result, private sector banks reported higher capital adequacy at 15.52% with Tier I CAR of 13.39% and CET I Ratio of 12.88% as on March 31, 2017.

On an aggregate basis, PSBs reported CAR of 12.20% with Tier I CAR of 9.54% and CET I ratio of 8.63%; however, on an individual basis, some of the PSBs would require significant capital infusion to meet the Basel III requirements and provisioning requirement on account of asset quality challenges and credit growth.

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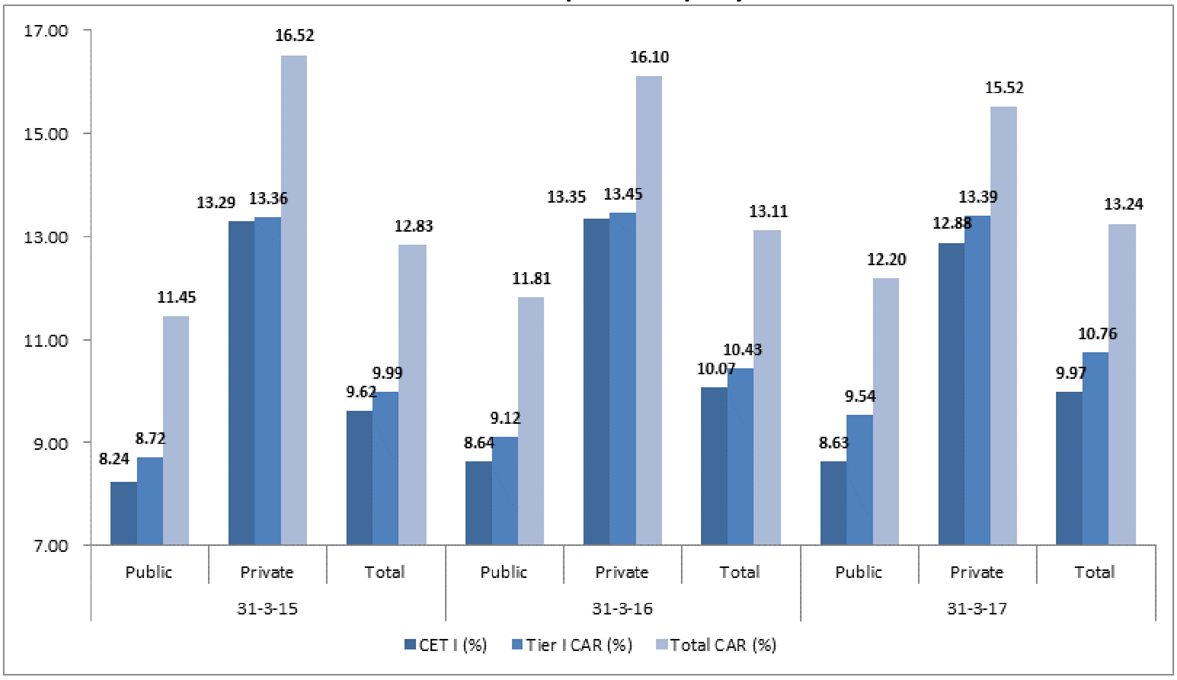
Chart 8: Capital Adequacy



Source: CARE Ratings and Banks

Outlook

As per CARE Ratings' estimate, India's GDP would see growth in the range of 7.5% to 7.8% during FY18. The major forces driving the growth would be increasing spending by the government especially in sectors like infrastructure which would result in increase in industrial output and increase in private investment would lead to growth in the economy. Other factors like expectations of a normal monsoon, awarding of the 7th pay commission allowances would help people have higher disposable income giving a boost to consumer demand. Further, implementation of Goods and Services Tax (GST), which was implemented from July 1, 2017, would also help in economic growth. Considering the improvement in GDP growth, declining pace of NPA addition and capital requirement, **CARE Ratings estimates the credit growth to be in the range of 8% - 10% during FY18.**

Asset Quality

As seen earlier, the asset quality has seen sharp deterioration over the last three years with increase in NPA levels. In spite of the several schemes proposed by RBI, the banks have been slow in taking decisive action against the defaulters on account of fear of large haircuts as well as provisioning which would further impact the profitability of the banks. With the RBI identifying top 12 large NPAs constituting around 25% of Gross NPAs of the sector, there will be some traction towards resolution of the stressed accounts, however resolution of stressed assets is expected to be a challenging task and may take longer than expected. Out of the 12 NPA accounts referred to NCLT, the tribunal so far has admitted

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proceedings under IBC for 6 accounts and for the remaining 6 accounts hearings are in process and are likely to be admitted soon. Thus, during FY18, also asset quality is expected to remain a key challenge. However, the rate of incremental NPA addition is expected to decline, **as per CARE Ratings' estimates, the Gross NPA ratio is likely to be in the range of 9.80% to 10.20% by end of FY18.**

Capital Adequacy

Currently, the Indian banking sector remains moderately capitalized. Although, subdued credit growth over the last three years has kept requirement of growth capital low, increase in provisioning for deterioration in asset quality has impacted the capital adequacy especially for public sector banks. Almost all the banks especially PSB would require capital infusion to meet the minimum regulatory requirement as well as maintain cushion to absorb unexpected losses as well as maintain credit growth.

Government of India (GoI) has been supporting the PSBs by way of periodic capital infusion and had committed capital of Rs.70,000 crore till FY19 and has infused capital of around Rs.50,000 crore till FY17. Though, the remaining Rs.20,000 crore would be much lesser than the capital requirement of PSBs, the intention to support the banks is a key positive. While some of the better performing banks may access capital markets for infusion of capital, the weaker banks would continue to depend on capital support from GoI. CARE Ratings expects GoI to maintain the controlling stake in the public sector banks.

As per CARE Ratings' estimates, public sector banks would require equity of capital of around Rs.1 lakh to Rs.1.20 lakh crore over the next two years to meet the regulatory requirement under Basel III which gets fully implemented by end of FY19. The said requirement may be higher in case the banks have to take a significant haircut as part NPA resolution in the 12 accounts referred to NCLT. While Additional Tier I capital requirement is estimated to be in the range of Rs.50,000 to Rs.70,000 crore in the next two financial years.

Profitability

Due to deterioration in asset quality, the provisioning requirement had increased significantly over the last two years impacting the profitability of the banks. Considering the lower pace in incremental NPAs, overall profitability is expected to see some improvement; however it is expected to remain subdued during FY18. **CARE Ratings estimates the overall ROTA to be in the range of 0.40% to 0.50% for FY18.**

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