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Progress Will Be Slow For India's Banks In 2017

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Table Of Contents

Private Sector Investment To Remain Weak, Despite Fading Effects Of Demonetization

Loan Growth Will Recover Marginally

Profitability May Have Bottomed Out

Capitalization Remains A Key Constraint For Several Public Sector Banks

Downside Risks Persist

1807110 | 302551798

Progress Will Be Slow For India's Banks In 2017

The past few years have been tough for India's banking industry. Anemic nominal GDP growth, a downcycle in the infrastructure and metal sectors, and demonetization resulted in the lowest loan growth in decades and high stress on profitability and asset quality.

S&P Global Ratings expects the Indian banking sector's growth and profitability to improve in fiscal 2018 (the year beginning April 2017), from the low base of fiscal 2017. However, the improvement will be sluggish at best, given low capacity utilization in the corporate segment and the wait-and-watch approach of borrowers in some retail segments post demonetization. Similarly, although the pace of new nonperforming loan (NPL) creation is likely to abate somewhat, banks with sizable corporate exposures remain vulnerable. That's because resolution of stressed assets is work-in-progress and banks need to make up the provision backlog.

Overview

- Indian banks' growth and profitability could begin to gradually improve over the next 12-18 months.
- Although the pace of new NPL creation will likely abate for corporate lenders, they will remain vulnerable, given their low provision coverage and inadequate resolution of stressed assets.
- Capitalization of several public sector banks will remain a downside risk.

Weak profitability and rising capital demands from Basel III implementation will continue to pressure the capitalization of several public sector banks in India. So far, these banks have been able to meet minimum regulatory requirements largely because of the government's capital infusions, issuance of Additional Tier 1 (AT1) capital, and lower growth in risk-weighted assets. However, barring further large capital infusions from the government, the credit profiles of some of the public sector banks we rate in India will remain vulnerable.

Private Sector Investment To Remain Weak, Despite Fading Effects Of Demonetization

We expect India's economy to shed the curtailing effects of demonetization on consumption demand gradually in fiscal 2018. But even before demonetization, corporate cash flows in a few sectors were weak in tandem with declining nominal GDP growth and export performance was poor because of tepid global demand (see chart 1). In addition, private sector capital spending was anemic due to low capacity utilization. In our view, certain factors, such as better prospects for agriculture, improved exports, completion of the currency exchange program, and lowering of interest rates by banks, should support consumption demand in fiscal 2018. That said, investment demand should still be moderate. That's because of uncertainties related to the implementation of the goods and services tax, lack of a full assessment of the effects of demonetization, fiscal consolidation by the union government, and the absence of a sharp credit stimulus.

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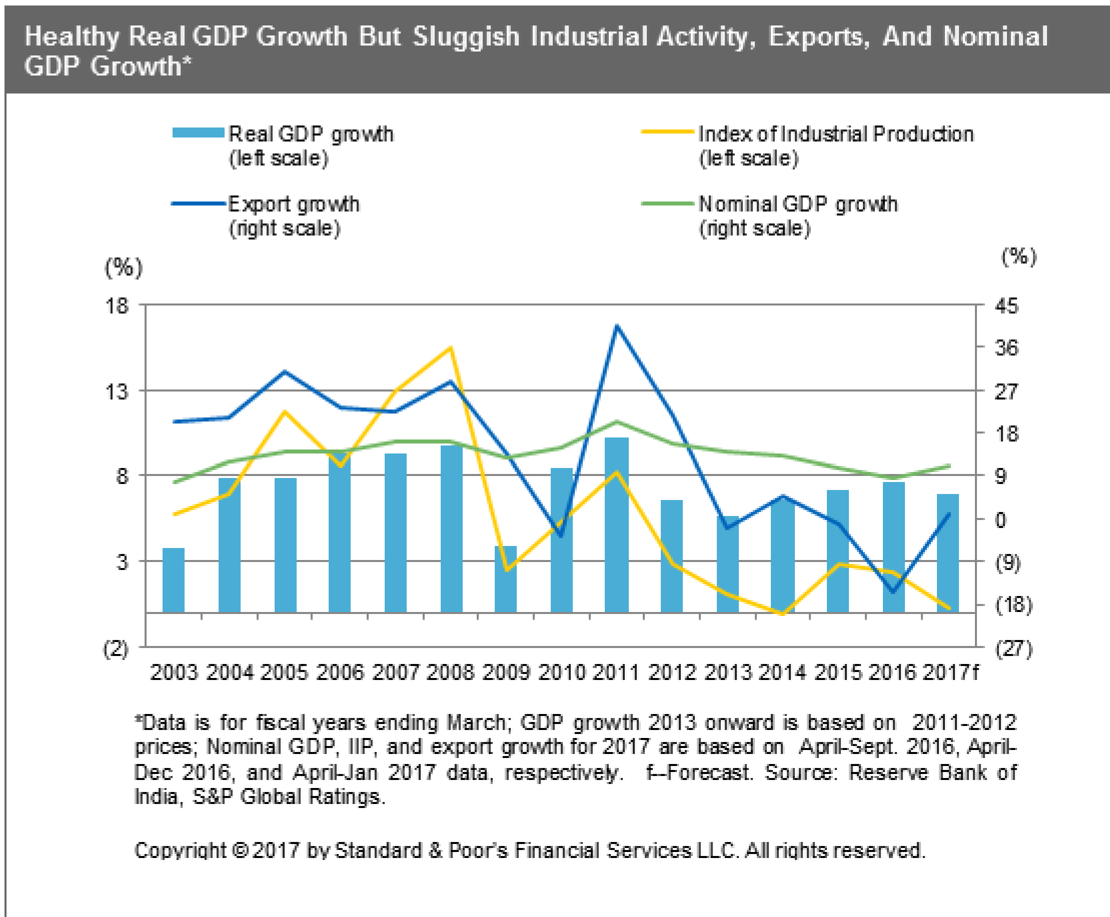
Chart 1



We expect mixed performance from certain corporate sectors that are facing low capacity utilization and high leverage (see chart 2). These include infrastructure, in which power contributes about 7.9% to total banking industry loans and roads contributes 2.7%, and iron and steel, which accounts for 4.7% of total bank loans. These two segments contribute to a sizable portion of Indian banks' stressed assets.

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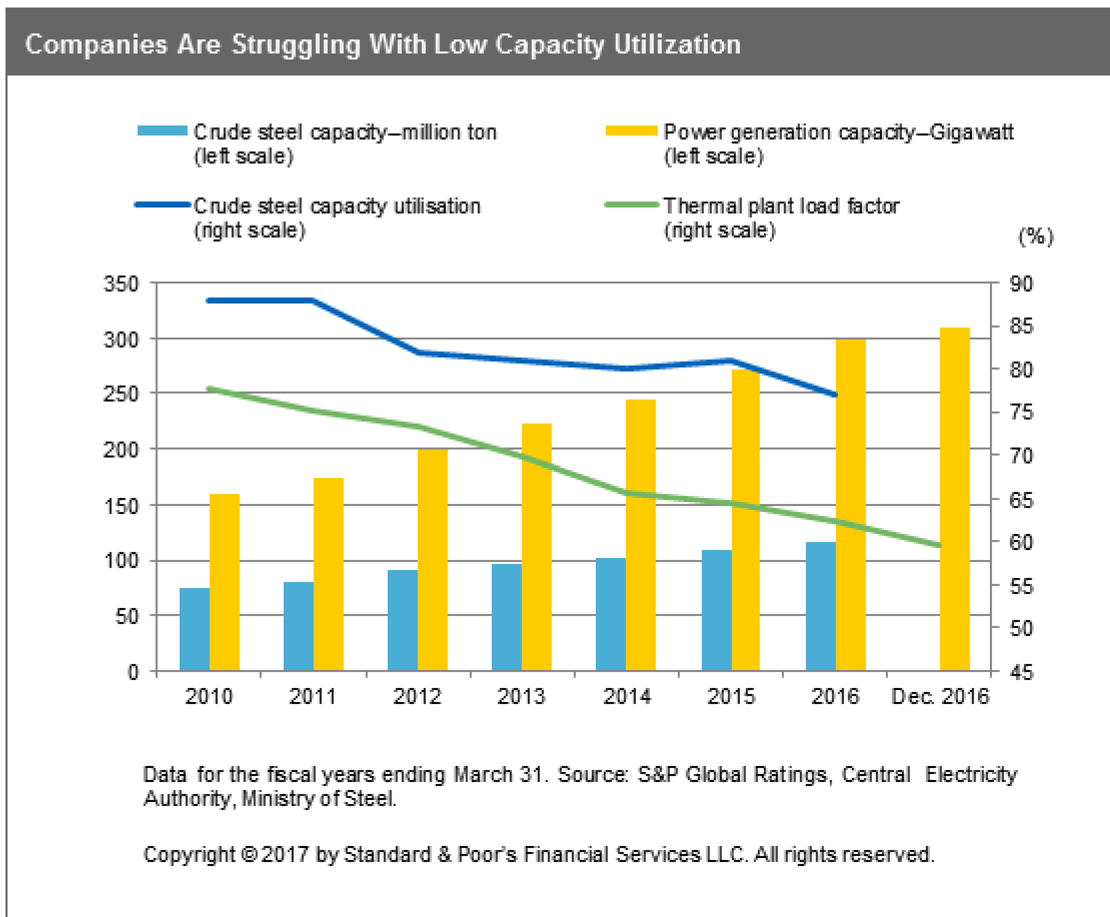
Chart 2



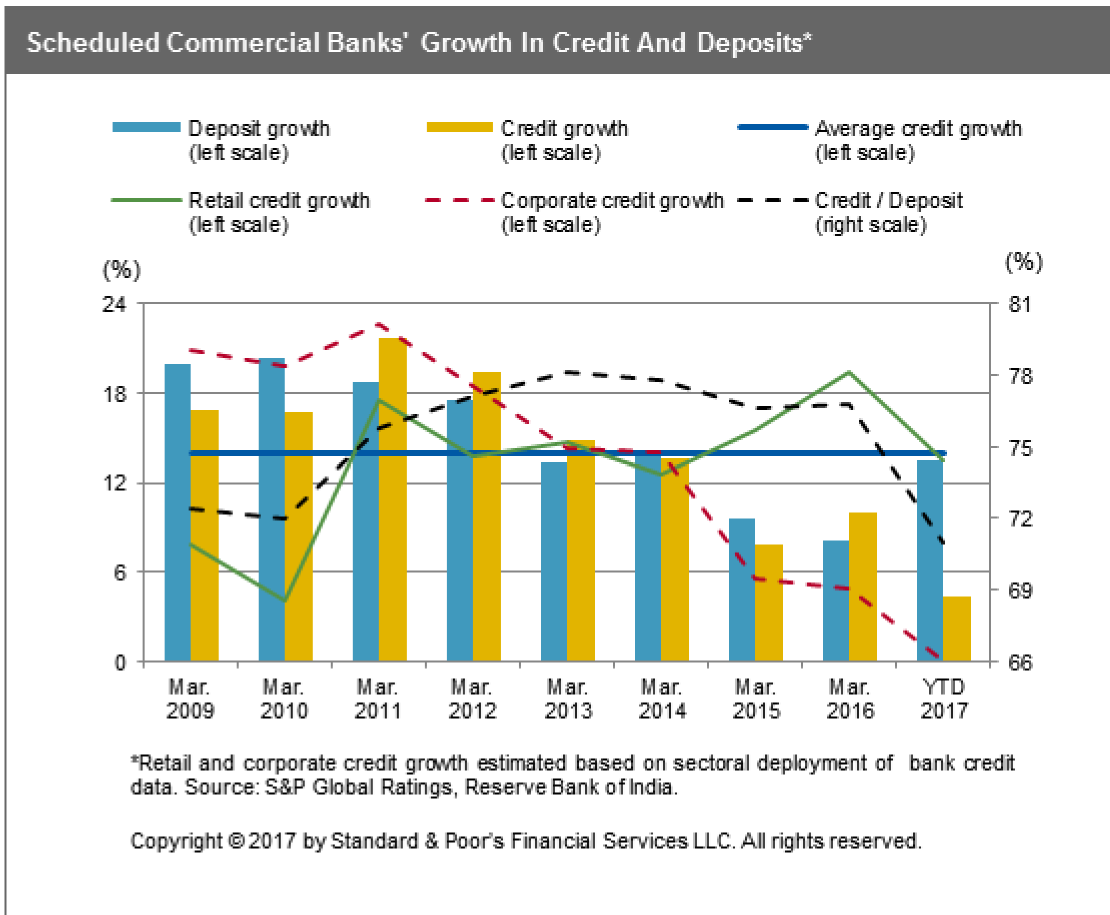
The iron and steel sector has recovered somewhat on the back of the government's import protection mechanism and global price increases. Also, banks have already recognized a sizable chunk of NPLs in this sector. But the power sector will still need to pare down debt, go through industry consolidation, increase capacity utilization, and resolve unviable power purchase agreements to revive itself. Similarly, difficulties in some other capital intensive segments, such as construction, roads, cement, and oil and gas, are still likely to cause an increase in NPLs from these segments.

Loan Growth Will Recover Marginally

We expect loan growth in India's banking sector to recover to 10% in fiscal 2018, from around 5% in fiscal 2017, the lowest in several years (see chart 3). Companies are the key users of bank credit in India. The industry and services sectors together account for 63% of bank loans, followed by retail (23%) and agriculture (14%). We anticipate that corporate capital spending will be weak, given still low capacity utilization and high leverage in certain sectors led by infrastructure, which was the key driver of corporate credit in the last cycle. Further, companies with higher ratings are tapping debt markets for working capital financing where short-term rates are 100-150 basis points (bps) lower than bank lending rates. However, a likely increase in nominal GDP growth and higher commodity prices will lead to increased working capital requirements for firms. In addition, demand in the retail, small business, and agriculture

segments will normalize from the lows following demonetization. Both these factors will support loan growth.

Chart 3



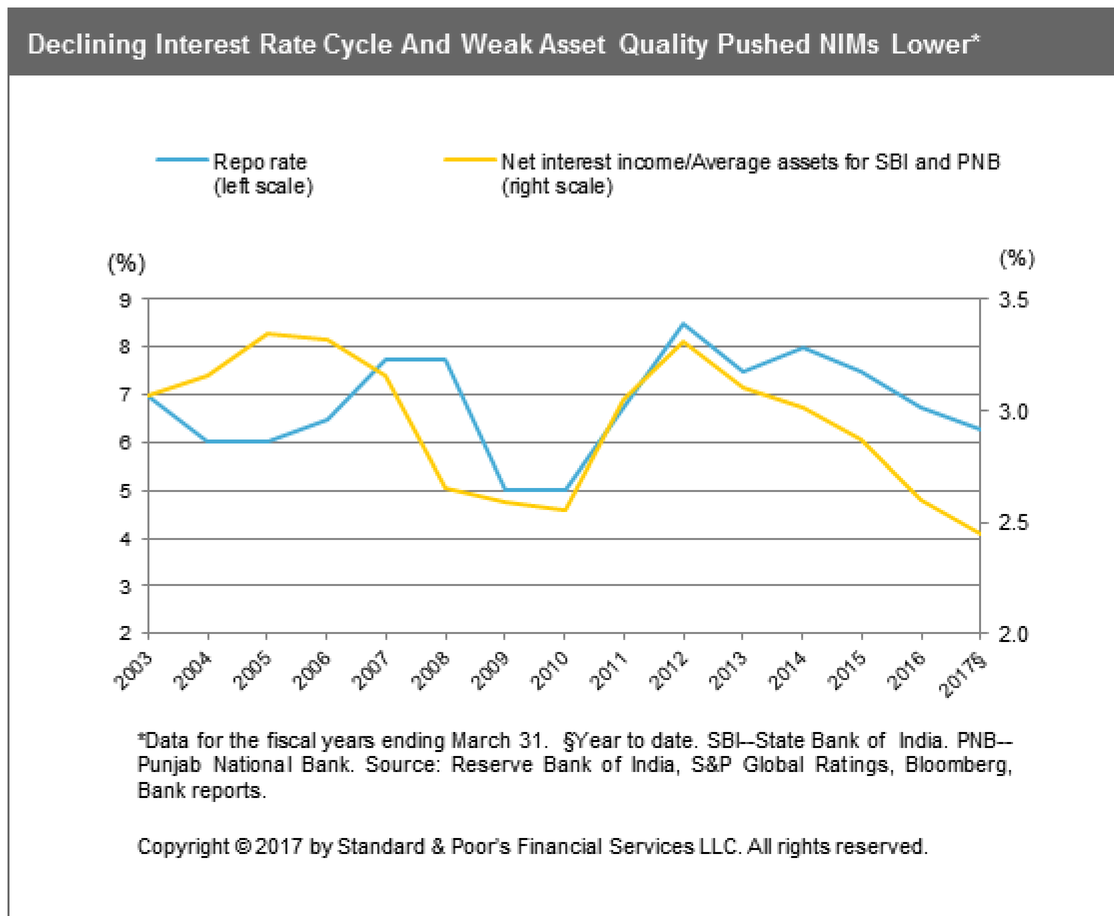
Loan growth in cash intensive segments dipped in the last quarter of calendar year 2016 due to demonetization. These segments include small business, agriculture, and rural-focused retail products such as gold loans, micro finance, and two wheelers. We expect these segments to revive only once borrowers and lenders fully understand the impact of the demonetization on business activity.

Retail products, such as autos, credit cards, and personal loans, continue to grow well. The retail sector should be the main beneficiary of bank rate cuts. That's because banks are increasingly looking to augment their retail books to offset weak corporate demand, and to benefit from better asset quality and higher yields in certain categories. Banks lowered their lending rates by around 200bps in the past two years with a sharper 90bps cut in the wake of demonetization in the last quarter of 2016. And the fastest transmission of these rate cuts is happening for retail loans. However, certain categories such as home loans will recover only slowly as borrowers wait for better prices in the tailwinds of lower interest rates, urbanization, and the government's efforts to provide low-cost housing.

Profitability May Have Bottomed Out

Indian banks' net interest margins (NIMs) typically weaken as interest rates fall, asset quality stress increases, and the loan-to-deposit ratio falls (see chart 4). All of these factors were in play in the past few years. The interest rate cycle is coming closer to its end, banks' low-cost deposits have increased due to demonetization, and the loan-to-deposit ratio should improve going ahead. These factors should benefit banks' NIMs. However, non-accrual loans and stiff competition in the retail segment will prevent NIMs from improving for another two to three quarters.

Chart 4

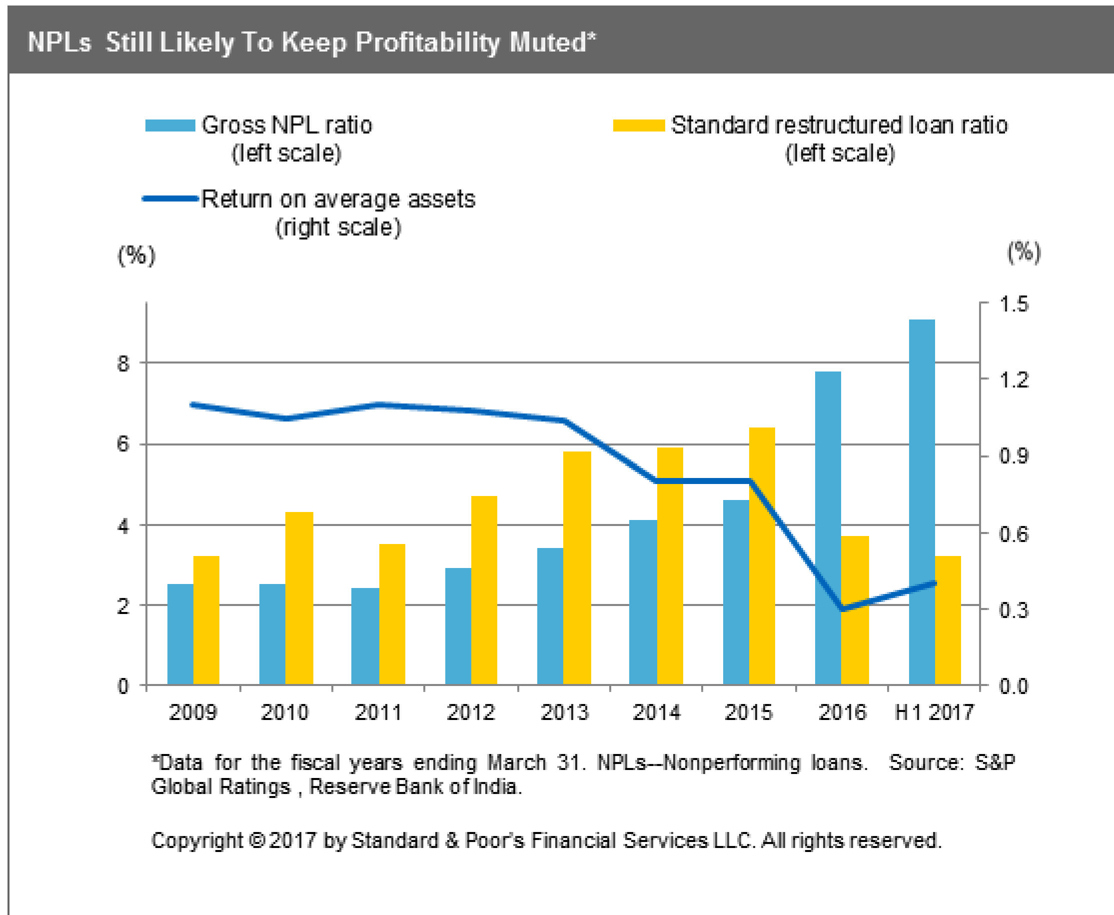


We expect banks' credit costs to moderate in fiscal 2018. The moderation will be more visible at banks that make better progress on resolution and recovery of stressed assets and can grow their loan books. Indian banks have sizable NPLs and even 10%-15% recovery should reduce credit costs. Downside risks to our view are: (1) weak progress on resolution and recovery of stressed assets; and (2) demonetization creating substantial permanent damage to small businesses, which will be known only by the middle of the year.

We estimate that Indian banks' ratio of gross NPLs plus standard restructured advances to total loans would be 12.5%-13.5% by the end of fiscal 2018, compared to 12.3% in the first half of fiscal 2017 (see chart 5). A substantial

amount of new NPLs were created in the past 18 months, and yet some of the large banks have reported that 1%-3% of their exposure could still slip into the NPL category. We expect the overall industry's return on assets to improve 0.40%-0.45% in fiscal 2018, from 0.3% in fiscal 2016.

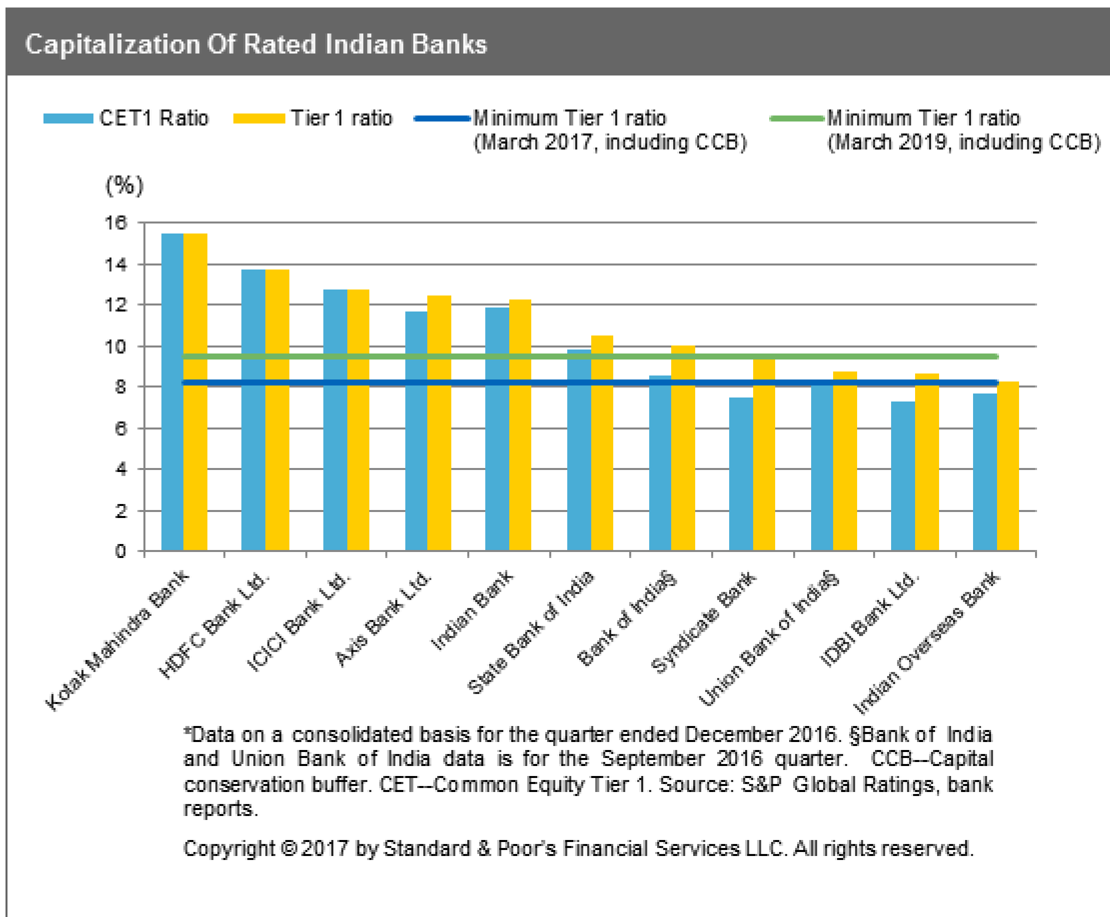
Chart 5



Capitalization Remains A Key Constraint For Several Public Sector Banks

Indian banks have sizable capital needs to support growth and meet Basel III requirements, which kicked in on April 1, 2013, and will gradually increase until 2019. We believe the private sector banks we rate--Kotak Mahindra Bank, ICICI Bank Ltd., Axis Bank Ltd., and HDFC Bank Ltd.--are better placed than their public sector peers to meet Basel III capital requirements (see chart 6). These private banks benefit from better capitalization, high pre-provision operating income, and greater investor appetite because of their stronger profitability. Private sector banks, which focus on the corporate segment, have also buttressed their balance sheets in wake of the higher credit costs in the past 12 months via partial stake sales in subsidiaries (ICICI Bank) and AT1 issuance (Axis Bank).

Chart 6



Most Indian public sector banks are relying on government infusion, infusions from other government entities, and AT1 issuance to meet their capital requirements. Some banks are even shedding risk-weighted assets and divesting stakes in other companies to maintain the regulatory minimum capital. In 2017, the central bank broadened the scope of available reserves through which banks can service AT1 bonds. This forbearance has bolstered the ability of banks, especially the ones which remain unprofitable, to make interest payments. The step was important, given public sector banks have issued about Indian rupee (INR) 390 billion worth of AT1 till now, of which INR216 billion was issued in the current fiscal year.

The Indian government has promised to infuse INR0.7 trillion into these banks over 2016-2019, with INR100 billion allocated for fiscal 2018. In our view, these amounts won't be sufficient to fully resolve the public sector banks' looming capital shortfall. Therefore, we expect that reducing risk weights and higher reliance on AT1 bonds may remain the near-term strategy for some.

The access to equity markets for most public sector banks is still likely to be limited this year, given their low profitability and sizable equity dilution risks. Also, the shares of most public sector banks in the Indian equity markets trade at a discount to their book values. We believe that this is unlikely to change unless these banks make significant progress in resolving profitability and governance issues.

The Tier 1 capital levels of some public sector banks are already close to the regulatory minimum requirement. The public sector banks we rate could face multiple-notch downgrades if their capital breaches the minimum regulatory requirement. We cap the stand-alone credit profile of a bank that breaches the regulatory capital requirement (and is still allowed to continue to operate) at 'ccc+'. Hence, the government's capital infusion and extraordinary support will be a key rating factor for India's public sector banks.

Capital shortfall and asset quality problems could pave the way for consolidation among the government-owned banks. However, this is fraught with significant execution challenges, barring the consolidation of State Bank of India's associate banks, which was a low-hanging fruit. Nevertheless, consolidation needs to be accompanied by significant improvement in risk management practices, efficiency gains, capitalization, and improvement in overall governance for improving the health of the sector.

Downside Risks Persist

The current credit cycle has tested the business models of banks in India. Retail-focused banks with good capitalization and profitability have fared better than others. We believe the peak of new NPL formation is behind us. However, resolution of stressed borrowers, turnaround in select corporate sectors, and recapitalization of public sector banks are still works in progress. As such, downward pressure on Indian banks' credit profiles is unlikely to ease.

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