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Banks - India

Resurgence of coronavirus raises asset risks but loan-loss buffers are sufficiently strong

Summary

A second wave of coronavirus infections in India is increasing asset risks for banks, exacerbating stress among individuals and small businesses that were hit the hardest by the initial outbreak. Still, a number of factors will prevent sharp increases in problem loans, and banks have sufficient buffers to absorb anticipated loan losses.

» **Second wave of coronavirus cases will lead to new loan impairments but a severe deterioration of banks' asset quality is unlikely.** Nonperforming loans (NPLs) will increase more quickly than during the first wave because new lock downs to contain the resurgence of the coronavirus will further erode savings and earnings among many self-employed individuals and small and medium-sized enterprises (SMEs) that have already suffered financially. Yet economic recovery, a tightening of loan underwriting criteria initiated prior to the pandemic and continued government support will prevent sharp increases in NPLs. As a result the resurgence in coronavirus cases will delay but not significantly derail improvements in banks' balance sheets that had begun a few years prior to the pandemic. However, the need to tackle new problem loans caused by the pandemic will prolong banks' efforts to clean up legacy NPLs.

» **Improved buffers will help banks withstand asset quality deterioration.** Loss-absorbing buffers at most rated banks have strengthened in the past year as a result of increases in capital and loan-loss reserves, coupled with improvements in profitability. This will enable banks to withstand the anticipated deterioration of asset quality and maintain their credit strength. For public sector banks, our baseline expectation is that newly formed NPLs will increase nearly 50% in the next two years, but banks' average NPL ratio will still edge down by the end of March 2023, largely a result of the resolution of legacy NPLs and an acceleration of credit growth, which will offset increases in new NPLs.

Second wave of coronavirus cases will lead to new loan impairments but a severe deterioration of banks' asset quality is unlikely

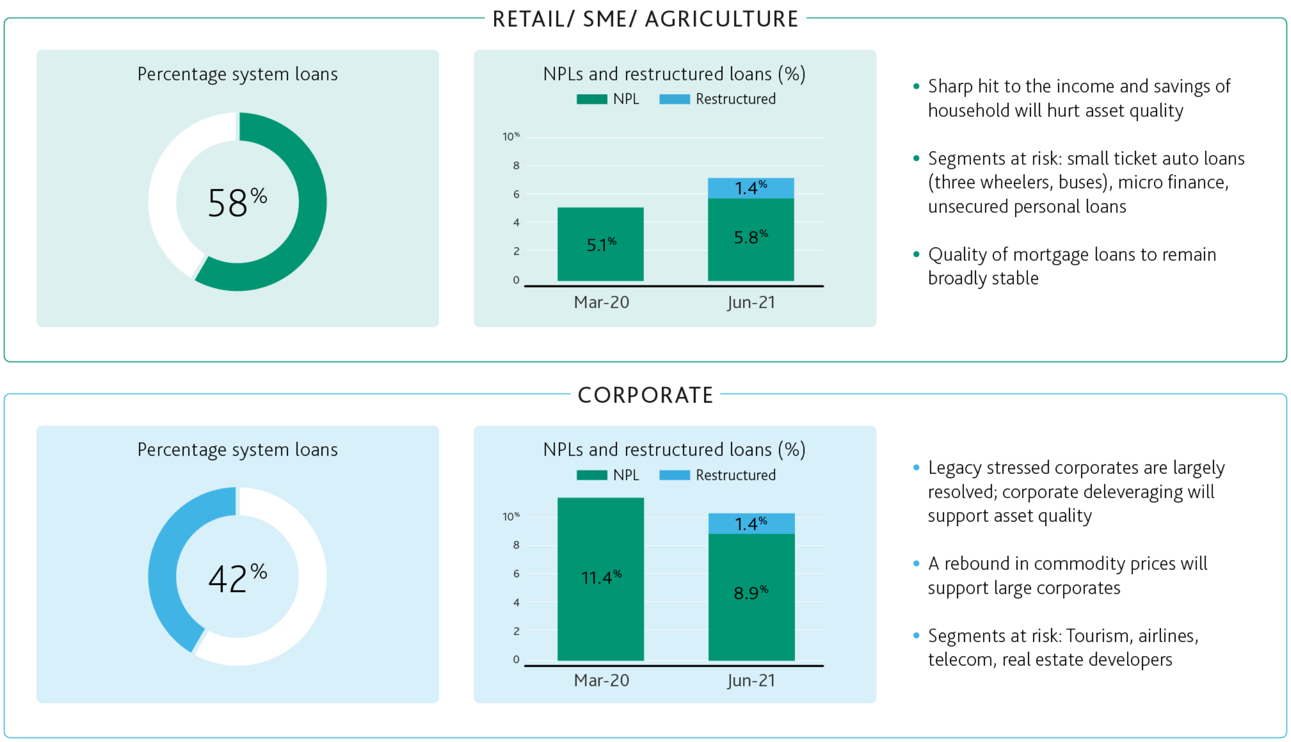
A second wave of coronavirus infections in India will result in new impairments of loans, mostly in the retail and SME segments. Yet economic recovery, a tightening of loan underwriting criteria that had been underway prior to the pandemic and continued government support for borrowers will prevent sharp increases in NPLs.

This means that the current situation will delay but not significantly derail improvements in banks' balance sheets that had begun few years prior to the pandemic. However, the need to tackle new problem loans caused by the pandemic will prolong banks' efforts to clean up legacy NPLs.

New lock downs to contain the resurgence of the coronavirus will further erode savings and earnings among many self-employed individuals and SMEs. Their income already took a hit from economic disruptions during the first wave, and families with infected members had to bear the additional burden of medical expenses. Also, government measures to support households and businesses are more limited this time around.

As a result, NPLs will form more quickly than during the first wave, with loans to self-employed individuals, such as auto loans, micro finance and unsecured loans, in addition to SME loans, being the most susceptible to deterioration. Some restructured loans will become impaired, although the volume will not be large, accounting for just about 1.4% of total retail, SME and agriculture loans. Reflecting the financial toll the pandemic has taken on individuals and small businesses, NPLs in the retail and SME segments have increased at most banks in the past year (Exhibit 1).

Exhibit 1
Retail, SME and agriculture loans are at greatest risk amid second wave of coronavirus infections



Sources: Banks, Moody's Investors Service

Among exposures to corporates, loans to tourism-related companies, such as airlines and hotel operators, are vulnerable because of a slow recovery of the sectors.

Still, banks' asset quality will not deteriorate severely.

One reason is that despite the resurgence of coronavirus infections, we expect India's economic activity will decline only in the first quarter of fiscal 2021 and rebound afterward, resulting in real GDP growth of 9.3% in fiscal 2022, compared with contraction of 7.2% in the previous fiscal year. This is because compared to policy responses to the first wave, the latest containment measures are more localized.

Also, banks had tightened their underwriting criteria for lending to corporates, to focus on financially sound companies, mostly those owned by the government (Exhibit 2), with legacy corporate problem loans largely resolved. As a result, while growth in corporate credit has been limited in the past few years, corporate NPL ratios fell at most rated banks, helping them maintain or improve their overall asset quality despite increases in NPLs in the retail and SME segments (Exhibit 2).

Exhibit 2
Corporate NPL ratios have declined at most rated banks, underpinning their overall asset quality
NPL ratio by segment for all rated banks in India

	RETAIL + SME		CORPORATE		OVERALL	
	Mar-20	Jun-21	Mar-20	Jun-21	Mar-20	Jun-21
HDFC	1.3%	1.7%	1.0%	0.9%	1.3%	1.5%
IndusInd	1.5%	2.9%	3.6%	2.9%	2.5%	2.9%
AXIS	1.9%	2.8%	9.3%	5.3%	4.9%	3.9%
ICICI	1.7%	3.2%	13.3%	10.0%	5.5%	5.2%
SBI	5.4%	5.1%	6.9%	5.5%	6.2%	5.3%
Canara	7.3%	7.0%	11.7%	10.3%	9.4%	8.5%
BOB	7.4%	9.3%	11.0%	8.6%	9.4%	8.9%
UBI	11.0%	12.7%	19.2%	14.7%	15.0%	13.6%
PNB	11.6%	15.6%	15.8%	13.0%	13.8%	14.3%
Yes Bank	1.5%	3.4%	26.6%	27.1%	16.8%	15.6%
IDBI	9.6%	6.9%	48.6%	48.5%	27.5%	22.7%

Note: HDFC = HDFC Bank Limited, SBI = State Bank of India, BOB = Bank of Baroda, UBI = Union Bank of India, PNB = Punjab National Bank, IDBI = IDBI Bank Limited. For IDBI, NPL ratio by segment is estimated based on Dec 2019 data. For HDFC, NPL ratio by segment for June 2021 is estimated based on March 2021 data.
Sources: Banks, Moody's Investors Service

The quality of mortgage loans will be stable because they are mainly for first-time home purchases by salaried workers with stable jobs.

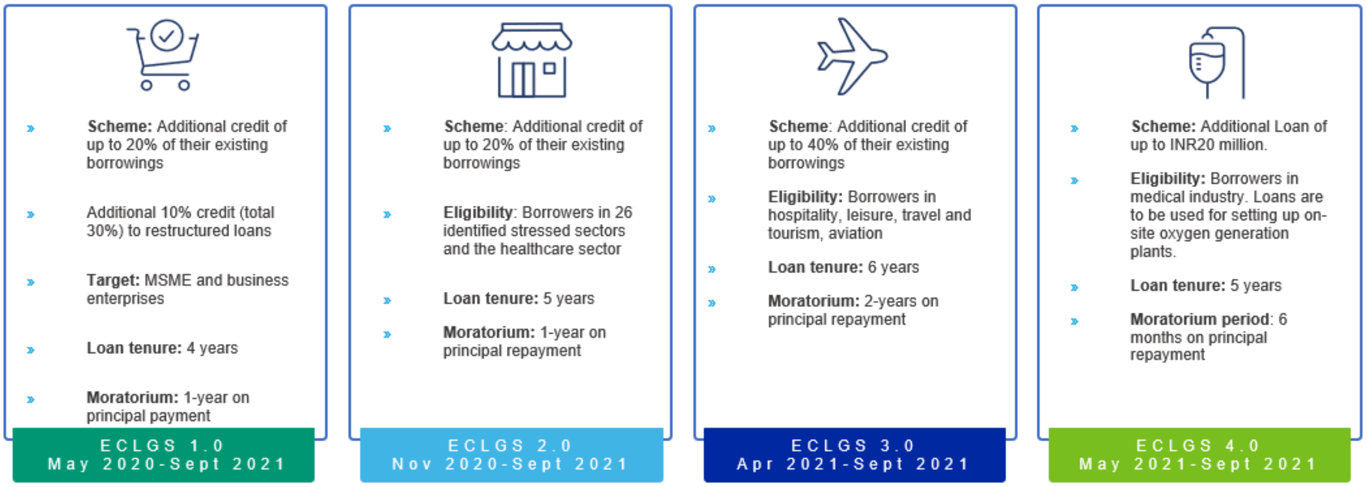
Support measures for borrowers will continue to limit problem loan growth

Continued policy support for borrowers from the government and the Reserve of Bank of India (RBI) will also help limit the deterioration of banks' overall asset quality.

The government's emergency credit linked guarantee scheme (ECLGS), implemented in May 2020, has been particularly effective in providing immediate liquidity for businesses hit by the pandemic.

Under the ECLGS, banks and other lenders can provide businesses with additional credit of up to 20% of their existing loans. The total size of the scheme is INR4.5 trillion (about $60 billion), and the government has continuously expanded the scope of eligible borrowers (Exhibit 3). ECLGS loans account for about 10% of rated banks' SME loans.

Exhibit 3
Government's ECLGS proved effective in support loan quality of SMEs



Source: Government of India, Moody's Investors Service

The program offers deferrals of principal repayment for the incremental debt until September 2021, with the government guaranteeing eventual repayment in full. However, risks remain for banks because borrowers can still default on their original loans.

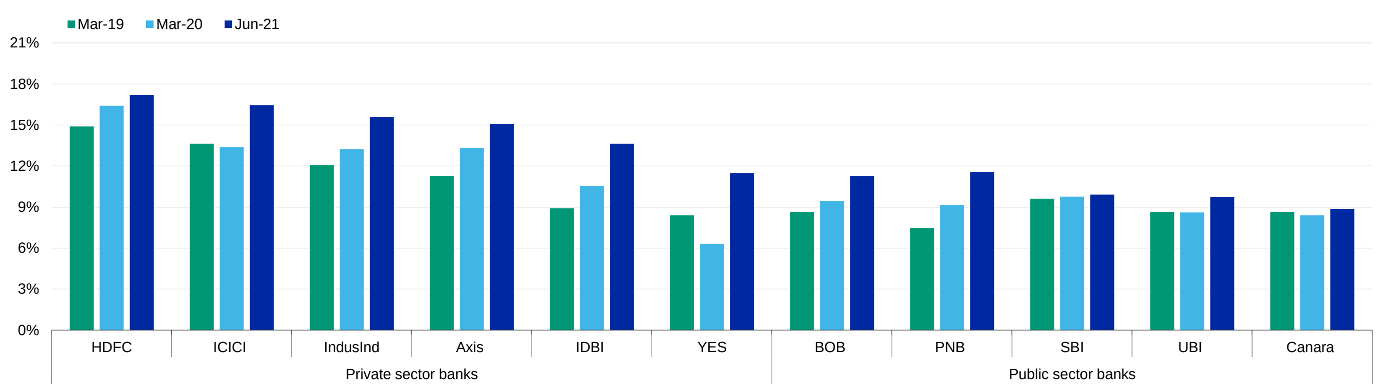
Apart from the ECLGS, loose monetary policy, which has boosted domestic liquidity and kept interest rates low, and loan restructuring schemes will continue to mitigate asset risks for banks.

Improved buffers will help banks withstand asset quality deterioration

Loss-absorbing buffers at most rated banks have strengthened in the past year as a result of increases in capital and loan-loss reserves, coupled with improvements in profitability. This will enable banks to withstand the anticipated deterioration of asset quality and maintain their credit strength.

Since 2020, rated banks across the public and private sectors have raised about INR640 billion in new equity capital from the market, boosting their average Common Equity Tier 1 (CET1) ratios by about 150 basis points (Exhibit 4).

Exhibit 4
Banks have proactively raised capital

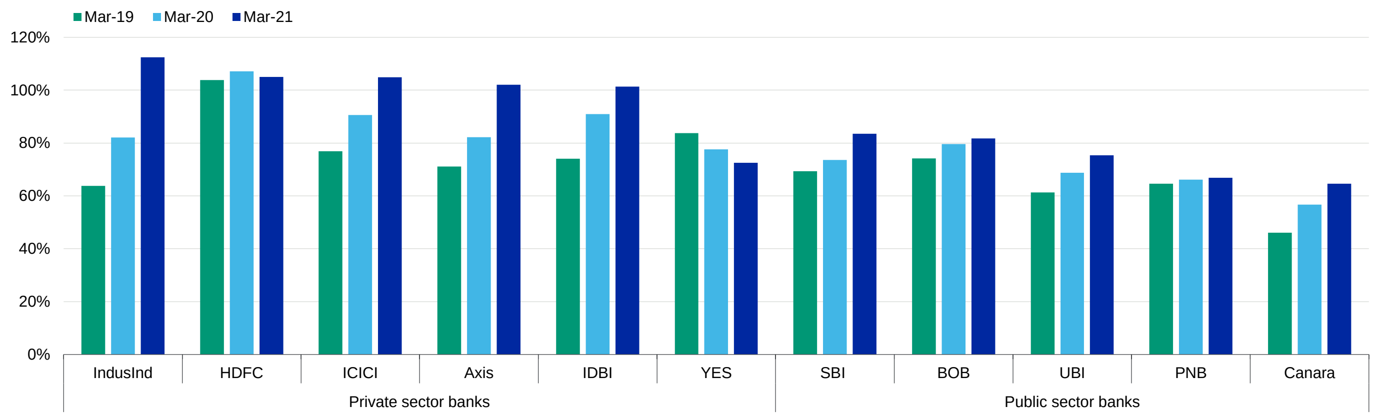


Sources: Banks, Moody's Investors Service

In addition, the government plans to infuse INR200 billion in new equity into public sector banks in the fiscal year ending March 2022, and it is likely to prioritize shoring up weakly capitalized banks such as Union Bank of India (Ba1 negative, b1) and Canara Bank (Ba1 negative, b1), as it has in the past. The government has yet to name banks to receive capital.

Also, banks' loan-loss reserves relative to problem loans have increased in the past three years (Exhibit 5) because their provisions have grown faster than new problem loans after covering most legacy NPLs. This will give banks sufficient cushions against loan losses that will result from the current outbreak of the coronavirus.

Exhibit 5
Banks' provisioning coverage has strengthened
Loan loss reserves as % of NPLs



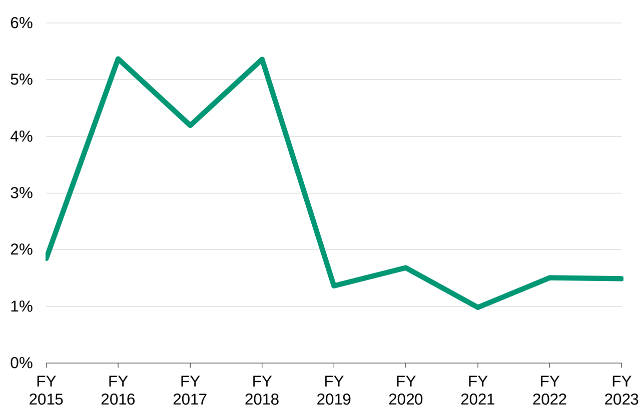
Note: Data includes reserves for standard assets
Source: Banks, Moody's Investors Service

Scenario analysis indicates public sector banks can withstand NPLs growth without materially eroding their buffers

For public sector banks, our baseline expectation is that newly formed NPLs – the gross amount of loans becoming NPLs after recoveries and upgrades are subtracted – will increase nearly 50% to about 1.5% of gross loans annually in the next two years from 1.0% in fiscal 2021, driven by the retail, SME and agriculture segments (Exhibit 6).

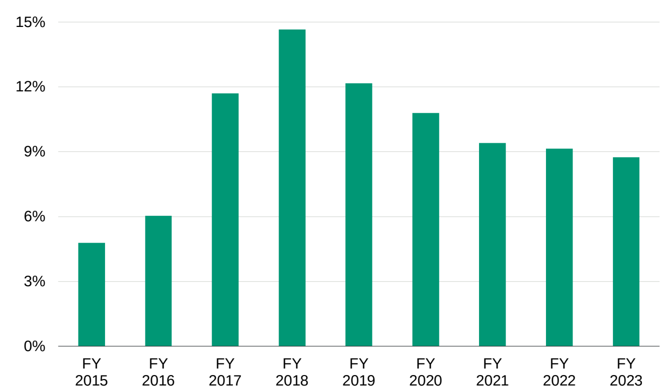
Under this scenario, banks' average NPL ratio will still edge down to about 9% by the end of March 2023 from 9.4% at the end of March 2021 (Exhibit 7), largely helped by an acceleration of credit growth, which will offset increases in new NPLs.

Exhibit 6
Net NPL formation will moderately increase in the next two years
Newly formed NPLs as % of gross loans



Source: Moody's Investors Service

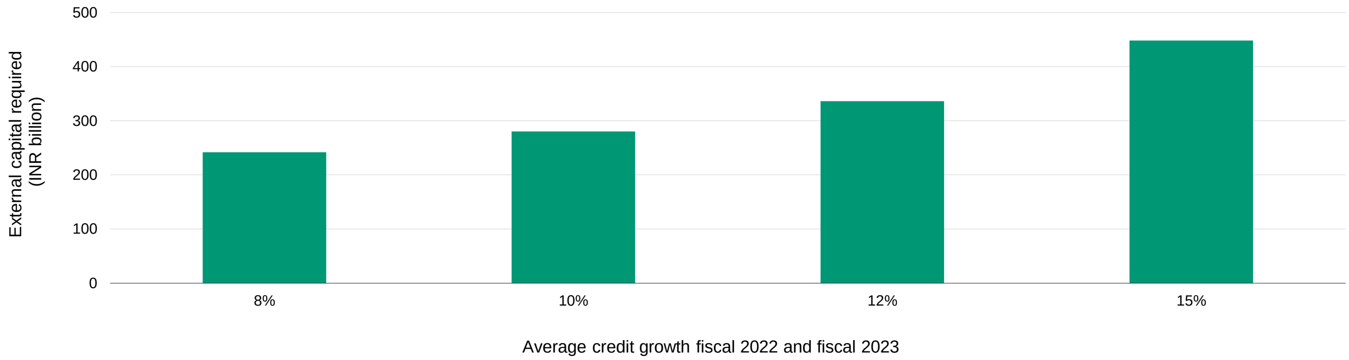
Exhibit 7
Yet overall NPL ratios will remain broadly stable
Gross NPL ratio



Source: Moody's Investors Service

Our scenario analysis also shows that public sector banks will need to raise about INR300 billion in external capital (Exhibit 8) in the next two years, a large part of which will be required to support credit growth of about 10%, instead of covering increases in credit costs as was the case in 2018-19. We expect banks will meet their capital requirements through the market and planned capital infusions from the government.

Exhibit 8
Public sector banks will need to raise external capital



Note: In assessing capital needs, we assume banks will maintain an average CET1 ratio of 10%.
Source: Moody's Investors Service

As for rated private sector banks, assuming new NPLs will grow 50% as well, their capital ratios will decline but from high levels that current average about 15%, so they will not face a capital shortage.

Appendix

Ratings overview: Indian banks

Positive Stable Negative

Banks	LT Bank Deposits Rating	Baseline Credit Assessment	Outlook	Gross nonperforming loans	Net nonperforming loans	Common Equity Tier 1
Public sector banks						
State Bank of India	Baa3	ba2	Negative	5.3%	1.8%	9.9%
Canara Bank	Ba1	b1	Negative	8.5%	3.5%	8.9%
Bank of Baroda	Ba1	b1	Negative	8.9%	3.0%	11.3%
Union Bank of India	Ba1	b1	Negative	13.6%	4.7%	9.7%
Punjab National Bank	Ba1	b1	Negative	14.3%	5.8%	11.6%
Private sector banks						
HDFC Bank Limited	Baa3	baa3	Negative	1.5%	0.5%	17.2%
IndusInd Bank Limited	Ba1	ba2	Stable	2.9%	0.8%	15.6%
Axis Bank Ltd	Baa3	ba1	Negative	3.9%	1.2%	15.1%
ICICI Bank Limited	Baa3	ba1	Negative	5.2%	1.2%	16.5%
Yes Bank Limited	B3	caa2	Stable	15.6%	5.8%	11.5%
IDBI Bank Ltd	Ba2	b1	Stable	22.7%	1.7%	13.6%

Note: Data as of June 2021
Source: Banks, Moody's Investors Service

Moody's related publications

- Banks – ASEAN and India: Asset risks will rise amid resurgences of coronavirus infections but credit strength will remain intact, published on August 10, 2021
- Banking system outlook - India, published on 25 March 2021
- Private sector banks - India: Q3 fiscal 2021 update: Modest growth in stressed assets point to receding asset risks, published on 5 February 2021
- Banks – India: Corporate loans will be more resilient to economic downturn than retail, SME credit, published on 9 September 2020

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EMEA	44-20-7772-5454

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