Short-term credit outlook of Indian Banks demonstrates stability in spite of low credit growth

By Amrita Parab

- **NUS-CRI Aggregate (median) 1-year Probability of Default demonstrates the improving credit health of Indian banks on the back of strong financial health and better than expected NPA levels**
- **A possible resolution of the Indian banking sector's bad debt woes appears in sight as public sector banks hope to offload a sizable portion of NPAs to National Asset Reconstruction Co. Ltd (NARCL), India's new 'Bad Bank'**

Despite the tough operational environment faced by Indian banks, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) (See Figure 1a) of Indian Banks showcases a recovery largely attributable to effective government and central bank initiatives, and the banks' strong capital and liquidity position. The Agg PD of public sector banks continues to remain elevated as compared to private sector banks due to higher exposure to micro, small and medium enterprises (MSMEs) which were hardest hit by the second wave of the pandemic in Apr-2021. Additionally, they have also been tackling a higher level of NPAs from large borrowers as compared to private sector banks which have continued to weigh on their balance sheets.

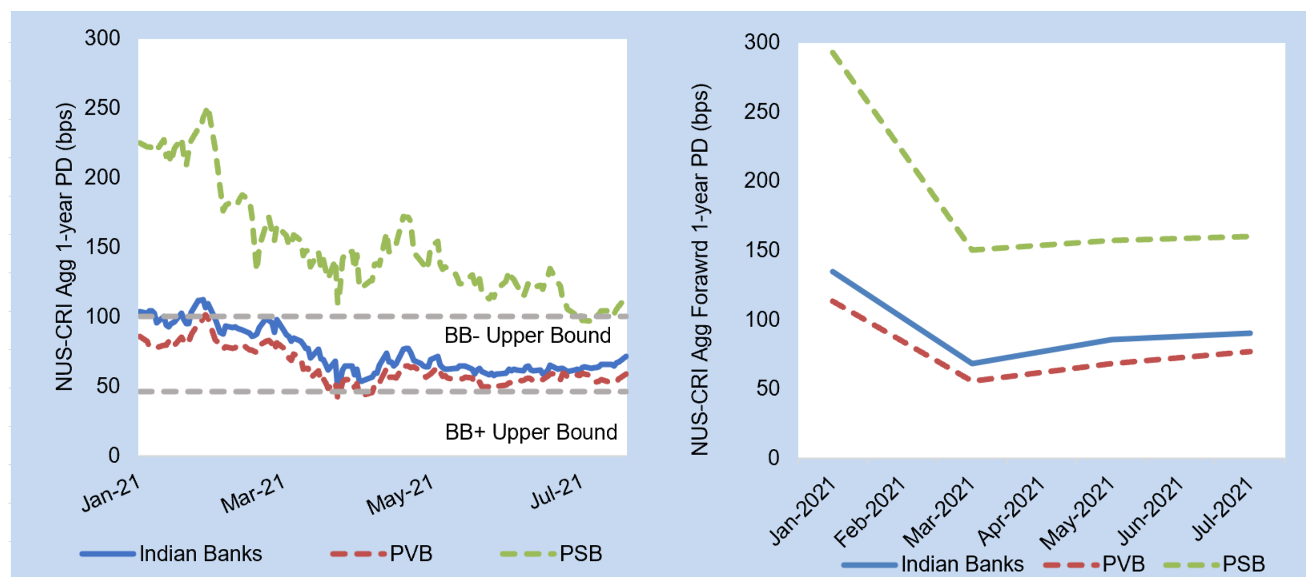

Figure 1a (LHS): NUS-CRI Agg 1-year PD for the Indian Banking Sector from Jan-2021 to Jul-2021 with reference to PDiR2.0[1] bound. Figure 1b (RHS): NUS-CRI Forward PD time series for Indian Banks, Private Sector Banks (PVB), and Public Sector Banks (PSB) as per data feeds from Jan-2021, Mar-2021, May-2021 and Jul-2021 looking to December 2021. *Source: NUS-CRI*

The asset quality of Indian banks as of FY21 was better than expected with gross non-performing assets (NPAs) at 7.6% as of 31 March 2021 as compared to 8.6% in the previous year, lower than projected baseline estimates of 12.5%. The capital and liquidity position of Indian banks also remains strong (See Table 1). Private sector banks demonstrated higher-quality capital and increased interest margins compared to their public sector peers, in tandem with their lower Agg PD in Figure 1a. Regulatory and policy measures such as moratoriums on loans,

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2]The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

a standstill on asset classification, and schemes such as the Emergency Credit Line Guarantee Scheme (ECLGS) have prevented a bigger dent on bank balance sheets and also helped prevent worsening of NPAs.

	Net Interest Margin (NIM)	Provisioning coverage ratio	Capital to Risk weighted asset ratio	Tier-I leverage ratio
Public Sector Banks (PSB)	2.9%	68.4%	13.8%	5.4%
Private Sector Banks (PVB)	4.0%	70%	18.4%	10.0%
All Banks	3.3%	68.9%	16%	7.4%

Table 1: Key financial ratios of Indian banks. Source: *Financial Stability Report July 2021, RBI*

The NUS-CRI Forward 1-year PD (Forward PD[2]) time series (See Figure 1b) also reflects the improved credit outlook for Indian banks as compared to the level seen in Jan-2021. However, as the effects of the second wave of COVID-19 pandemic become apparent in H2 2021, bad debts are expected to rise. Given that Indian banks remain well-capitalized, the forward PD time series demonstrates the outlook for Dec-2021 has remained relatively stable at current levels since Mar-2021.

Credit growth in Indian banks reached a six-decade low in FY21 as they remained risk-averse in the face of uncertainty posed by the recurring waves of the pandemic. Loan growth has been subdued at 5.6% in March 2021 as per data released by the RBI (See Figure 2b). The slowdown in aggregate loan growth for the sector was driven by public sector banks which recorded a loan growth of 3.6% as compared to that of 9.1% for private sector banks. Public sector banks are already impeded by higher NPAs (See Figure 2a) and hence, may have been increasingly risk-averse in issuing new loans. In addition, companies are also postponing capital expenditures in light of the uncertainty in cash flow generation capabilities, adding to the slowdown in corporate borrowings from banks. Corporate bond issuances also surged over the last year, as several companies took advantage of the lower rates available in the bond markets to reduce reliance on expensive bank loans. In addition to refinancing costly debt, many companies have tried to deleverage their balance sheets by partially using funds raised via equity markets. Around 1000 listed companies had cut their debt by a cumulative INR 1.7tn by the end of March 2021. The risk aversion of banks in combination with deleveraging by companies may offset worries of heightened NPAs in the near future, especially in public sector banks. However, the lower credit growth may stress banks' net interest margin (NIM), which is showcased by the Forward PD time series remaining slightly elevated since Mar 2021.

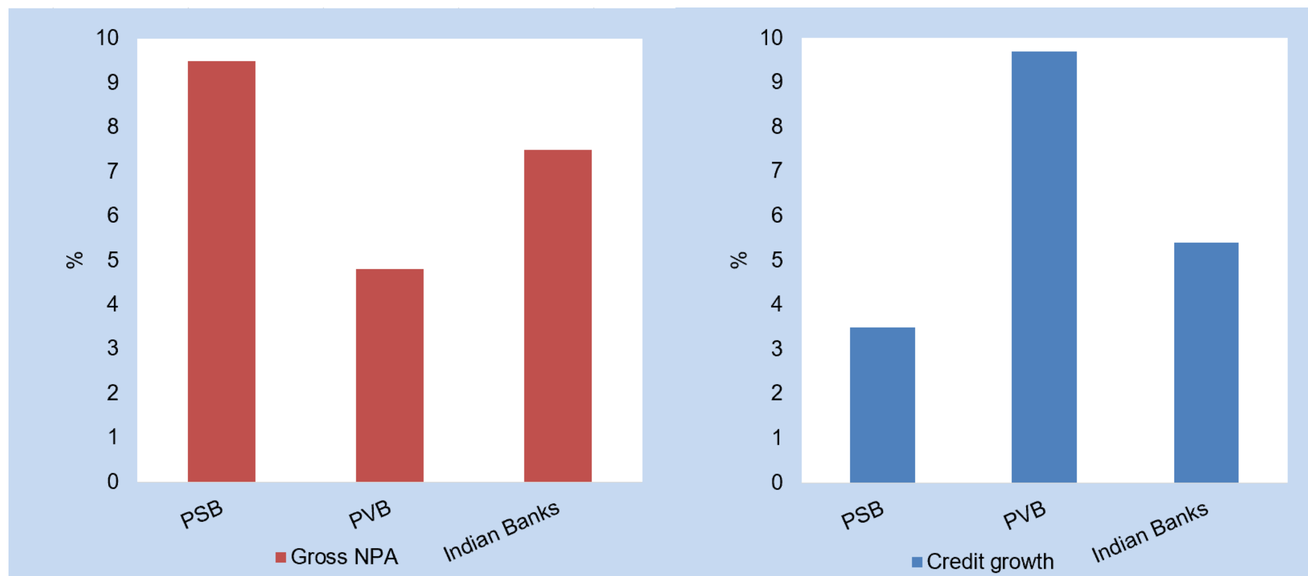

Figure 2a (LHS): % Gross NPA as of March 2021 for Public Sector Banks (PSB), Private sector Banks (PVB); Figure 2b (RHS): % Credit growth as of March 2021 for Public Sector Banks (PSB), Private sector Banks (PVB). Source: *Financial Stability Report July 2021, RBI*

The Indian banking system houses one of the worst non-performing debt piles in the world. Improving management of bad loans will ensure higher flexibility, clean up bank balance sheets and allow banks to increase core lending activities. The Indian Banks' Association plans to apply for permission to set up National Asset Reconstruction Co. Ltd (NARCL), which will house bad loan accounts of INR 5bn or more each. NARCL will be owned by the public and private sector banks and is expected to house total bad loans of INR 2tn. Currently, assets worth INR 900bn have already been identified for transfer to the NARCL.

Although the NARCL is a big step towards resolving Indian banks' NPA problem, additional regulatory reforms are required to ensure faster resolution of bankruptcy proceedings. The government introduced a pre-packaged insolvency process for MSMEs in April 2021 which is one such step towards facilitating faster and efficient

resolution in the event of bankruptcies. The current Corporate Insolvency Resolution Process (CIRP) is time-consuming and can take 6 months or more, during which the value of assets of the company could further decline. In contrast, the new process will allow faster resolution (approximately 120 days) and allow the management to maintain control of operations with the aim of preventing a decline in asset value, thus benefiting the recovery amount available to banks in the case of borrower default. The process also allows banks to negotiate settlements with borrowers, thus avoiding court delays.

India's public sector banks are also in dire need of structural reforms to rein in their NPAs and make them operationally efficient. Public sector banks have long posed a challenge due to their weak governance which has resulted in poor performance and weak asset quality. With a goal to overhaul the banking system, the government announced its divestment plan in Feb 2021 which includes a privatization plan of state-owned financial institutions in FY22. It is believed that this move would serve to improve the operational efficiencies of public sector banks as a whole, and introduce stronger regulatory and control frameworks. However, due to their incumbent weak finances and high NPA ratios, the government will have to take additional steps to resolve NPAs and improve the balance sheet of the banks in order to facilitate the privatization. At present, the NARCL seems to represent the fastest route to clean up NPAs from public sector banks' balance sheets.

The Indian economy has been on a path of recovery since June and is still vulnerable to higher commodity prices and inflationary pressures. While Indian banks have weathered the pandemic better than expected and have managed to limit damage to their balance sheets, building a robust banking system and stimulating credit growth will require effective implementation of structural reforms aimed at reducing bad debts, increasing investor confidence, and improving management governance across the financial sector.

Credit News

‘Forceful for longer’: Investors bet ECB bond buying is here to stay

July 21. Investors are confident that the European Central Bank (ECB) will continue buying bonds and drive yields lower in the Eurozone. With increasing fears of the Delta variant, Germany’s 10-year bond yield fell to -0.41% as many flocked toward the safe asset. However, many are doubtful of the ECB’s ability to hit its inflation target despite cutting interest rates into the negative territory. Additionally, the ECB governed council agreed that its policy must be forceful and persistent when operating in an environment of low rates and low inflation, something the bank said may mean a temporary and moderating overshoot of its new inflation target. (FT)

Big investors stick with bets against bonds after painful run

July 24. Big investors are continuing to bet against US treasuries, claiming that the rally in prices depicts a false pessimism about the economic conditions, wagering the treasury's yield will rise. The resurgence of COVID-19 cases has hurt some of the optimism in bond markets that fueled a sell-off earlier this year. Investors also argue that continued bond purchases by central banks, as well as a bearish consensus among investors, has created an environment where there are fewer sellers. This has exaggerated the drop in yields, which pushed the US treasury yield as low as 1.13% this week before bouncing higher. Further gains in the economic recovery could urge Fed to lay out plans to pull back the support and the slump in yields could begin to reverse. (FT)

Fed’s MBS buying high on agenda as officials begin taper talk

July 25. The debate over whether to taper the Fed’s purchases of MBS faster than its buying of Treasury debt will likely be near the top of the agenda when officials gather Jul 27 to 28. A record rise in US home prices has led policy hawks at the Fed to consider scaling back the US central bank’s massive MBS purchases. However, some Fed leaders, including Powell, do not seem convinced by arguments in favor of a hasty exit strategy. They emphasize that MBS purchases are not intended to support the housing market in particular and that a proportional tapering of both MBS and Treasury debt purchases drives down risk premiums, reducing rates paid by mortgage borrowers. Nevertheless, even if the hawks have their way, some economists believe the impact on house prices will be small, citing an increase in supply as the primary way to relieve valuation pressures. (Bloomberg)

Earnings to lower ceiling on U.S. high-grade bond sales next week

July 25. The investment-grade bond primary market will remain subdued this week, with fresh supply expected to be between USD 15bn and USD 20bn as earnings season ramps up. In the meantime, high-yield bond sales are likely to stay active amid a refinancing wave that has allowed some COVID-hit companies to reduce borrowing costs. Several regional and corporate banks are expected to issue bonds next week, along with corporate bonds, following their earnings reports. This week saw just USD 10.6bn of high-grade bond issues, the second-lowest of the year. Even as concerns grow about growing COVID case counts, analysts led by Bradley Rogoff continue to see corporate earnings potential in a positive light. (Bloomberg)

FICO Score’s hold on the credit market is slipping

July 17. Powerful forces are aligning to change the dominance of FICO. Big lenders and housing-finance giants like Fannie Mae are moving away from the scoring metric, while financial regulators are encouraging banks to de-emphasize credit scores pegged on FICO to expand access to affordable credit. Many banks now use internal data to refine the proprietary scores, which they say are more reliable. This shift accelerated during the pandemic, as FICO did not accurately reflect deferment and forbearance programs. Nevertheless, it still has an advantage in the securitization market, as lenders rely on them for loan securitizations. However, it may soon face competition from the likes of VantageScore, which passed Fannie Mae and Fannie Mac’s credit-score assessments earlier this year. It may also find competition in the Office of the Comptroller of Currency’s efforts to find ways to underwrite loans to people without traditional credit scores, known as Project REACh. (WSJ)

Evergrande bonds pledged at 53% discount in China funding market (Bloomberg)

Yellen warns of default risk by October without debt-limit hike (Bloomberg)

Corporate bond credit spreads widen as investors shun risk (Reuters)

Regulatory Updates

Not even 50% inflation will make Argentina boost interest rates

July 24. Even though the inflation rate increased back to 50.2% in Jun-2021, Argentina's Central Bank (BCRA) forecasts that the inflation will slow down during the remainder of 2021, and international reserves will continue to grow. The BCRA does not plan to increase the interest rates that have held steady at 38% since Mar-2020. In criticism of the traditional monetary policies such as interest rate hikes, which failed to stop the inflation surge during the government of Mauricio Macri, the current BCRA adopts unorthodox ones to control price expectation. These policies include using subsidies, company fines, and price controls on items. Interest payments, which have driven up the money supply in the economy, are another reason why BCRA is hesitant to increase benchmark rates that will increase repayment cost on the domestic Leliq notes. However, analysts still estimate that BCRA will print ARP 900bn in the second half of 2021, nearly double the amount in the first half. (Bloomberg)

ECB divisions open up over pledge to persist with negative rates

July 23. The ECB stated that it would continue its bond-buying program and pledge to not raise its negative interest rates currently at -0.5% to shift the Eurozone economy out of its long-term pattern of low inflation. The bank also stated that it would tolerate a moderate and transitory overshoot of its 2% inflation target. The German and Belgian bank heads sitting on the ECB's governing council objected to this stance. Some argued this is too aggressive due to the risk of inflation surging above target levels, while some called for the ECB to separate the timing of when it will stop buying bonds from its new rate guidance. The ECB president Christine Lagarde said there had been "minor divergence" on the stance set forth by the ECB. She also said there was still "some way to go before the fallout from the pandemic on inflation is eliminated", implying the ECB was unlikely to taper its bond-buying soon. (FT)

Indonesia central bank holds rates amid growing COVID-19 crisis (CNA)

Russian central bank set to hike rates (Reuters)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Emir Hrnjic, Raghav Mathur