



Indian banks' credit quality benefits from improved profitability in the face of a looming liquidity crunch

by [Amrita Parab](#)

- **NUS-CRI Agg PD of Indian banks shows an improving trend in the second half of 2022, as banks post record quarterly earnings amidst improved asset quality, though a potential liquidity crunch poses headwinds**
- **Stress tests show that further widening of the funding gap deteriorates the credit quality of Indian banks, with public sector banks worse off than the broader industry**

Indian banks have posted their [strongest](#) quarterly performance on record, buoyed by a [favorable](#) interest rate environment, a strong rebound in credit growth and improved asset quality. As seen from the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for Indian banks in Figure 1a, credit risk for the sector has steadily declined over the second half of the year, concurrent with the Reserve Bank of India (RBI)'s [rate hike cycle](#) and amidst a robust growth in [demand](#) for credit. The improving trend was seen across the sector, as both public and private sector banks posted [strong earnings](#). Looking ahead, Indian banks will continue to benefit as RBI remains [committed](#) to hiking interest rates in the near term. However, if credit growth continues to outpace deposit growth, banks may see a rise in their liquidity risk that may impact their capital position and loss absorption capacity. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD¹) in Figure 1b suggests that such headwinds may potentially keep the credit risk of Indian banks elevated in the short-to-medium term.

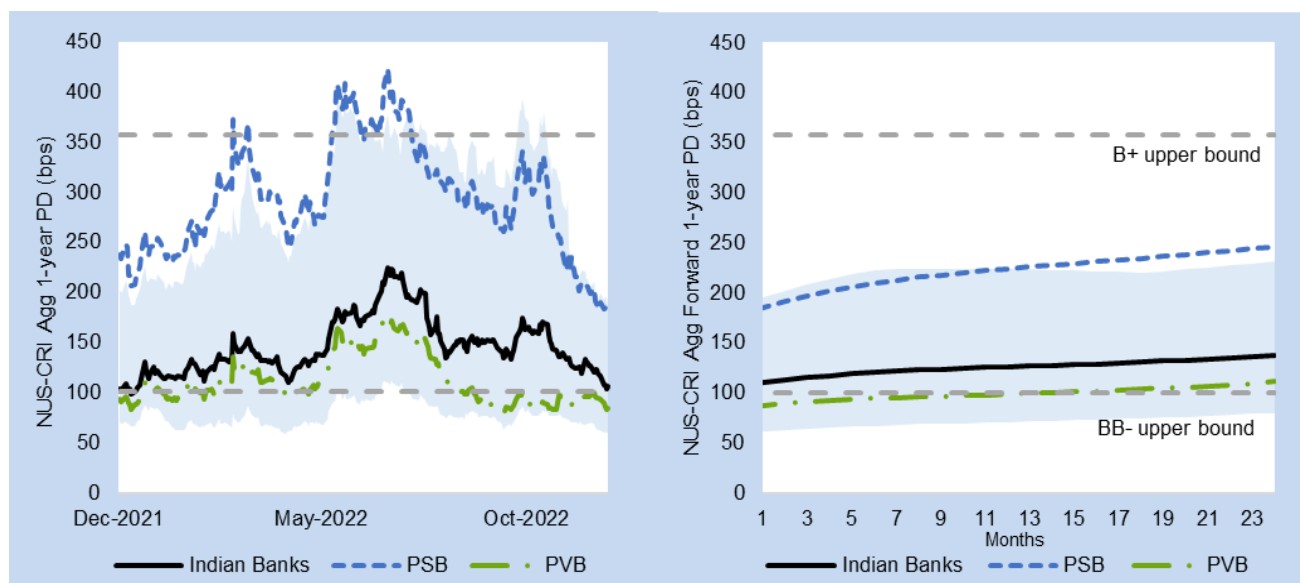


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Indian banks, public sector banks (PSB) and private sector banks (PVB) with reference to PDiR2.0² bounds and the interquartile range of Indian banks. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Indian banks, public sector banks (PSB) and private sector banks (PVB), as of Dec-2022, with reference to PDiR2.0 bounds and the interquartile range of Indian banks. *Source: NUS-CRI*

Indian banks posted their [highest](#) ever quarterly profit in the quarter ended Sep-2022, registering a [57%](#) YoY profit growth, largely attributable to loan growth and higher net interest margins. As of Oct-2022, as per RBI data, bank loans have shown a growth of 18% YoY, largely due to higher demand for credit from the [retail sector](#).

¹ 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.

² 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.

Consumers are undertaking big-ticket purchases such as houses and vehicles, driving India's credit expansion with personal loans increasing by [20%](#) in Oct-2022. Another segment [driving](#) India's credit growth is increased credit extension to micro, small and medium enterprises (MSMEs), with loans to micro & small enterprises increasing by six percentage points to [20.4%](#) YoY, possibly benefiting from the [extension](#) of the Emergency Credit Line Guarantee Scheme³. Similarly, the credit growth in large corporates jumped to [10.9%](#) in Oct-2022 as compared to a contraction of [0.4%](#) in Oct-2021. With bond yields now trending [higher](#) than bank lending rates, banks may witness a further increase in credit demand from large corporates in the coming quarters. Additionally, successive interest rate hikes by the RBI have helped boost banks' net interest margins since banks' deposit rates have [lagged](#) lending rates.

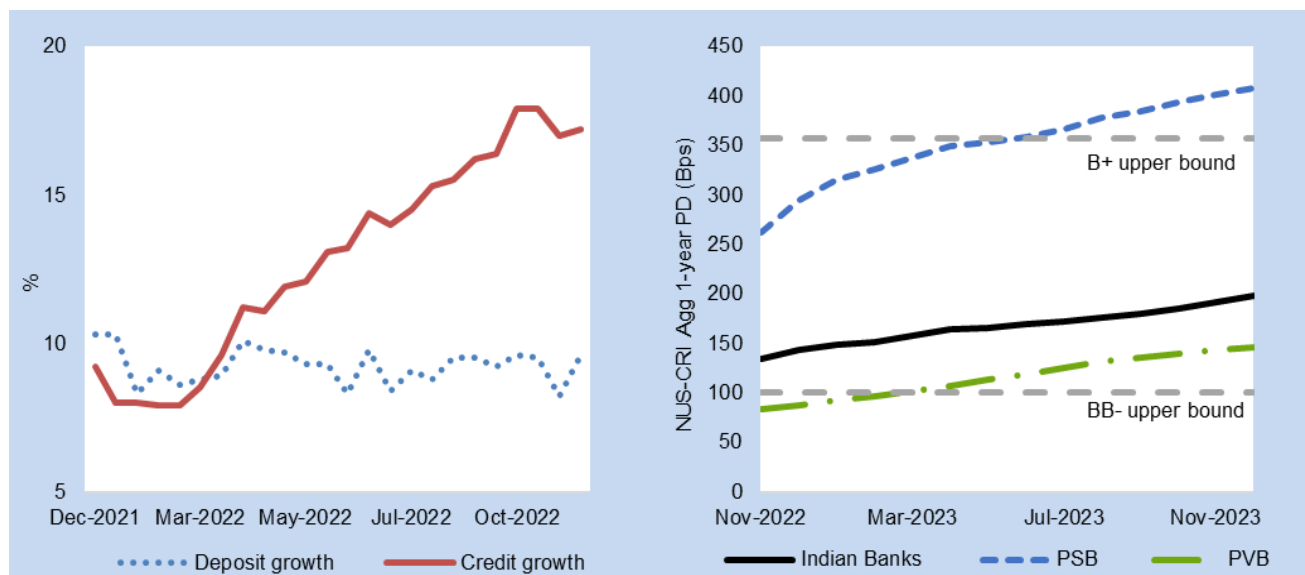


Figure 2a (LHS): Fortnightly credit and deposit growth of Indian banks. Figure 2b (RHS): Stressed NUS-CRI Agg (median) 1-year PD of Indian banks, public sector banks (PSB) and private sector banks (PVB). Source: *Trading Economics, BuDA v3.5.1*

Indian banks' credit health is supported by cleaner balance sheets, with NPAs currently at a 7-year low of [5.9%](#). The fall in bad debts has allowed banks to [lower provisions](#) and book higher profits. Going forward, the [National Asset Reconstruction Company Ltd \(NARCL\)](#), India's "[bad bank](#)" that has been established to take on stressed loans within the Indian banking industry, may provide further respite to banks still saddled by legacy bad debts. As of [Oct-2022](#), NARCL has already acquired almost INR 400bn of stressed assets from public sector banks as part of its phase I mandate of INR 900 bn.

Despite the improvement in asset quality, the near-term credit risk outlook for the Indian banking sector remains relatively elevated. Further widening of the funding gap, as the banking sector pursues faster credit growth, may rapidly unravel the sector's recovery. As of Nov-2022, overall credit growth in the sector has been 18% YoY, far outpacing the overall deposit growth in the banking system, which is currently at 9.5% (See Figure 2a). Without additional funding, the Indian banking sector faces heightened liquidity risks, potentially leading to banks scrambling for funds by tapping into capital markets or turning towards RBI to inject more liquidity. Stress tests can be conducted using the NUS-CRI Bottom-up Default Analysis Toolkit (BuDA toolkit⁴) to see how private and public sector banks respond to the further widening of the funding gap. As shown in Figure 2b, public sector banks, under an extreme stress scenario where the funding gap widens from 8.2% in Nov-2022 to 10.8% by Dec-2023, see their credit risk jump sharply compared to their private sector counterparts. This may be due to PSBs having lower loss absorption capabilities with their CET-1 ratios (PSB: 12.7% vs PVB: 16.4% as of Sep-2022) and higher NPAs (PSB: 7.8% vs PVB: 2.9% as of Sep-2022) that make the impact of the liquidity crunch worse.

As of now, banks have resorted to [certificates of deposit](#) (CDs) to limit the impact of the current funding gap. The total amount of outstanding CDs has jumped to [INR 2.41tn](#) in Oct-2022, from INR 0.57tn seen in the same period last year. However, banks' funding cost for CDs is also high, with 360-day CD rates at [7.97%](#).⁵ Additionally, rapid expansion in credit also [narrows](#) the banks' loss-absorption buffers, further highlighting the importance of deposit growth. In the near term, banks may aggressively compete for deposits by offering

³ The Emergency Credit Line Guarantee Scheme was introduced by the government to extend financial support to firms impacted during the COVID-19 pandemic.

⁴ The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).

⁵ In comparison, the weighted average INR term deposit rate was [5.49%](#) in Oct-2022.

attractive rates, which may eat into their interest margins. Market analysts believe that as banks rush to take advantage of higher credit demand, the possibility of [mispricing credit risk](#) is high, which may lead to lower provisioning for bad loans should the asset quality worsen. For instance, increased lending to micro, small and medium enterprises (MSMEs) may potentially result in such mispricing. As per a [survey](#) conducted by the Federation of Indian Chambers of Commerce & Industry (FICCI) and the Indian Banks' Association (IBA), the majority of banks expect NPAs in the MSME sector to rise potentially driven by heightened inflation and the global growth slowdown in 2023. As such, public sector banks in particular, which have a [higher proportion](#) of their loan portfolio in MSMEs compared to private sector banks, face higher credit risk due to a potential increase in NPAs stemming from this loan segment. Even though the industry has benefitted from rampant credit growth and higher interest rates, headwinds pertaining to the widening of the funding gap, in conjunction with a potential worsening of asset quality, could lead to an elevated credit risk outlook for Indian banks in the near term.

Credit News

Bond market bulls are USD 2.8tn better off after rebound

Nov 30. Investment grade companies and government bonds rebounded USD 2.8tn, to USD 59.2tn, in market value in Nov-2022, as inflation worries and central bank intensive rate hikes signal easing. With softer inflation data available in the US, investors are expecting the Fed to pivot its aggressive rate hike narrative soon. Analysts are also expecting bond spreads to thin in the second quarter of 2023 as better indications of a soft landing become apparent for the US. Looking forward, analysts have their eyes set on key inflation data and the Fed's December announcement for further indication of how the markets are going to respond entering 2023. ([Bloomberg](#))

BOE starts sales of bonds bought in UK market mayhem

Nov 29. The Bank of England has sold GBP 346mn of lang-maturity index-linked debt that it bought under emergency action to halt a rout that was caused by Truss's government in Sept-2022. The BOE plans to unwind the asset purchases it had made in Sept over the next week, highlighting the temporary nature of the program, given that stability had returned in the market. It is yet to be seen how the market fully digests this sale, given that similar moves may be made by the BoE in the near future hoping for higher demand for the gilts. ([Bloomberg](#))

Emerging market stocks and bonds stage powerful rebound rally

Dec 01. Emerging markets stocks and bonds have been rallying on the hopes that China is loosening its zero-COVID policy. JP Morgan's broad-gauge dollar-denominated emerging market debt gained 7.6% in Nov-2022, while the MSCI EM index gained 14.6% in dollar terms. A promise of slower interest rate hikes by the Fed has also boosted EM debt and stocks, potentially increasing inflows into emerging markets. For context, USD 85bn has flown out of EM bond funds this year. An increase in liquidity as buyers re-enter the market could have a profound impact on EM bonds. Investors are also looking at protests happening around China as a sign of policy easing, though the consensus is that China will ease restrictions over the next two quarters. Headwinds remain as global growth is expected to slow next year, and it remains to be seen how emerging markets' growth is affected relative to growth fears in developed markets. ([FT](#))

With debt coming due, investment-grade companies are paying up, too

Dec 01. Investment-grade companies are contemplating whether to refinance at higher rates or take on shorter-term options on the chance that rates might go down next year. USD 59bn of investment-grade debt coming due in 2023, companies have only three weeks to refinance this year. In recent days, however, demand for non-financial investment-grade bonds has been rising, with companies such as Amazon refinancing bonds that are due in 2023. Generally, companies have been refinancing at higher rates to capture the rising demand from investors, though the refinancing may potentially be only for a short period, as expectations of slower rate hikes, or even a complete fed pivot by the end of next year increase. As such, some companies that have maturities in the latter part of 2023, or 2024, have been taking term loans rather than tapping the bond market. ([WSJ](#))

ESG downgrade sparks new penalty in USD 200bn bond market

Nov 29. A Poland-based oil refiner, PKN Orlen, has paid creditors a higher coupon on its sustainability-linked bond (SLB) due to a downgrade on its ESG rating by MSCI. As SLBs are linked to triggering targets, such as emissions or water usage goals, companies that outsource performance indicators to rating agencies are rare due to corporate reluctance and perceived rating-methodology opaqueness. The downgrade follows MSCI methodology change that incorporates corporate behaviour. The SLB market is facing enormous pressure from the ongoing energy crisis that has put its decarbonization goals at risk. The market is apprehensive about SLBs, citing weak and flexible targets and small penalties for breaches reducing the bond's credibility. With more companies issuing SLBs, regulators are in the process of introducing a code of conduct for the industry. ([Bloomberg](#))

Credit Suisse surges as much as 10% after halt to mass outflows ([Bloomberg](#))

SoftBank taps yield-hungry retail investors in Japan bond market ([Bloomberg](#))

FTX collapse sends shockwaves through Coinbase's stocks and bonds ([FT](#))

Regulatory Updates

SEC backs down from bond-market plan that rattled industry

Nov 30. Banks are happy that the SEC is postponing a new set of transparency-related rules for bonds that had been sold privately, hoping that issuance and sale of bonds can remain buoyed and not come to a standstill. The bonds, called the 144a securities, are normally used by private companies to raise funds and can be used to bundle mortgage or consumer loans. The transition has potentially been postponed to 2025, with the SEC hoping that it would give industry players more time to comply. The rule in question forbids broker-dealers from quoting prices unless a certain financial disclosure threshold has been met. ([WSJ](#))

Saudi Central bank steps up efforts to ease liquidity crunch

Dec 01. Saudi Arabia's central bank, SAMA, has increased efforts to pump more money into the financial system to combat the current liquidity crunch that is raising borrowing costs. Through open market operations, the central bank is adding more short-term liquidity. Though oil prices are higher, a greater demand for funding without a matching increase in deposit base has left financial institutions searching for liquidity. Analysts consider SAMA's intervention a "band-aid" fix to a structural liquidity problem. They state that the central bank should incentivize banks to raise funding through capital markets or securitizing loans such as mortgages. SAMA has already injected SAR 50bn at discounted rates in June, which relieved short-term liquidity concerns, though the conditions have worsened. The liquidity squeeze is due to higher policy rates as SAMA matches the Fed's rate hikes. However, domestic demand for funding and banks' aggressive loan-book expansion strategy adds to the liquidity woes. ([Bloomberg](#))

Pakistan central bank says it paid USD 1bn dollar bond ([Bloomberg](#))

RBA to raise rates another modest 25 basis points in December ([Reuters](#))

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