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# Banks & Financial Services: One of the most challenging quarters

Earnings declined 55% y-o-y as provisions for bad loans doubled while revenue growth was weak at 8% y-o-y

By: [Kotak Institutional Equities](#) | Updated: February 29, 2016 1:40 AM

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Q3FY16 had nothing to cheer for banks. Revenues increased 8% y-o-y (year on year) while provisions doubled resulting in 55% y-o-y decline in earnings. 60% of the slippages for the quarter were under the directives of [RBI](#). For NBFCs (non-bank financial companies), NIM (net interest margin) expansion and improving loan growth supported core earnings. Bajaj Finance, Chola, Shriram Transport, SKS and LICHF reported strong performance while HDFC, MMFS, Magma, Muthoot were weak during Q3FY16.

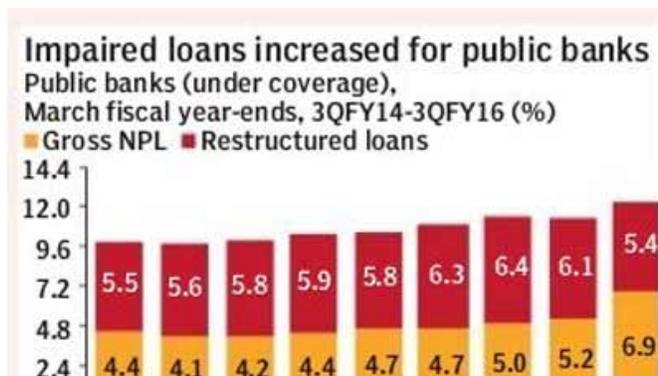
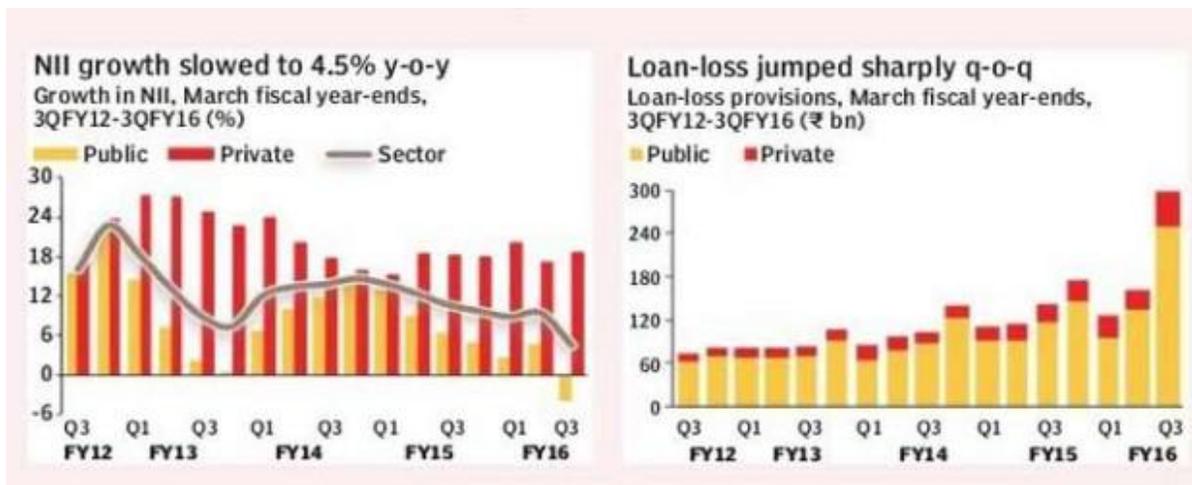
### Earnings dip sharply led by high provisions for bad loans

It was one of the most challenging quarters for Indian Banks as earnings declined 55% y-o-y as provisions for bad loans doubled while revenue growth was weak at 8% y-o-y. NII (net interest income) grew 5% y-o-y but public banks reported a decline of 5% y-o-y due to high income de-recognition due to slippages as well as the full impact of the base rate cut taken in September 2015. NII for private banks grew 19% y-o-y but overall NIM profile is showing a fair bit of pressure which is not comforting considering that loan growth is not showing any sign of improvement. The industry has seen a decline in

tier-1 ratios post the losses reported in the current quarter though this appears to be less of a near term concern amongst all banks that we have under coverage. Only BoB in public banks and retail oriented banks have come out with a strong positive outlook on their growth or impairment prospects.

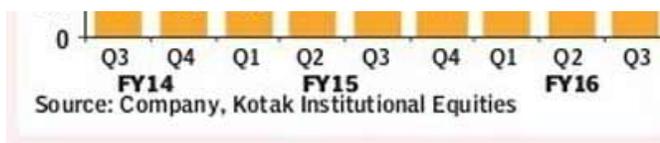
NPLs increase sharply as banks were directed by RBI to recognise certain loans

Outstanding impaired loans (banks under coverage) increased 60bps q-o-q to 9.7% of loans with gross NPLs increasing 120bps q-o-q to 5.5% while restructured loans declined 60bps q-o-q to 4.2% of loans. Impaired loans for public banks increased 90bps q-o-q to 12.2% with gross NPLs increasing 170bps q-o-q to 7.9% while impaired loans for private banks increased 40bps q-o-q to 4.3% of loans. Fresh slippages were at 8% of loans with ~60% of this directed by RBI. We understand that these loans were from iron and steel, textiles and power sectors and most of these loans were restructured in the past few years. There have been no strong signs of improvement in recovery and upgrade in Q3FY16.



Another quarter of pain ahead but we hope it is the beginning of the end

Discussion with banks indicates that the full impact of RBI directives has not been taken by banks in this quarter and one



could see a broadly similar/marginally lower quantum in Q4FY16. While there is some hope that this could see the

beginning of the end of the recognition of peak bad loans, it nevertheless raises a few questions: Limited access to fresh funds, impact of supply chain of these large accounts, reduction in M&A transactions could result in higher NPLs than initially estimated while a cautious outlook to underwrite fresh credit would significantly delay the investment cycle.

NBFCs: Operating growth strong

NIM expansion and improving loan growth supported strong core earnings of most NBFCs. Housing finance companies continue to toggle between higher NIM and growth. Asset quality trends are mixed as incremental NPLs in CV finance are reducing but rural loans reported severe stress. We note two incremental trends: (i) competition in housing finance is taking a toll of NII growth and (ii) Shriram Transport's performance is getting stronger. Post recent correction, we prefer niche retail plays Shriram Transport, [Mahindra Finance](#) and Cholamandalam. Bajaj Finance and SKS remain in sweet spots.

Net impaired loans rise on the back of sharp rise in slippages

RBI's action of directing NPL recognition of certain large exposures had its toll on impaired loans which increased 33% q-o-q in gross NPLs while restructured loans declined 10% q-o-q. Fresh impairments were at a near term high at 8.1% of loans with sharp rise in slippages at 7.7% while fresh restructuring was negligible at 0.4% of loans.

BoB, PNB, BoI, OBC among public banks reported sharp rise in slippages while HDFC Bank, IndusInd Bank and Yes Bank in private banks reported better performance on fresh impairment ratios. Comparison across banks is not strictly proper as a few banks have taken the entire charge of RBI's initiatives in the current quarter while most other banks have spread the pain across two quarters in different proportions.

**AQR-related slippages comprised around 50-60% of total 3QFY16 slippages for most banks**  
Slippages to NPL, March fiscal year-end, 3QFY16

|                           | Total slippages (₹ bn) | AQR-related slippages(₹ bn) | AQR slippage (% of total) |
|---------------------------|------------------------|-----------------------------|---------------------------|
| Allahabad Bank            | 31                     | 17                          | 54                        |
| Axis Bank                 | 21                     | 10                          | 48                        |
| Bank of India             | 98                     | 49                          | 50                        |
| Bank of Baroda            | 158                    | 105                         | 67                        |
| Canara Bank               | 54                     | 33                          | 61                        |
| Dena Bank                 | 29                     | 16                          | 55                        |
| ICICI Bank                | 65                     | 44                          | 67                        |
| Indian Bank               | 17                     | 11                          | 63                        |
| J&K Bank                  | 3                      | 1                           | 19                        |
| Oriental Bank of Commerce | 40                     | 32                          | 80                        |
| Punjab National Bank      | 127                    | 56                          | 44                        |
| State Bank of India       | 207                    | 140                         | 68                        |
| Union Bank of India       | 34                     | 20                          | 60                        |
| <b>Total</b>              | <b>885</b>             | <b>533</b>                  | <b>60</b>                 |

Source: Company, Kotak Institutional Equities

Overall gross NPLs increased 33% q-o-q at 5.6% of loans (160bps increase to 5.9% of loans for public banks and 40bps q-o-q to 2.5% of loans for private banks). While most large private banks had indicated that the stress level was gradually easing, it clearly was not the case looking at the current quarter's performance and the commentary for the next quarter. Public sector banks continue to be the worst impacted by the restructured portfolio. A few banks continued to resort to sale of loans, both standard, NPL and written-off loans to ARCs at a steep discount.

Disappointing trends on recovery/upgrade as it was lower than the previous quarter at 0.8% of loans while the write-offs declined to ~0.7% of loans. Typically, the second half of the year is stronger on recovery and upgrades though we are yet to see this. It could be seasonal and probably not cyclical and we would need to see the trends in 2HFY16 to establish the trend on impairment ratios.

Managements, especially of public banks, continue to highlight that a disproportionate bandwidth is towards impairment management but the efforts can pay-off only when there is recovery in the economy. The earliest sign that we would need to read to gain

confidence on the impairment cycle would be the reduction in slippages which at this stage is not visible though one would argue that it has probably stabilised. 

Provision coverage showed some improvement, albeit nothing substantial. SBI reported one of the best improvements in provision coverage ratios.

Net NPL and restructured loans increased 30 bps at ~7.4% of loans

The overall restructured loans declined by 60 bps q-o-q to 4.2% of loans. The pace of decline was not on expected lines, considering that a large share of slippages have come from a reasonably strict recognition directed by the regulator. Loans restructured in the SEB segment were stable q-o-q at 46% from 50% in the last few quarters. There would be no fresh disbursements from FY2016 to the SEB as a part of the financial restructuring package. Overall stress (net NPL and restructured loans) stands at 2.9% of loans for private banks and 9.5% of loans for public banks.