

TOP NEWS: **This wedding season, click with e-tailers, digital wallets**



CFA Institute

A Difference That Matters™



[Home](#) / [Market](#) / [Indian banks: Time for a clean-up of the system](#)

Indian banks: Time for a clean-up of the system

We see a tough year for Indian banks. The Reserve Bank of India's drive to build up contingencies will result in higher credit costs at times when NIMs (net interest margins) are declining.

By: [Deutsche](#) | Updated: January 18, 2016 12:37 AM

G+

We see a tough year for Indian banks. The Reserve Bank of India's drive to build up contingencies will result in higher credit costs at times when NIMs (net interest margins) are declining. Divergence will widen further between retail and corporate banks—retail will stand out, while corporate remains weak. Even as valuations are again in a comfort zone (similar to pre-2014 levels), our preference for banks are premised mainly on operating earnings growth. Our top picks are HDFC Bank, Indusind Bank and Yes Bank. Amongst corporate banks, we like ICICI Bank, given its attractive valuations.

Time for final clean up; likely higher provisioning on stressed loans

We believe that [RBI](#) will call for higher provisions on stressed assets to guard the banks against any future risks. Unrecognised stress levels are high at 12-14%—restructured loans (~5%), SDR (1.5-2%), 5:25 refinancing (1.5%) and few big exposures which are stressed (~4-5%). We estimate banks will build about 10% provision on such exposures – likely increase of 1% of loans as provision cost spread over FY16/FY17. We raise credit

costs by 30-50 bps each in FY16/FY17, consequently impacting our earnings by 5-18% for FY17e. 

Weak operating drivers over the next 4 quarters

Amongst private banks, we find divergence in core performance—smaller banks like Yes, IIB (IndusInd Bank) will deliver strong operating profit (28-30% CAGR), as a result of faster loan growth and stable margins, while larger banks —ICICI/Axis—will deliver growth at 10% CAGR as NIMs may come off. We expect pressure on NIMs for HDFC Bank as well, but a strong loan growth should translate to PPOP (pre-provision operating profit) growth of 21% CAGR (compound annual growth rate). PSU Banks will deliver sub-10% operating profit growth, as NIMs may contract even as loan growth remains subdued.

Valuations offer comfort for risks involved; but we prefer growth plays

Valuations for corporate banks (ICICI, Axis, SBI) have already corrected sharply, which makes us positive on these stocks despite the near-term headwinds; however, we prefer growth, (operating profit growth in the current context).

Benign rate/liquidity environment to prevail; gradual improvement likely

We believe that the ensuing environment will be pro growth and we like asset financiers (private banks, mortgage/CV financiers) which can deliver strong growth. Given easy liquidity, we believe that smaller banks—Yes, IIB and NBFCs (non banking financial companies) will benefit the most in terms of funding costs decline and will be able to protect/improve NIMs, while for most banks NIMs will decline.

Lower earnings and target prices for banks

We revise our estimates largely for corporate banks, as we build in slightly slower growth and higher credit costs for FY16/FY17. Further likely lower margins would impact operating profit growth. We raise our credit cost estimates by 20-60 bps for FY16/FY17 and this impacts our earnings by 5-18%.

Asset quality— time to clean up; expect higher credit costs

On asset quality, while the problems are now known, ultimate recognition of the stressed assets has not happened. Banks have pushed back the problems by doing restructuring, 5:25 and now SDRs (strategic debt restructuring). This translates to 8-10% of the system loan book which is stressed but not yet recognised as an NPL (non-performing loan). The outcome of restructured cases has also not been great and we are now witnessing a higher NPL slippage out of the same.

We believe that with RBI now wanting banks to clean up, the likely credit costs which were supposed to be spread over the next three years will have a much higher incidence in FY16/FY17 and may be higher than usual. We adjust our credit cost estimates to factor in the same for all corporate banks.

₹ million	ICICI Bank	Federal Bank	SBI	Axis Bank	BoB	Bol	Union Bank	Canara Bank	PNB
GNPA	158,578	14,987	568,343	44,511	237,103	298,937	155,412	140,213	249,452
Current PCR	57.4%	55.0%	49.7%	65.3%	46.0%	44.9%	46.4%	33.1%	39.1%
PCR satisfactory level	70.0%	70.0%	70.0%	70.0%	70.0%	70.0%	70.0%	70.0%	70.0%
Shortfall	12.6%	15.0%	20.3%	4.7%	24.0%	25.1%	23.6%	36.9%	30.9%
Provision required for shortfall as percentage of advances	0.49%	0.44%	0.86%	0.07%	1.37%	1.96%	1.49%	1.60%	2.02%
Advances	4,096,927	508,667	13,371,532	2,980,656	4,148,998	3,816,667	2,462,170	3,230,775	3,809,577

Source: Company Data, Deutsche Bank

SDR invoked to date

(₹ billion)	Total debt	Debt converted to equity
JP Power ventures	303	93.0
Monnet Ispat & Energy	118	3.7
Gammon India	113	2.5
ABG Shipyard	110	–
Electrosteel Steels	106	–
IVRCL	92	27.5
Transstory	43	–
Coastal Projects	33	2.1
Visa Steel	31	1.7
Jyoti Structures	29	3.1
GOL Offshore	26	–
AMW Motor	14	–
Ankit Metal & Power	12	2.4
GTL Infra	50	–
Rohit Ferro-Tech	26	1.1

While this impacts earnings for FY16/FY17, we believe investor concerns about private banks wanting capital due to this event are unfounded as the banks are well capitalised. However, for PSU banks, there needs to be another big capital infusion by the government next year.

Stress remains high: GNPA + restructured loans are ~10%

Reported stressed assets for PSU banks are above 10% while for private banks (corporate banks, especially Axis, ICICI) the rate is in a 4-8% range. We believe the

Lanco Teesta Hydro power	24	—
Shiv-vani oil & gas	40	5.0
TOTAL	1,169	

Source: Media reports, Company Data, Deutsche Bank

RBI's recent view of clearing the banking system's bad assets by March 2017 should lead to higher provision (credit cost) in the near term. If RBI asks banks to

improve their coverage ratios, there is likely to be an increased requirement of credit costs. Assuming a 70% requirement in PCR (provision coverage ratio) would lead to an increase in provisions of 0.5-2% of total advances across banks. Private banks would see an increase in credit cost of 40-50bps, while PSU banks are under-provided and hence would see their credit cost increase by 100-200bps.

Standard assets of stressed corporates at potential risk of being restructured

Some corporate accounts are still classified as standard on bank books even though the financial strength of the company has deteriorated significantly. Such assets remain at risk of being slipped into NPA or going through refinancing (5:25), thus increasing the risk of higher provisions going forward.

Credit costs to remain elevated— higher than earlier expected

We believe that with RBI wanting the banks to clean up their loan books, the likely credit costs which were supposed to be spread over the next three to four years will have a much higher incidence in FY16/FY17 and may be higher than usual. With almost 2% of the system loan book moving under SDR (banks have a c.18-month window for resolution), the likely risk of future mark-downs remains high. The likely recovery of the previously recognised NPLs also remains lower than in earlier cycles—as cyclical sectors such as commodities and steel still remain under stress.

Exposure to stressed sectors

The banks' exposure to stressed sectors stands at 8-20% of total funds-based exposure. The stressed sectors mainly comprise iron & steel, metal & metal products, coal and power. There can be slippages from these known sectors which can keep credit costs elevated if recognized by banks in a prudent manner. Already known risks in terms of stressed book stand at 3-10% of advances where there can be substantial increases in provisioning due to the RBI's current mandate.

Banks are comfortable on capital, but not on earnings—assuming a 25% loss on stressed book; earnings hits are likely 

While near-term earnings may be a challenge, we do not see material issues on capital. Compared to their stressed exposure, even assuming a 25% loss given defaults, banks are comfortable on capital (though capital declines by 10-20%). However, a higher LGD (loss given default) would result in a capital shortfall, but this is a fairly unlikely event in our view .

BV could get impacted, assuming big contingency build-up

It is quite likely that the RBI will ask banks to start building up big contingency provisions. We assume additional provisions for various types of loan classification. The impact on BV (book value) is 6-15%. In our revised assumptions, we build in almost 50-60% of this through our earnings estimates.