Indian Banks: A fundamental overview

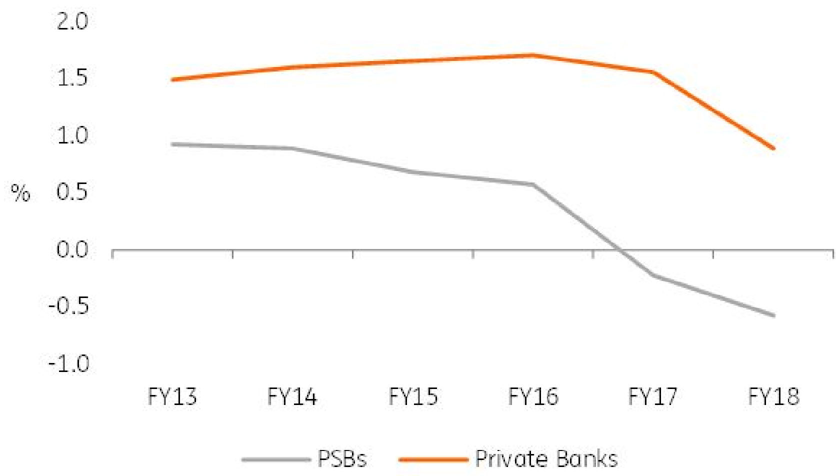
In India, public sector banks have been harder hit than their private counterparts. Will that trend continue? We take a look


Source: Shutterstock

Profitability

Indian banks' profitability has come under pressure over the past two years as the costs associated with cleaning up their balance sheets overwhelmed their earnings. These include not just direct costs, such as higher provisioning charges, but also the decline in income resulting from the rising load of non-performing loans. Consequently, net interest margins have been under pressure. Public Sector Banks (PSBs) have been harder hit than their private counterparts due to their higher exposure to troubled assets. We expect this to be the last year of negative profitability for them.

Return on average assets development



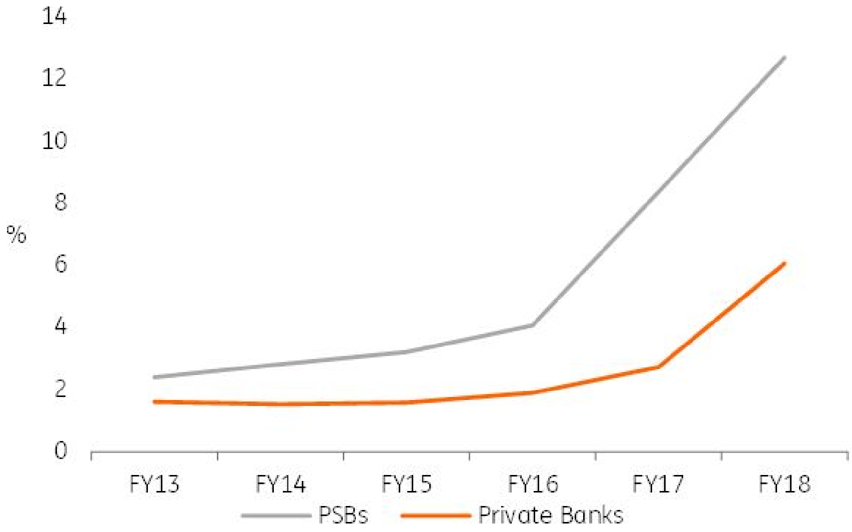
Source: Company data, SNL, ING

Interestingly, the cost/income ratio already seems to have peaked for the PSBs. On the other hand, private banks have been making a big grab for market share while the PSBs were unable to lend as freely. This has reduced their efficiency over the past year, though we expect things to settle down over the next few quarters as normal service is gradually resumed.

Asset quality

Asset quality ratios have been declining across the sector as banks are forced to recognise and deal with bad debt. Once again, the PSBs come off markedly worse than their private counterparts, as credit costs and NPL ratios rise. The headline NPL ratio for PSBs is now very high at around 13% on average, while private banks weigh in at a more modest 6%. We expect these ratios to be close to peak levels, and they could fall swiftly as the lumpy National Company Law Tribunal exposures are worked out. Since July 2017, 41 NPL accounts (35-40% of all system NPLs) have been referred by the Internal Advisory Committee to the NCLT for insolvency proceedings.

NPL ratio development



Source: Company data, SNL, ING

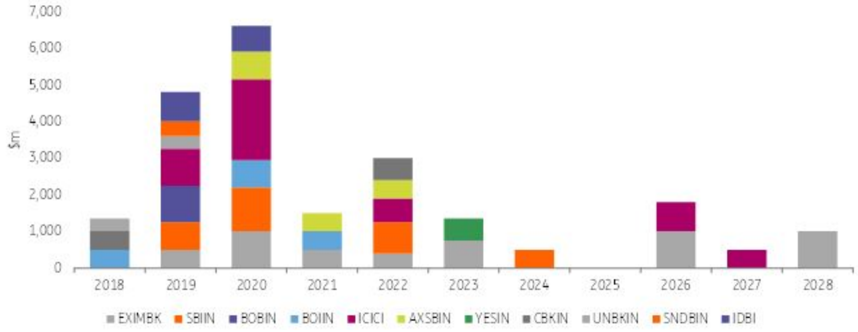
Where PSBs have outperformed their rivals, however, is in the maintenance of their provisioning cushion. Most Indian banks have a coverage ratio of about 50%. While we would like to see this ratio rise further, banks are already making such an effort on the provisioning front that it's unrealistic to expect more from them in the short term. It's interesting to note that the PSBs have managed to maintain, or even increase, their coverage ratios over the past few years, whereas their private counterparts have seen theirs slip from 80% to 50% since 2014. We think that they will arrest this decline as the market is likely to punish them if these ratios fall much below current levels, and the cyclical upswing they look set to enjoy over the next couple of years should make it easier for them to rebuild their stock of provisions.

Liquidity and funding

Indian banks generally have a strong funding position. As is the case in China, the system has a surplus of deposits, giving the banks secure access to cheap, sticky funding pools. This can most easily be seen in the loans/deposits ratios, which stand at a very strong 75% for state banks and a reasonable 104% for private banks. The private banks have expanded their loan books aggressively over the past few years, which explains some of the rise in their loan/deposit ratios, whereas the PSBs have been in retrenchment mode.

Liquidity is also ample. Banks have considerable securities portfolios, amounting to 25% of total assets. The vast majority (if not all) of these holdings are government securities. This gives us comfort when facing Indian banks' short maturity profiles. Some 77% of outstanding bonds mature by 2022, with 57% of redemptions due in the next two years. This potential supply overhang could weigh on the market in the medium term, though investors have their minds on broader concerns at present, such as rising core rates, the strong US dollar and the possibility of a trade war between the US and China. It's worth noting that, as a relatively closed economy, Indian banks are better protected against these risks than many similarly rated peers.

Indian bank maturities (USD senior paper)



Source: Bloomberg, ING

Capitalisation

Capital ratios vary widely across the sector and are PSBs' Achilles' heel. Two years' losses (in some cases) have caused capital depletion, such that the average Tier 1 ratio is 10%, which is adequate but not comfortable. Having said that, the sector should be able to generate organic capital again once it returns to profitability in the next few quarters, while the INR 2.1 trillion capital injection into PSBs will neutralise the expected losses from NPL write-offs. Private banks are faring much better. Despite significant RWA inflation over the past year, Tier 1 ratios are at 14% on average, which is very strong. The contrast is even more stark when we look at a truer picture of banks' leverage, the Tangible Equity/ Tangible Assets ratio, where the average for the private banks is 9% against a mere 6% for the PSBs.

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