Indian Banking Sector: Private banks to account for ~38%-40% of banking advances by FY2020; leveraging technology for deposit mobilisation to be a key driver of growth

ICRA RESEARCH SERVICES

Financial Sector Ratings

Karthik Srinivasan
+91 22 6114 3444
Karthiks@icraindia.com

Rohit Inamdar
+91 124 4545847
Rohit.inamdar@icraindia.com

Anil Gupta
+91 124 4545 314
anilg@icraindia.com

Niraj Jalan
+91 33 7150 1146
niraj.jalan@icraindia.com

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Summary

The Indian banking industry is currently going through a transition and private and public sector banks are facing different sets of challenges. Public sector banks (PSBs) are plagued with asset quality issues leading to higher credit costs and losses. With increasing regulatory capital requirements, weak internal accruals and limited capital infusion by the Government of India (GoI) in relation to requirements, PSBs have been into capital conservation mode by constraining their lending activities. Tier-I capital of PSBs stood at 9.7% (of risk weighted assets - RWA) as on June 30, 2017 as against regulatory requirements of 9.5%[1] required by March 31, 2019, indicating the limited capital cushion available to grow the advances. PSBs' advances grew by less than 1% YoY during Q1FY2018.

With Tier I capital of 14.1% as on June 30, 2017, private banks (PVBs) are well capitalised to capture the lending opportunities ceded by PSBs; however increasing competitive intensity because of weak credit demand and the buoyant debt capital markets pose challenges of balancing growth and profitability. Notwithstanding these challenges, PVBs have performed well and capitalised on the opportunities by delivering a credit growth at 3-year CAGR [2]of 17.8% as against 2.5% for PSBs and with relatively better asset quality. The YoY growth in advances of PVBs during Q1FY2018 stood at 15.3%. Gross non performing asset (GNPA) of PVBs stood at 4.24% as against 12.75% of PSBs, as on June 30, 2017. With higher than industry growth, PVBs market share in banking sector advances increased from 19.9% as on March 31, 2014 to 27.5% as on March 31, 2017.

The incremental market share of PVBs during the trailing twelve months (TTM) ending June 30, 2017 stood at ~100% given the limited growth in PSB advances in this period. Assuming an incremental market share of 80% for PVBs and a credit growth of 7-9% for the banking sector during FY2018-FY2020, the market share of PVBs in banking sector advances is expected to increase to ~38-40% by FY2020.

PVBs have better current account and savings account (CASA) deposit ratios than PSBs, as on June 30, 2017, the CASA deposits ratio for PVBs stood at 42% as against 37% for PSBs. On TTM basis for the period ending Q1FY2018, while the incremental share in advances stood at ~100% for PVBs, the incremental share of PVBs in the deposits stood lower at 37%. Assuming a banking sector deposit growth of 7-10% and an incremental PVB market share of 40% in deposits, the credit/deposit ratio[3] (CD ratio) of PVBs is expected to be 94-102% during FY2018-2020 as against average of 86.9% (76% adjusted for net worth) during FY2014-17. Such a high CD ratio means that the PVBs will need to either have an market share of 60-70% in incremental deposits to maintain a CD ratio of 87% or rely on high cost market borrowings. In case the PVBs are unable to mobilise the requisite quantum of deposits, the ability of PVBs to grow advances may be constrained and overall credit growth of the banking system may also be lower. In such an emerging landscape, ICRA expects technology, better services and the higher interest rates on saving accounts to act as catalysts for deposit growth for PVBs. With almost 90% of banking transactions being through digital channels and ATMs, and with electronic verification (e-KYC) of customers for new account opening, ICRA expects PVBs to further accelerate the pace of retail customer addition, which can enable them to accelerate deposit growth and maintain a higher share of CASA in their overall deposits.

[1] Including capital conservation buffer of 2.5%

[2] June 2014 to June 2017

[3] CD Ratio = Advances / deposits x100. CD ratio adjusted for net worth = Advances / (deposits + net worth) x 100

PVBs have better asset quality, and hence, better profitability and stronger capital levels

Chart 1: PSB asset quality continues to weaken

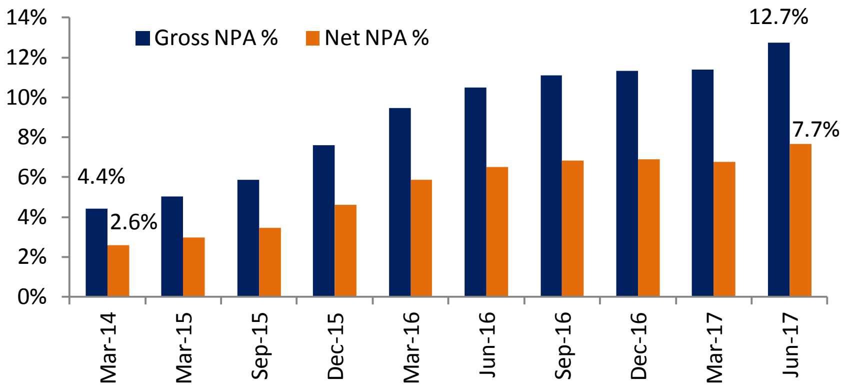


Chart 2: PVB asset quality significantly better

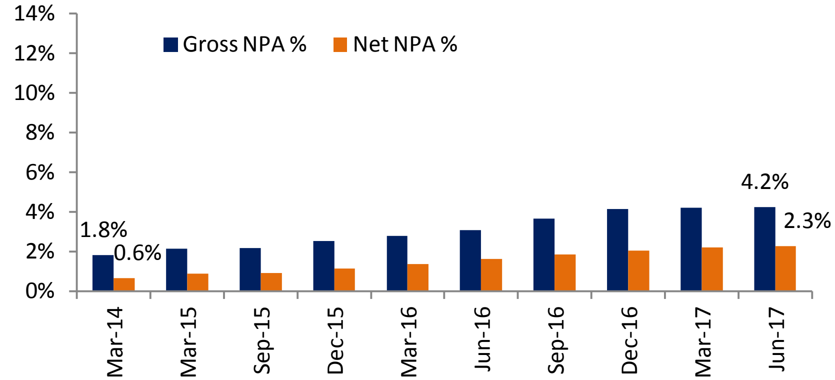


Chart 3: Better asset quality results in relatively better profitability for PVBs

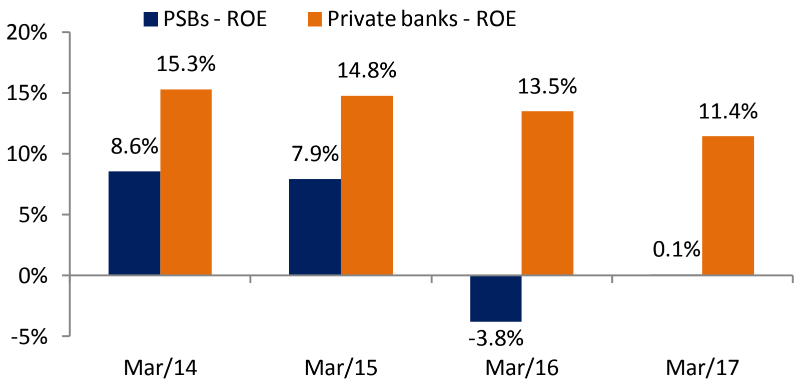
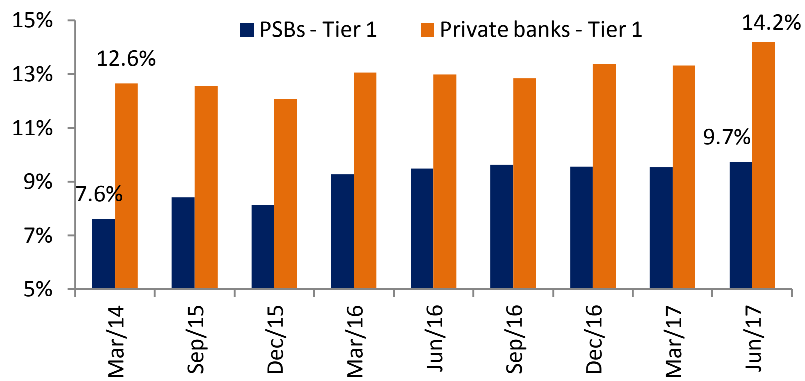


Chart 4: PVBs have stronger capital levels



Source: Banks, ICRA Research

As seen from Charts 1 and 2, PVBs have significantly better asset quality as compared to PSBs. The superior asset quality is an outcome of PVBs' relatively superior underwriting standards and account monitoring processes and their relatively lower exposure to sectors like infrastructure, metals and construction, which are currently under stress. Given their better asset quality and lower credit provisions (of 2.00% of advances as compared with 3.01% of advances of PSBs for FY2017), PVBs' profitability and internal capital generation has been better than that of PSBs (refer chart 3). With higher internal capital generation, the capitalisation of PVBs has also remained stronger (refer chart 4) than PSBs despite the higher growth in their advances. Despite their weak internal capital generation, the capitalisation of PSBs has been supported by capital infusion by the GoI. However, while the capital levels of PSBs increased during the last three years (FY2014-2017), their regulatory Tier –I requirement has also increased from 4.5% under Basel II regulations to 8.25[4]% with transition to Basel III capital regulations.

[4] Including capital conservation buffer of 1.25%

With an 80% share in incremental bank credit; PVBs can hold ~38-40% of advances market share by FY2020

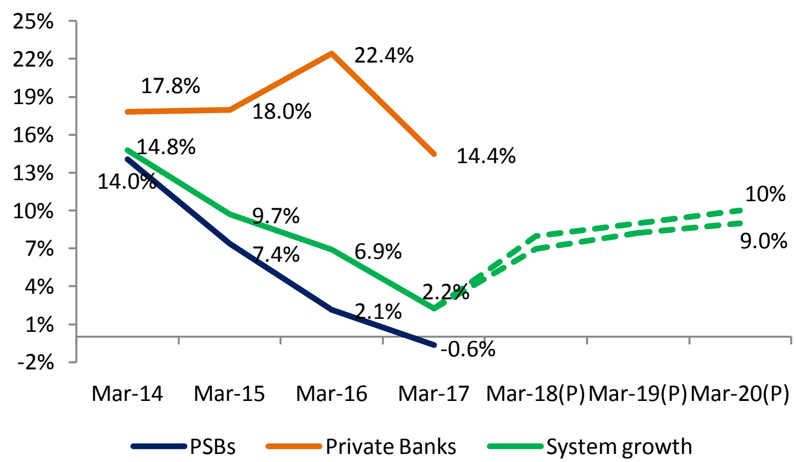
The banking industry reported a marginal growth of 2.2% in FY2017 as compared with 6.9% in FY2016. The growth in advances was mainly led by the growth of 14.4% in the advances of PVBs, which was partially offset by the 0.6% degrowth in the advances of PSBs in FY2017.

The weak credit growth of PSBs was driven mainly by the degrowth in the corporate loan book where credit demand was muted on account of weak investment activity and the large and better rated corporates increasingly resorting to the debt capital markets (commercial papers (CPs) and corporate bonds) for their funding requirements. However, PVBs reported a healthy growth backed by their focus on the retail loan segment. Retail loans accounted for over 40% of total loans for PVBs as compared with around 20% for PSBs.

PSBs have been plagued with asset quality concerns and capital constraints which resulted in a de-growth in their advances and consequently a decline in market share. PSBs' market share in advances declined from a high of 75.7% as on March 31, 2014 to 68.8% as on March 31, 2017. The space ceded by the PSBs was seized by PVBs who were better placed to grow their advances, in terms of capital adequacy and asset quality. The 3-year CAGR [5] in credit growth stood at 17.8% for PVBs as against 2.5% for PSBs. With higher credit growth, PVBs' market share in advances increased to 28.6% as on June 30, 2017 (27.5% as on March 31, 2017) from 19.9% as on March 31, 2014.

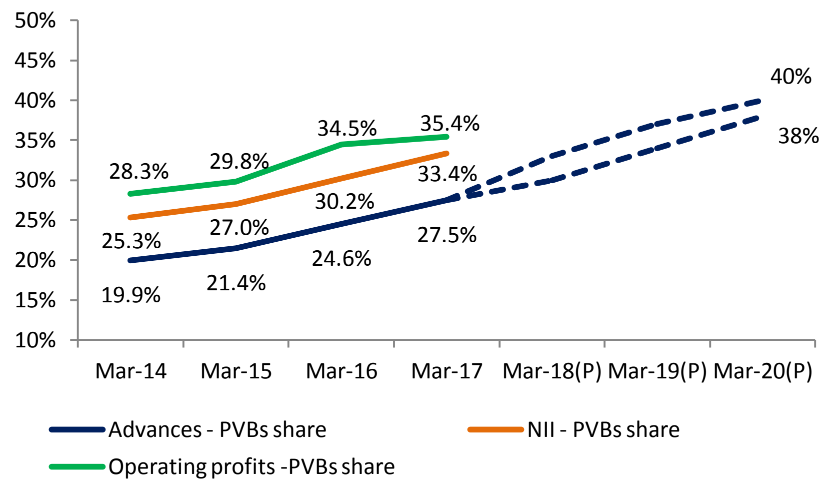
The incremental market share of PVBs during the trailing twelve months (TTM) ending June 30, 2017 stood at ~100% given the limited growth in PSB advances in this period. Assuming an incremental market share of 80% for PVBs and a credit growth of 7-9% for the banking sector during FY2018-FY2020, the market share of PVBs in banking sector advances is expected to increase to ~38-40% by FY2020.

Chart 5: Credit growth for PVBs has been consistently higher than system



Source: Banks, ICRA Research

Chart 6: PVBs market share can reach 38-40% by 2020



[5] June 2014 to June 2017

Ability to grow the deposit base critical for the growth of PVBs, leveraging technology can improve deposit mobilisation

PVBs are well capitalised to grow their loan books and capture the opportunities ceded by PSBs. However, their ability to expand their deposit base while maintaining higher CASA ratios will be critical to maintain a competitive cost of funds and granularity of deposits.

Despite a higher growth in deposits than banking sector averages, PVBs have maintained high CASA ratios and good granularity in their depositor base. The 3 year CAGR for the period (June 2014-June 2017) in deposit base for PVBs stands at 16.8% vs 6.9% for PSBs. Accordingly, the market share of PVBs in deposits increased to 23.5% as on June 30, 2017 from 19% as on June 30, 2014. PVB's CASA ratios have also consistently been higher than those of PSBs (see chart 7). As on March 31, 2017, top 20 depositors accounted for 9.2% of the total deposits of PVBs as compared to 8.7% for PSBs reflecting the former's relatively good granularity of deposits. While some PVBs offer higher interest rates on saving deposits, the average cost of deposits for PVBs at 5.51% was only marginally higher than the 5.46% for PSBs in FY2017.

On TTM basis for the period ending Q1FY2018, while the incremental share in advances stood at ~100% for PVBs, the incremental share of PVBs in the deposits stood lower at 37%. Assuming a banking sector deposit growth of 7-10% and an incremental PVB market share of 40% in deposits, the CD ratio of PVBs is expected to be higher at 94-102%[6] during FY2018-2020 which may be unsustainable given their statutory liquidity ratio (SLR) and cash reserve ratio (CRR) requirements of 20% and 4% respectively. Such a high CD ratio means that the PVBs will need to either have an market share of 60-70% in incremental deposits to maintain a CD ratio of 87% or rely on high cost market borrowings. Hence, PVBs will need to either aggressively mobilise deposits or rely on relatively high cost market borrowings for meeting their funding requirements. In case the PVBs are unable to mobilise the requisite quantum of deposits, the ability of PVBs to grow advances may be constrained and their market share of advances will be lower than our estimate of 38-40% by FY2020, this apart it may also impact the overall credit growth of the banking system. In such a situation, ICRA expects technology, better services and the higher interest rates on saving accounts to act as catalysts for deposit growth for PVBs. With almost 90% of banking transactions being through digital channels and ATMs, and with electronic verification (e-KYC) of customers for new account opening, ICRA expects PVBs to further accelerate the pace of retail customer addition, which can enable them to accelerate deposit growth and maintain a higher share of CASA in their overall deposits.

Chart 7: PVBs have been improving CASA share in total deposits

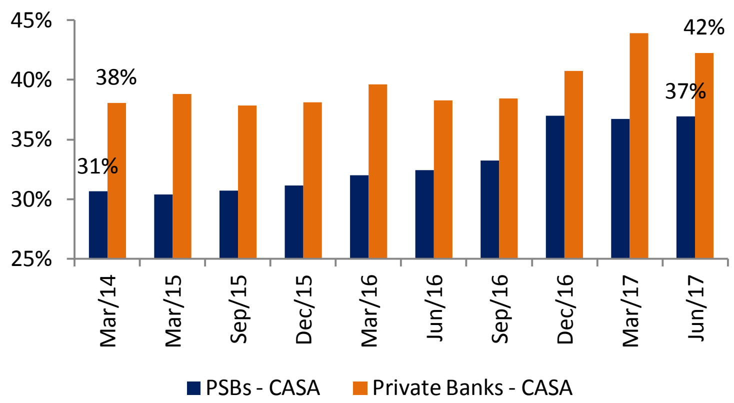
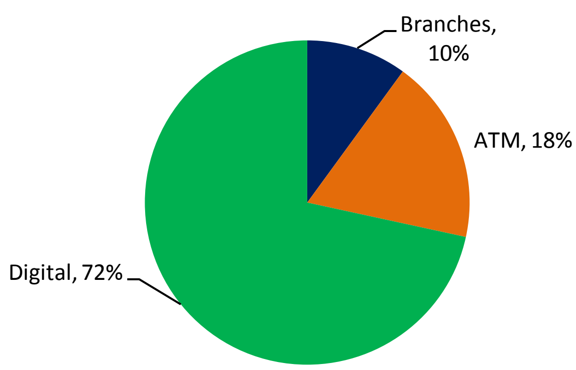


Chart 8: PVBs transaction mix in FY2017^



Source: Banks, ICRA Research
^ Top three private banks

[6] As against average of 86.9% (76% adjusted for net worth) during FY2014-17

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: naznin.prodhani@icraindia.com
Tel: +91 124 4545 860

Ms. Malika Munjal
E-mail: malika.munjal@icraindia.com
Tel: +91 124 4545 840

Branches

Registered Office:

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi - 110 001
Tel: + 91 11 2335 7940-45

Corporate Office:

Building No.8, 2nd Floor,
Tower A, DLF Cyber City Phase II,
Gurgaon- 122 002
Tel: +91 124 4545300

Ahmedabad

907 & 908, Sakar – II,
Ellisbridge, Opp. Town Hall,
Ahmedabad - 380 006
Tel: +91 79 4027 1500/01

Bengaluru 1

'The Millenia', Tower- B,
Unit No. 1004, 10th Floor,1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber,
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre,
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',
Above SBI-HPS Branch,
Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Hyderabad 2

4A, 4th Floor, SHOBHAN,
6-3-927, A&B Somajiguda,
Raj Bhavan Road,
Hyderabad – 500082
Tel: +91 40 40676500

Kolkata

A-10 & 11, 3rd Floor, FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 0202
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg, Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road, Shivajinagar,
Pune - 411 020
Tel: +91 20 2556 1194

Email: info@icraindia.com
Helpdesk: 124 3341580
Website: www.icra.in/ www.icraresearch.in