Banking: Is Profitability at the Peak?

April 02, 2024 l Ratings

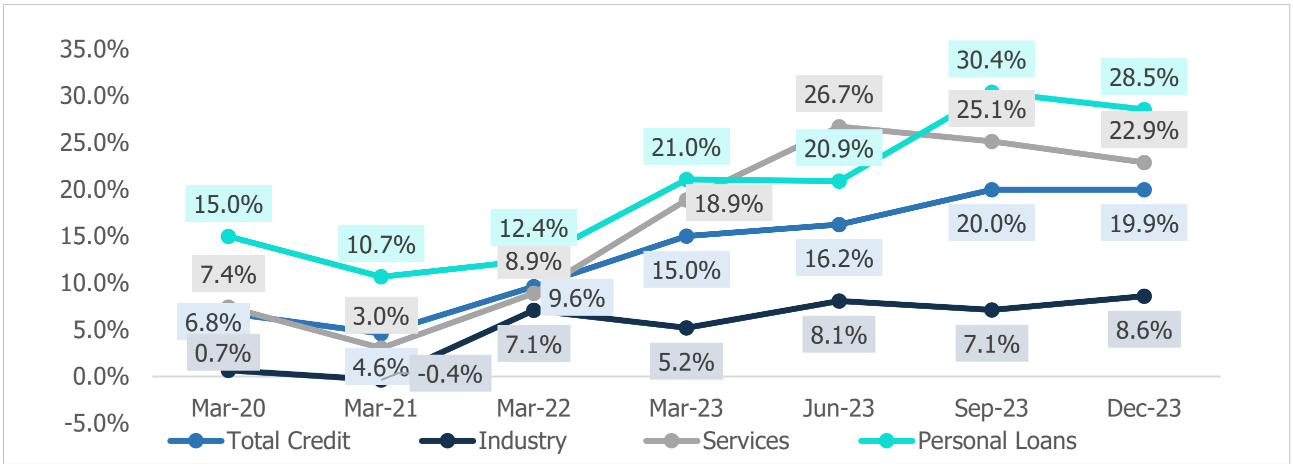
Synopsis

- Over the last two years, there has been a pick-up in economic growth and banks have witnessed credit growth at a Compound Annual Growth Rate (CAGR) of 18.2% from March 2022 to December 2023.
- Banks had surplus liquidity generated through deposits at a relatively lower cost during the Covid period. Which were utilised to fund the credit growth thus enabling banks to improve net interest margin (NIM). This, along with low credit costs, helped banks to report strong profitability during FY23.
- RBI had increased interest rates from May 2022 to till date by 250 bps which to a certain extent were passed on to the customers.
- With the central bank removing the accommodative stance, there is a tightening of the money supply in the economy. The tightening of liquidity along with a lag in the deposit growth vis-à-vis credit growth is increasing the cost of funding of banks thereby impacting the NIMs during Q3FY24 and is likely to keep the margin under pressure over the next two to three quarters.
- Additionally, banks have spent heavily on technology and branch expansion and have seen an increase in employee expenses, especially public sector banks due to the wage revision and pension liability which has led to an increase in the cost-to-income ratio of the overall private and public sector banks from 48.4% in FY20 to 50.6% in Q3FY24.
- Thus, with the increasing cost of funds, elevated cost-to-income ratio and continued lag of deposit growth vis-a-vis the pace of credit expansion, CareEdge Ratings expects the ROTA to decline slightly during FY25.

Credit growth remains strong, with Personal loans outpacing other sectors

The advances grew by 15.0% in FY23 and continued to grow at 19.9% (y-o-y) during 9MFY24. The growth was largely driven by personal loans followed by the services sector. Personal loans grew at the highest CAGR of 27.7% from March 2022 to December 2023 while the services sector has grown at a CAGR of 23.7% for the same period with NBFC and trade being the major contributors. Following the RBI guidelines requiring higher risk weights on unsecured personal loans and higher-rated NBFCs, the growth rate in personal loans declined in Q3FY24 after growing sequentially by 13.3% in Q2FY24 to 7.2% in Q3FY24; however, it continues to grow at a decent pace.

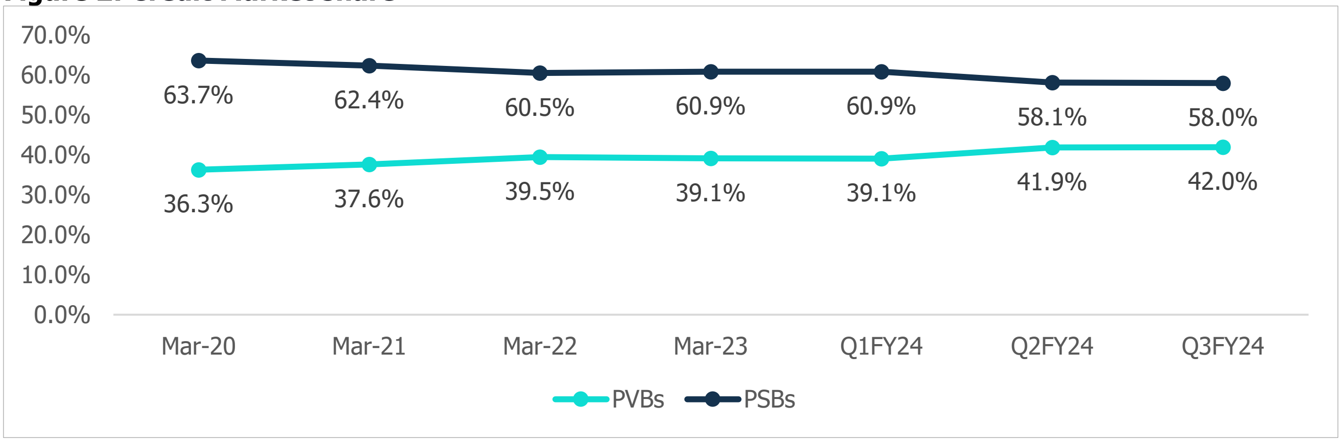
Figure 1: Credit offtake (Growth)



Source: RBI monthly data releases

Private sector banks (PVB) continued to outpace public sector banks (PSBs) in overall acceleration in credit growth. PVBs share in total credit has increased to 42.0% in Q3FY24 from 36.3% in March 2020 including the HDFC merger. Without the merger, the share of PVBs would be 37.5% as of December 2023. Additionally, the credit-deposit ratio is high for PVBs i.e. in the range of 88% to 97% (including the HDFC merger) as compared to 76% to 81% for PSBs.

Figure 2: Credit Market share

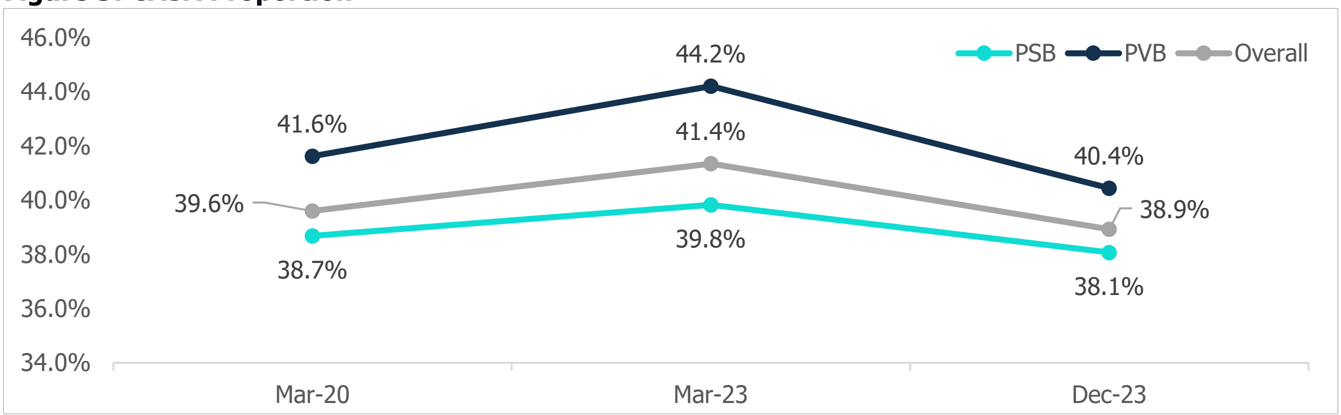


Source: Ace Equity, CareEdge Calculations; Note: Includes HDFC Ltd. Merger with HDFC Bank for Q2FY24 and Q3FY24; Market share is based on total share of PVBs and PSB; Includes 12 PSBs and 18 PVBs.

Challenges in the mobilization of low-cost CASA deposits; Credit growth outpacing deposit growth

An increasing interest rate scenario resulting in deposits moving from Current Account and Savings Accounts (CASA) to term deposits for better yield and shift towards other investment avenues like mutual funds, equities, etc., along with a reduction in market liquidity has posed the challenge of mobilization of deposits especially low-cost CASA for banks. This has led to the Banks building their deposit base by providing higher interest rates. Consequently, a higher growth in term deposits can be observed as compared to CASA. Further, the CASA ratio of banks has reduced from 41.4% as of March 31, 2023, to 38.9% as of December 31, 2023. In comparison to PSBs, a sharper contraction in the PVBs CASA ratio can be observed.

Figure 3: CASA Proportion

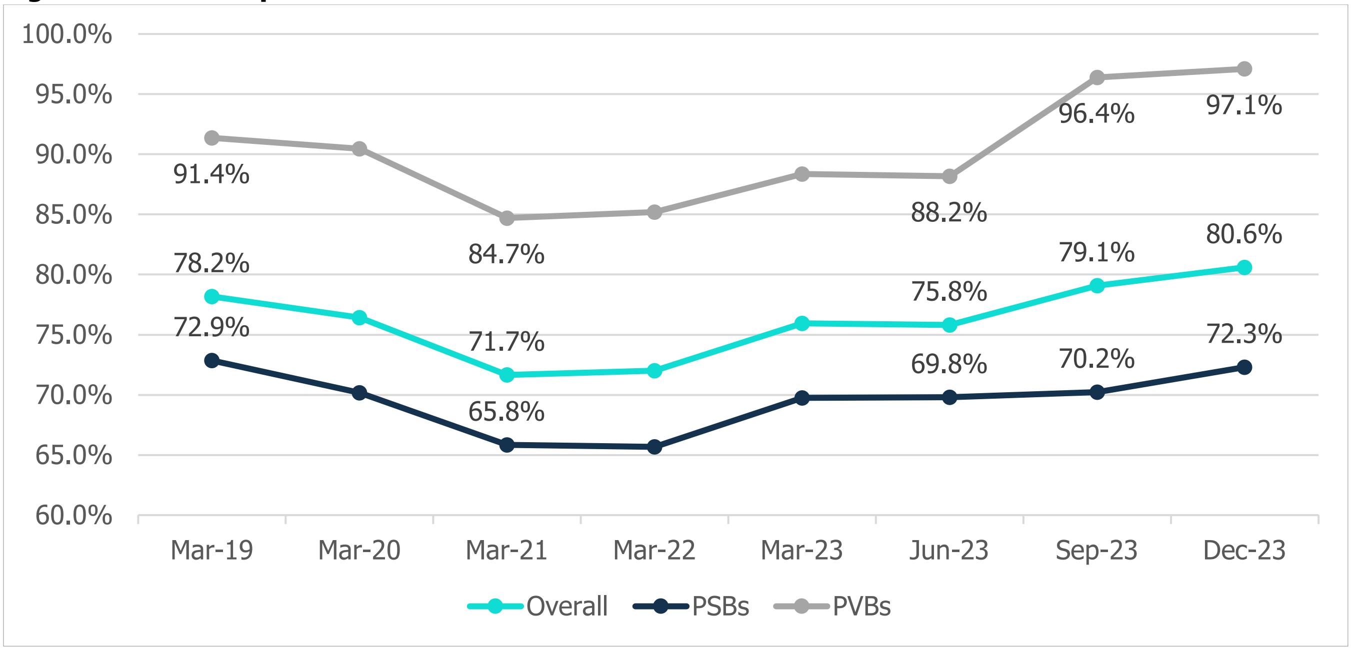


Source: Ace Equity, CareEdge Calculations; Note: Includes 12 PSBs and 18 PVBs

Deposits have grown at a CAGR of 11.0% from March 2022 to December 2023 as compared to advances which have grown at a CAGR of 19.5% during the same period. As a result, the Credit to Deposit (C/D) ratio has increased for banks at around 81% with a higher C/D ratio for private banks at around 94% and for public banks at around

74%. The spike in the C/D ratio for private sector banks from September 2023 is due to the HDFC merger. Adjusted for the merger, it stood at 87.4% as of December 2023.

Figure 4: Credit-Deposit ratio trend

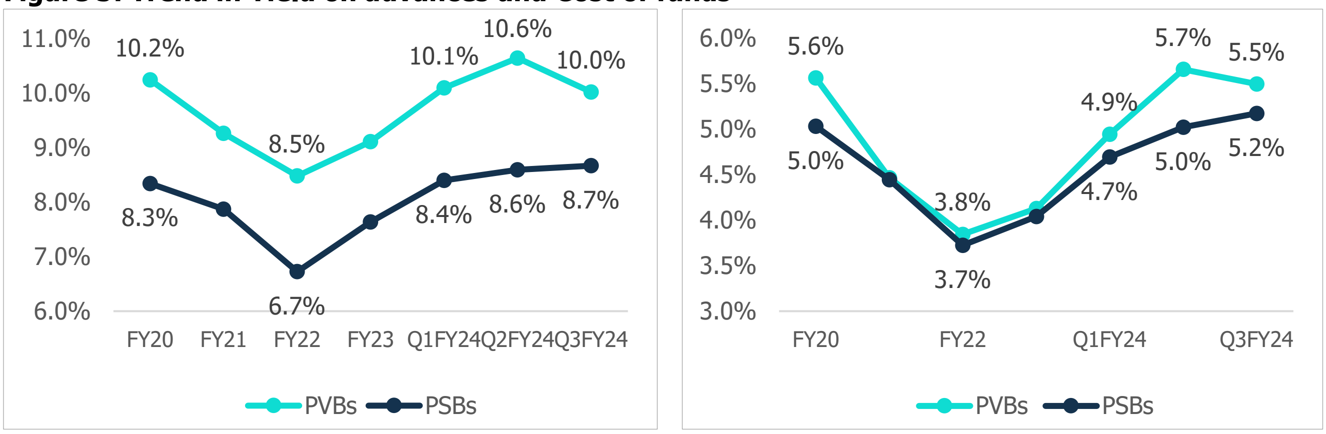


Source: RBI Quarterly Data releases

Margins hit with sharp upswing in cost of funds

The RBI has increased the repo rate by 250 bps from April 2022 to till date and a significant portfolio of banks being linked to external benchmark-based lending rates (EBLRs), has passed on the increase in rates, resulting in increase in yield on advances. As per RBI, the 1-year median Marginal Cost of Funds-based Lending Rate (MCLR) has increased by 155 bps from May 2022 to January 2024. However, since there was a gradual increase in the cost of funds for the banks from FY23 onwards due to the re-pricing of deposits and a shift of depositors from CASA to term deposits, the cost of funds of the banks increased in 9MFY24, which impacted the net interest margins of the banks in 9MFY24. Furthermore, the tight liquidity condition existing in the market is further pressuring the deposit rates and consequently NIMs.

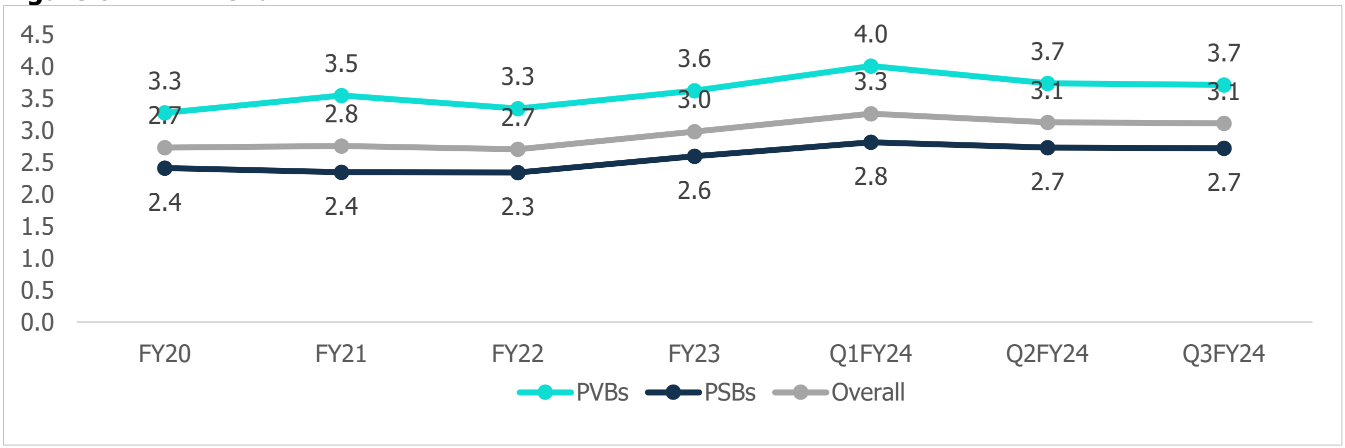
Figure 5: Trend in Yield on advances and Cost of funds



Source: Ace Equity, CareEdge Calculations (based on yearend figures); Note: Includes 12 PSBs and 18 PVBs

In the last three quarters, NIM has seen a downward trend. From a peak of 3.3% during Q1FY24 it has reduced to 3.1% during Q3FY24. With stable interest rates and a liquidity deficit situation in the market, CareEdge Ratings expects the cost of deposits to remain higher, which would further exert pressure on the margins.

Figure 6: NIM Trend

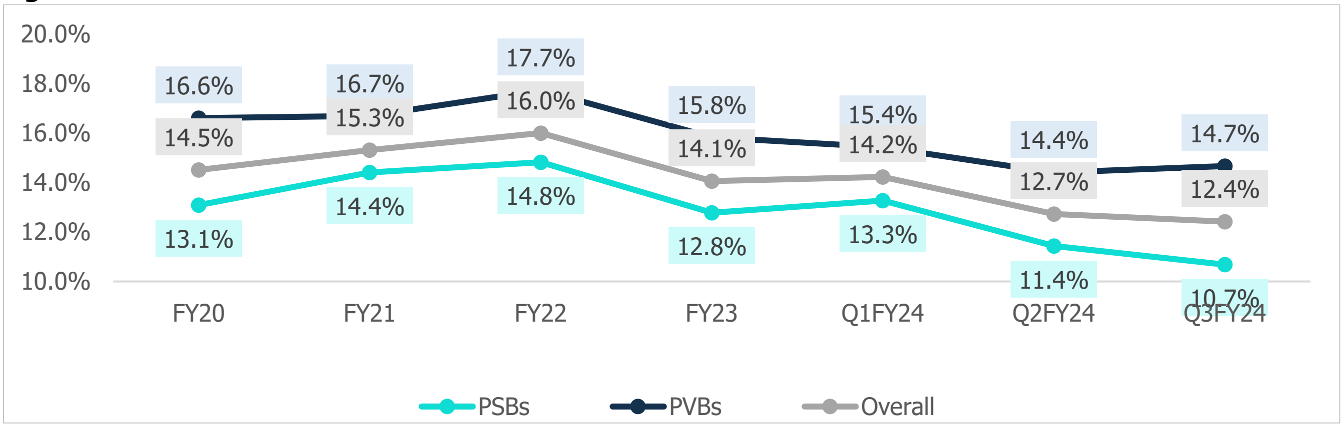


Source: Ace Equity, CareEdge Calculations (based on yearend figures); Note: Includes 12 PSBs and 18 PVBs

Share of non-interest income declines with the fall in treasury income

Non-interest income, although is growing in absolute terms, its proportion of overall income has reduced from 16.0% of total income during FY22 to 12.4% of total income in Q3FY24.

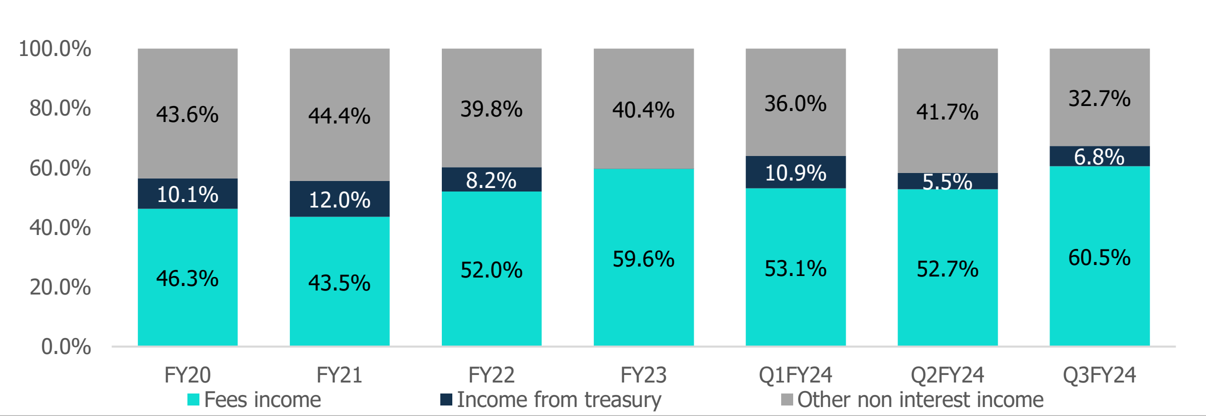
Figure 7: Non-interest income share in total income



Source: Ace Equity, CareEdge Calculations; Note: Includes 12 PSBs and 18 PVBs

The reduction is mainly because of a decline in treasury income due to an increase in interest rates resulting in banks reporting mark-to-market (MTM) losses during FY23. A major component of the non-interest income is the fee-based income which has grown at a CAGR of ~15.7% from FY20 to FY23 resulting in the increased proportion of fee-based income from around 46.3% of total non-interest income in FY20 to around 59.6% in FY23 and 57.7% in 9MFY24 (April 01, 2023, to December 31, 2023).

Figure 8: Composition of non-interest income

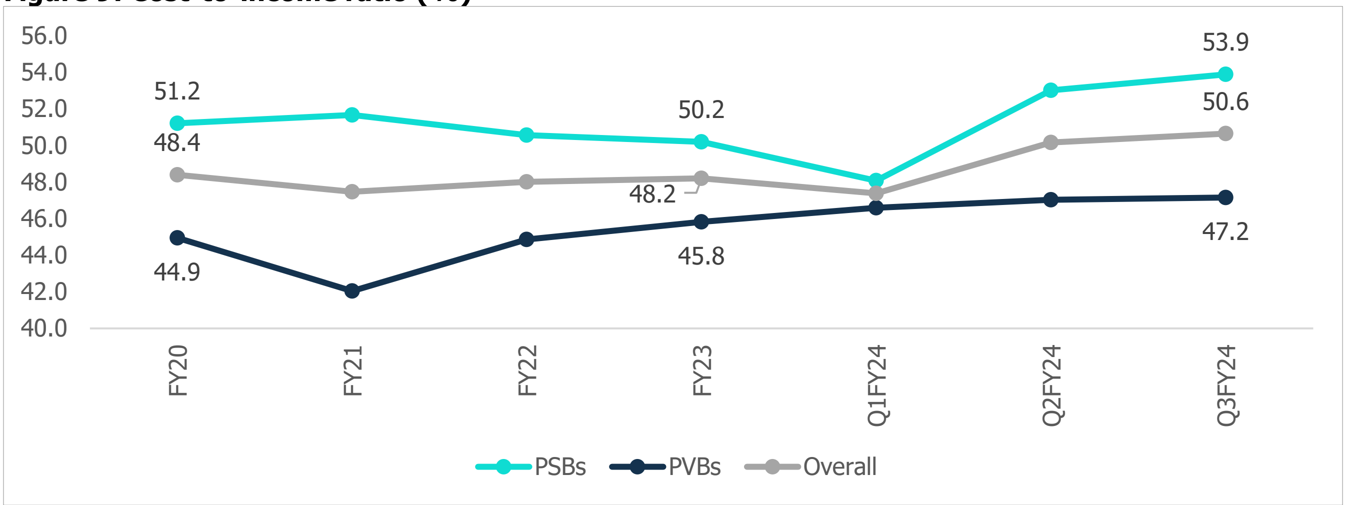


Source: Ace Equity, CareEdge Calculations; Note: Includes 12 PSBs and 18 PVBs

Branch expansion along with an increase in technology and employee expenses led to an increase in cost-to-income ratio

Both PVBs and PSBs have reported an increased cost-to-income ratio. The PVB Cost to income ratio has increased from 44.9% during FY20 to 47.2% during Q3FY24, while PSBs have increased from 51.2% to 53.9%. The increase in the technology expense, number of branches from ~34k to ~41k (as per RBI) and increase in employee cost due to branch expansion and salary costs, have been the primary drivers of cost to income in the case of PVBs while for PSBs, the 17% hike in the annual wages of the employees and technology expense has been a key driver.

Figure 9: Cost-to-income ratio (%)

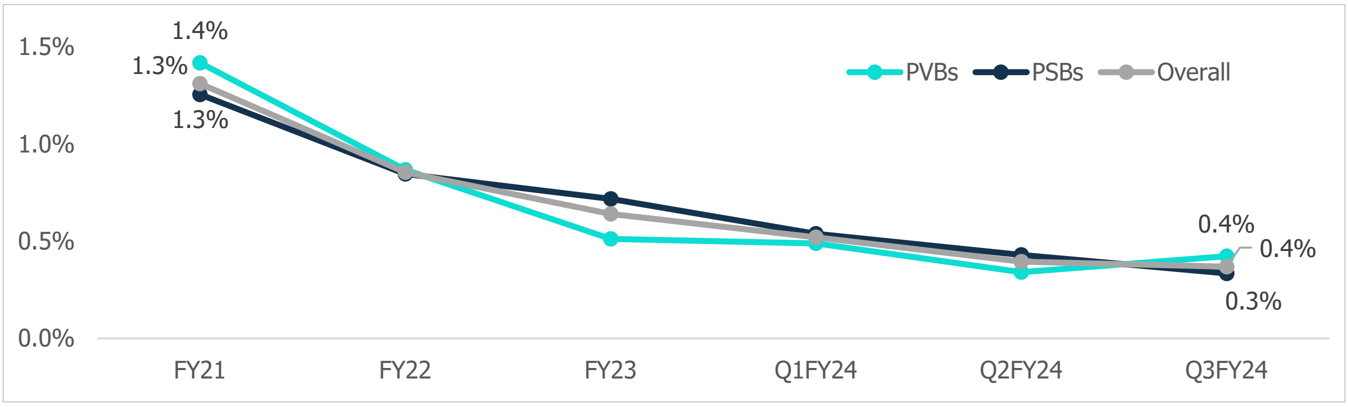


Source: Ace Equity, CareEdge Calculations; Note: Includes 12 PSBs and 18 PVBs

Improvement in asset quality and decline in credit cost resulting in improved profitability

Banks have seen a declining trend in credit costs, which is a major factor in the improvement of the overall profitability of the banks (refer figure 12). The credit cost declined from 1.3% in FY21 to 0.4% in Q3FY24 for banks.

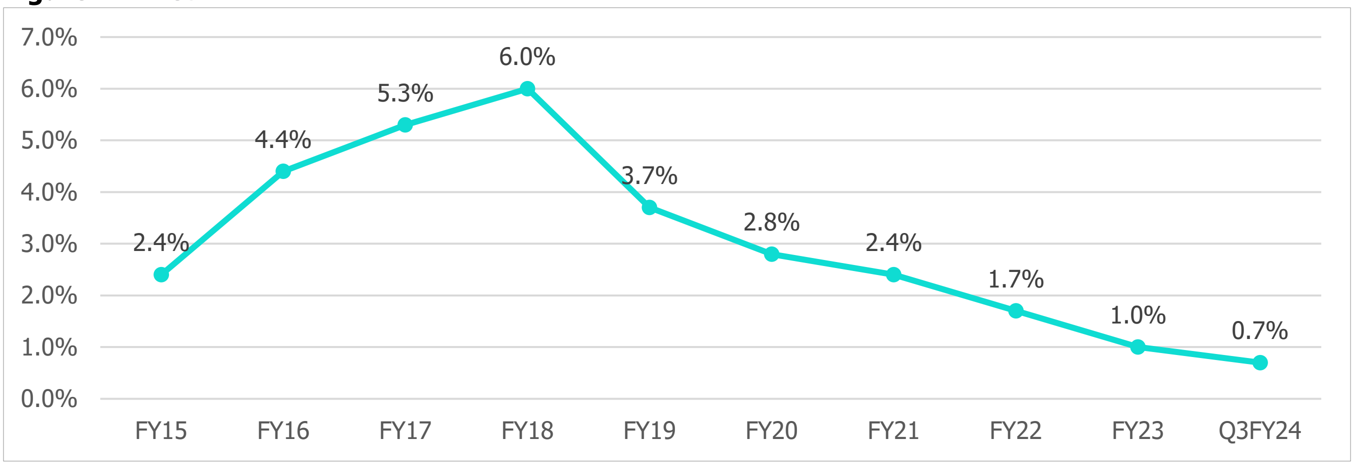
Figure 10: Credit cost



Source: Ace Equity, CareEdge Calculations; Note: Includes 12 PSBs and 18 PVBs

Public Sector Banks (PSBs) have been holding substantial buffers for provisions over the last 6-8 quarters, in addition, the continuous improvement in the asset quality required a lower level of incremental provisioning, resulting in lower credit costs. The banks, largely public sector banks have a high provision coverage ratio in the range of 80% to 90% indicating low incremental provisioning requirement and a potential upside in case of recoveries of NPAs while private sector banks have relatively lower NPAs and the PCR for private sector banks stood at around 75%.

Figure 11: Net NPA

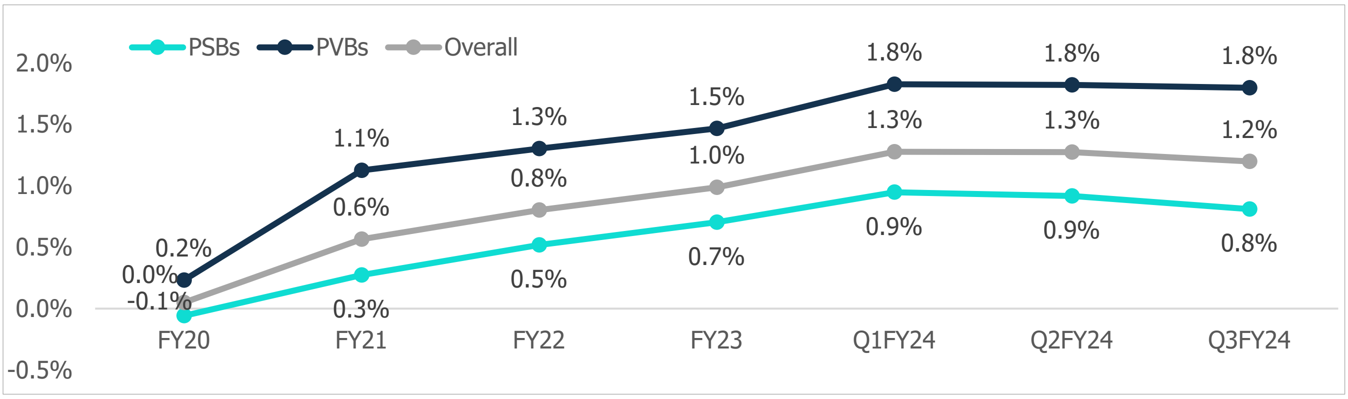


Source: RBI data releases, CareEdge Calculations; Note: Q3FY24 includes 12 PSBs and 18 PVBs

ROTA likely to normalize

Banks have witnessed an increasing trend in return on total assets (ROTA) due to the increasing lending rates along with a reduction in credit costs facilitated by ongoing improvements in the asset quality parameters. However, going forward, the falling NIMs along with the ability to meaningfully grow non-interest income and the increased cost-to-income ratio are anticipated to affect ROTA.

Figure 12: Trend in ROTA



Source: Ace Equity, CareEdge calculations; Note: Includes 12 PSBs and 18 PVBs

CareEdge Ratings View

The credit-deposit ratios of the banks are likely to remain elevated due to a persistent shortfall in deposit growth compared to the pace of credit expansion, aligned with the overall positive growth outlook for the economy. The deposit lag, coupled with the repricing of deposits and a liquidity deficit in the market, is likely to elevate the cost of funds in the near term. This may exert pressure on banks' net interest margins, potentially leading to a moderation in overall profitability. While the asset quality of banks is anticipated to remain largely stable, with no significant signs of stress evident, the asset quality within the newly originated retail portfolio warrants close monitoring.

Contact

Sanjay Agarwal	Senior Director	sanjay.agarwal@careedge.in	+91 - 22 - 6754 3582
Sudhakar Prakasam	Director	p.sudhakar@caredge.in	+91 – 44 - 2850 1003
Aditya R Acharekar	Associate Director	aditya.acharekar@careedge.in	+91 - 22 - 6754 3528
Soniya Mehta	Lead Analyst	soniya.mehta@careedge.in	+91 - 22 – 6754 1480
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

Connect:

Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | Noida | Pune

About Us:

CareEdge is a knowledge-based analytical group offering services in Credit Ratings, Analytics, Consulting and Sustainability. Established in 1993, the parent company CARE Ratings Ltd (CareEdge Ratings) is India's second-largest rating agency, with a credible track record of rating companies across diverse sectors and holding leadership positions in high-growth sectors such as BFSI and Infra. The wholly-owned subsidiaries of CareEdge Ratings are (I) CARE Analytics & Advisory Private Ltd previously known as CARE Risk Solutions Pvt Ltd, and (II) CARE ESG Ratings Ltd, previously known as CARE Advisory Research and Training Ltd. CareEdge Ratings' other international subsidiary entities include CARE Ratings Africa (Private) Limited in Mauritius, CARE Ratings South Africa (Pvt) Ltd, and CARE Ratings Nepal Limited.