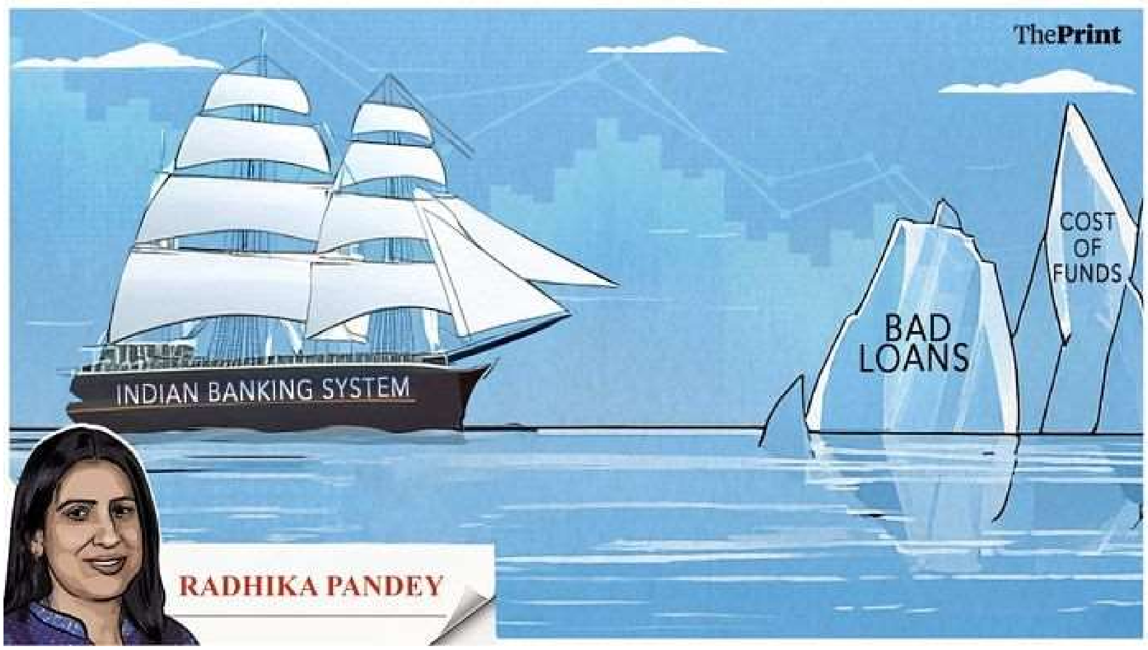
Indian banks have solid asset quality & profitability for now, but risks are emerging on both counts

Narrowing of the wedge between credit and deposit growth, and the possible easing of the monetary policy, could weigh on the net interest margin of banks in 2025.

Radhika Pandey and Madhur Mehta /03 January, 2025 07:30 am IST



The latest Financial Stability Report released by the Reserve Bank of India presents an overview of the state of India's financial sector and highlights areas of incipient stress. The report notes a sustained improvement in banks' asset quality, alongside a robust capital position.

However, the report projects a rise in the share of bad loans and an erosion in the capital position of banks in adverse stress scenarios. It red-flags worsening asset quality of unsecured retail loans and raises concerns on the retail lending portfolio of small finance banks.

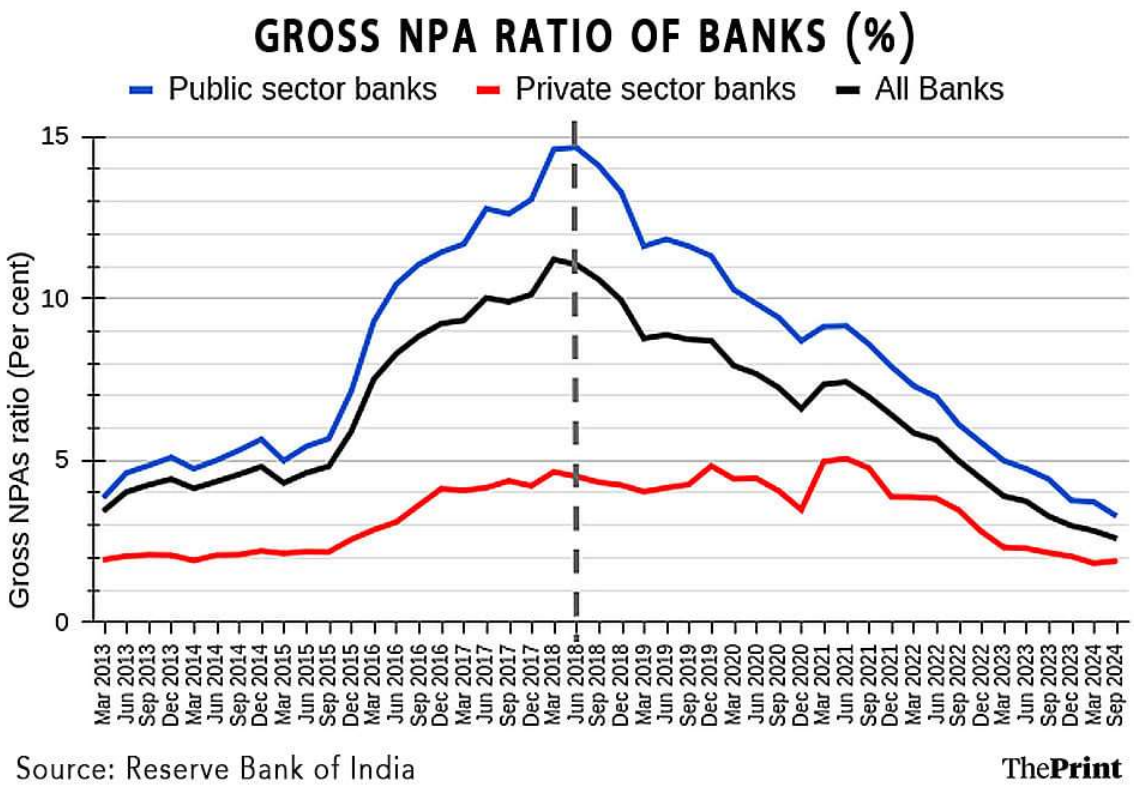
While banks' profitability is seen to be strong, the rise in the share of term deposits and reliance on certificates of deposit resulted in increase in cost of funds and moderation in the net interest margin in the first half of the current financial year.

Going forward, narrowing of the wedge between credit and deposit growth, and the possible easing of the monetary policy, could weigh on the net interest margin of banks in 2025.

Improvement in asset quality, but write-offs persist

Asset quality expressed as gross non-performing assets ratio (NPA) moderated to a 12-year-low of 2.6 percent in September 2024. The net non-performing ratio was at 0.6 percent.

The NPA ratio has seen a consistent decline after peaking in June 2018. What has led to the reduction in the NPAs? In addition to loan recoveries and upgradation of loan accounts, the report shows that write-offs were a significant contributor to NPA reduction in the first half of the current financial year.



In particular, the report notes a sharp rise in write-offs among private sector banks' retail loan portfolio. This might be masking the asset quality of the retail loan segment. Overall, the rise in write-offs is particularly prominent among unsecured retail loans.

While the share of large borrowers in NPAs has seen a steady decline, there are some leading indications of build-up of stress in large borrower accounts, particularly for private sector banks. This is visible in the form of a sequential increase in the Special Mention Accounts (where principal or interest payment remains partly or wholly overdue from 31 to up to 90 days).

Sector-wise, there is a broad-based improvement in the asset quality. However, within the personal loans segment, the credit card receivables segment witnessed an uptick in the NPA ratio.

Going forward, this segment of personal loans would warrant careful monitoring. Further, the report notes an increase in slippages in the unsecured loan segment.

Improved profitability, but higher cost of funds

Banks' profitability improved during the first half of the current year, with profit after tax growing by 22 percent. Notably, there is a shift in the drivers of profitability.

In contrast to net interest income that drove profitability in the last two years (due to high credit growth and tight monetary policy), other operating income contributed significantly to banks' profitability this fiscal.

In recent months, banks' cost of funds increased due to an increase in the share of high cost term deposits. The yield on assets, however, remained stable. As an outcome, net interest margin contracted across all banks.

Going forward, the pressure on net interest margin could weigh on the profitability of banks. Slowing credit growth, narrowing gap between lending and deposit rate, and the possible rate cuts in 2025, could put pressure on the margins of banks.

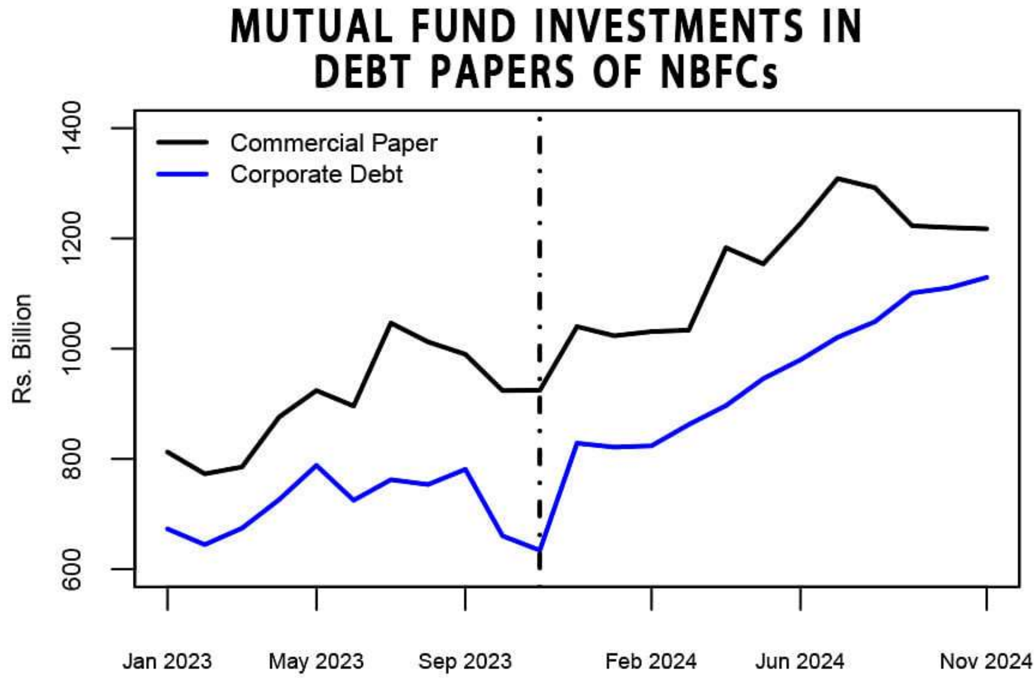
Reduced reliance of NBFCs on banks

The headline numbers point to the sound health of the NBFC segment. Their GNPA ratio is at 3.4 percent with sizable capital buffers and robust interest margins. However, there are areas of concern. Similar to banks, write-offs have increased as a share of NPAs for NBFCs.

The imposition of restrictions to contain bank lending to NBFCs has slowed its growth. Bank lending to NBFCs, which was growing at almost 30 percent in March 2023, slowed down to just 7.7 percent by November 2024.

Overall, banks' exposure to NBFCs moderated from 43.1 percent at March-end in 2023 to 42.7 percent at March-end in 2024. The reduced reliance of NBFCs on banks bodes well for systemic stability.

Parallelly, there is an increase in raising of funds through the issuance of non-convertible debentures and commercial papers. In particular, in the last few months, there has been a significant rise in mutual funds' subscription of NBFC papers that had slumped post the IL&FS crisis.

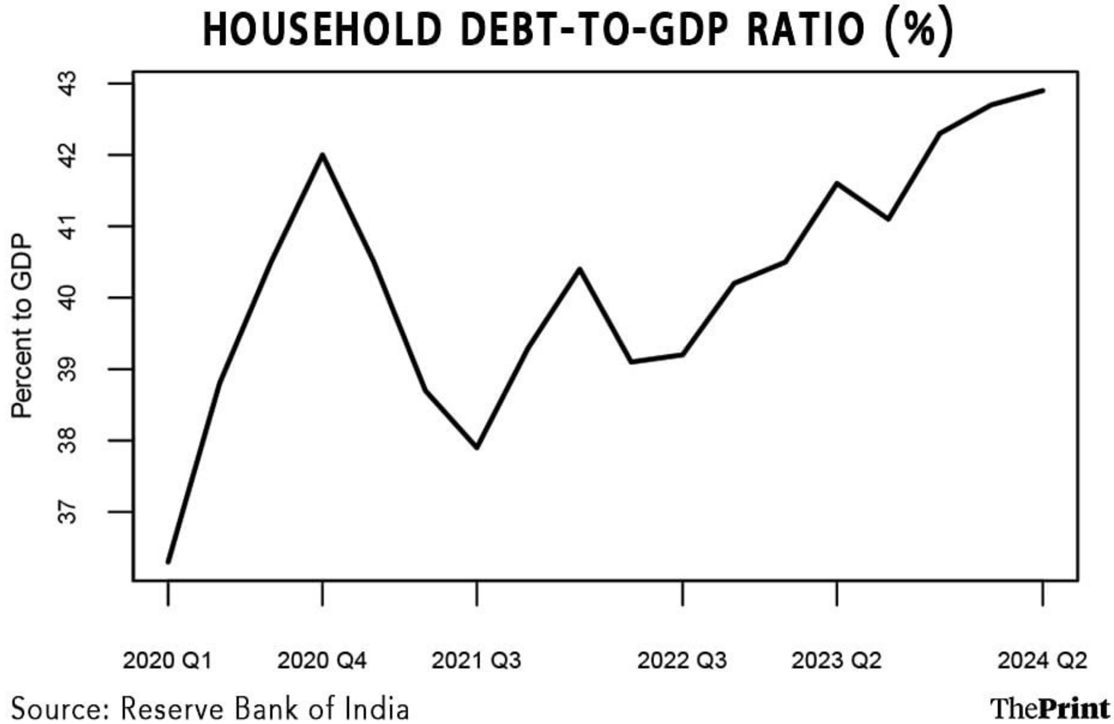


Source: CMIE Economic Outlook ThePrint

NBFCs have also increased their foreign currency borrowing to diversify their sources of funds. This could pose currency risks to those NBFCs that have exposure to unhedged currency borrowings.

Rise in household borrowings

Recent RBI data has shown an increase in household debt-to-GDP in recent years. The report provides additional details on the profile of household borrowers, which may be useful from a financial stability perspective. The increase in household indebtedness is primarily driven by a growing number of borrowers rather than an increase in average indebtedness.



Households are borrowing for three primary purposes: consumption (personal loans, credit cards, consumer durable loans), asset creation (vehicle loans, mortgage loans) and productive purposes (agriculture loans, business loans and education loans).

The high quality borrowers are seen to be borrowing for asset creation and the rise in per capita debt is seen for this category of borrowers. For the other categories (including subprime borrowers), the per capita debt is stable or may have risen at a gradual pace.

The assessment of the nature of borrowers and the purpose of borrowings holds significance in light of the sharp surge in retail borrowing till a few months back. The current assessment does not reveal worrying signs, but is something that needs continuous vigil.

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