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Indian banks are walking on thin ice as expectations of high NPAs dominate the market

by Raghav Mathur

- **The Forward PD demonstrates that Indian banks face potential credit deterioration as NPAs are expected to increase**
- **Public banks have higher credit risks than private banks as they hold a larger proportion of bad loans**

Similar to other banks around the world, India domiciled banks (Indian banks) have faced significant credit woes in 2020. Not only did the industry have to deal with the fallout of the global economic slowdown which severely affected their asset quality, but also it had to brace itself for the possibility of a large number of domestic corporate defaults in the near future due to a weak operating environment. Due to public sector banks having a higher exposure to loans from heavily affected SMEs, the impact is disproportionally felt by Indian public sector banks compared to private sector banks[1]. The NUS-CRI Aggregate (median) 1-year median Probability of Default (Agg PD) demonstrates this dispersion between the aggregate credit qualities of the public sector and private sector banks (Figure 1a). Given the worsening credit outlook of public banks and their importance in the domestic banking system as per NUS-CRI Systemically Important Banks (CriSIB[2]), the two aforementioned factors may signal signs of industry-wide systemic distress.

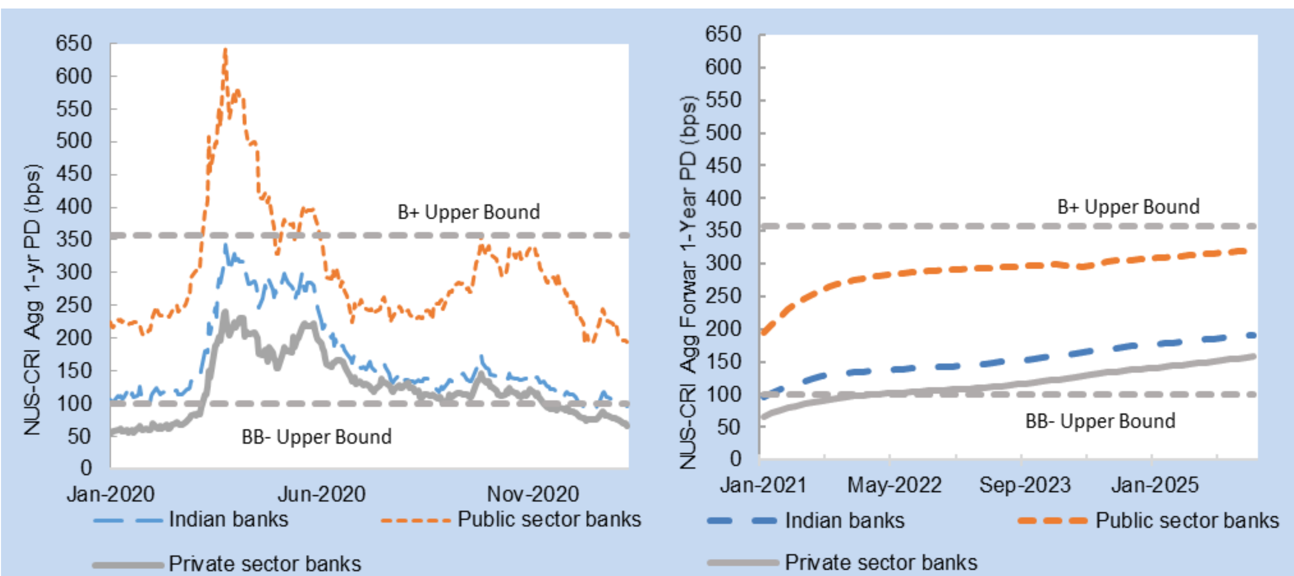

Figure 1a (LHS): NUS-CRI Agg 1-year PD of Indian Banks, broken down by public and private sector banks with reference to PDiR2.0[3].
Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD of Indian banks based on Jan 2021 data with reference to PDiR2.0. *Source: NUS-CRI*

[1] Public and private sector banks are classified under RBI's definition.
[2] CriSIB is the ranking of systemic importance for exchange-listed banks around the world. It is dynamic by nature, and it determines a firm's systemic risk by its size and interconnectedness with others. A higher ranking of a firm means it is likely to pose a larger threat to the global (group) financial system.
[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

Reserve Bank of India (RBI) passed relief policies that helped to mitigate the severe stress of Non-Performing Assets (NPAs) on Indian banks' credit quality. These policies include:

- **A Moratorium:** offering the option to corporate borrowers to halt payments of loan equated monthly instalments[4] (EMIs) for six months (Mar 2020- Aug 2020).
- **Allowing a one-off restructuring** of loans for banks without classifying them as non-performing assets to reduce stress on financial creditors (specifically banks).
- **Lowering** the benchmark repo rate to historic lows of 4.4%.

The first two policies above may be instrumental during sudden recessionary periods to temporarily avoid the burden of large NPAs and mitigate possible capital shortfalls. Meanwhile, a lower repo rate would decrease Indian banks' cost of borrowing.

Looking forward, Indian banks are possibly entering an increasingly challenging operating environment as expectations of monetary policy roll-backs and the repercussions of the delayed bad-debt recognition could increase their credit risk. From Figure 1b above, the NUS-CRI Agg Forward 1-year Probability of Default (Forward PD[5]) displays a worsening credit outlook for the whole industry. The Forward PD also shows that banks in the public sector will face a worse credit deterioration in the short run compared to their private counterparts. This could be partially attributed to a higher exposure to loans affected by the moratorium, as well as to SMEs that were highly impacted by the pandemic. Currently, 41% of public banks' loan portfolio is under the moratorium, compared to 34% for private banks. Furthermore, gross NPAs (GNPA) from SMEs make up a larger proportion of public banks' loan portfolio compared to that of private banks (14.10% and 8.76% respectively). This phenomenon is not surprising given that many private banks, such as HDFC Bank Ltd and ICICI Bank Ltd, have a stronger asset quality due to more robust underwriting capabilities when compared to their public counterparts. Furthermore, compared to five months ago, CriSIB indicates that public banks now constitute a majority of the top 10 most important domestic banks in India. With the above-mentioned possibility of credit quality deterioration in this sub-sector in the short run, more systemically important banks are getting riskier.

In addition, as of Mar-2020, the median Tier-I capital adequacy ratios for public and private sector banks were 9.46% and 14.20% respectively. Though both the public and private sector banks met the required capital ratios under Basel-III of 8%, public sector banks fell short of the additional 2.5% capital conservation buffer for high-stress situations. At the end of FY 2020, the ratio of GNPA[6]/Total Term loans for public sector banks was 11.3% compared to 4.2% for their private-sector counterparts, highlighting public banks' worse credit health going into the pandemic. Furthermore, under RBI's stress tests in Jan 2021 for the domestic banking sector, potential NPAs for the whole industry reached as high as 14.8%, compared to 7.6% in Sept 2020. As of Jan 15th, 2021, the NUS-CRI shows that there is almost a 90%, compared to 68% in June 2020, probability that 48-71 publicly-listed companies will default in India over the next year (see Figure 2a). Without any extension on the moratorium of bad-debt recognition or restructuring, these corporate defaults could lead to large NPAs in the upcoming year.

[4] EMIs are fixed payment amount made by a borrower to a lender at a specified date each calendar month. These can largely be thought of as interest payments.
[5] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.
[6] Gross Non-performing assets (NPAs) for banks are generally defined as loans/advances that are in default or close to being in default. These loans are normally classified as NPAs due to non-payment for 90 days.

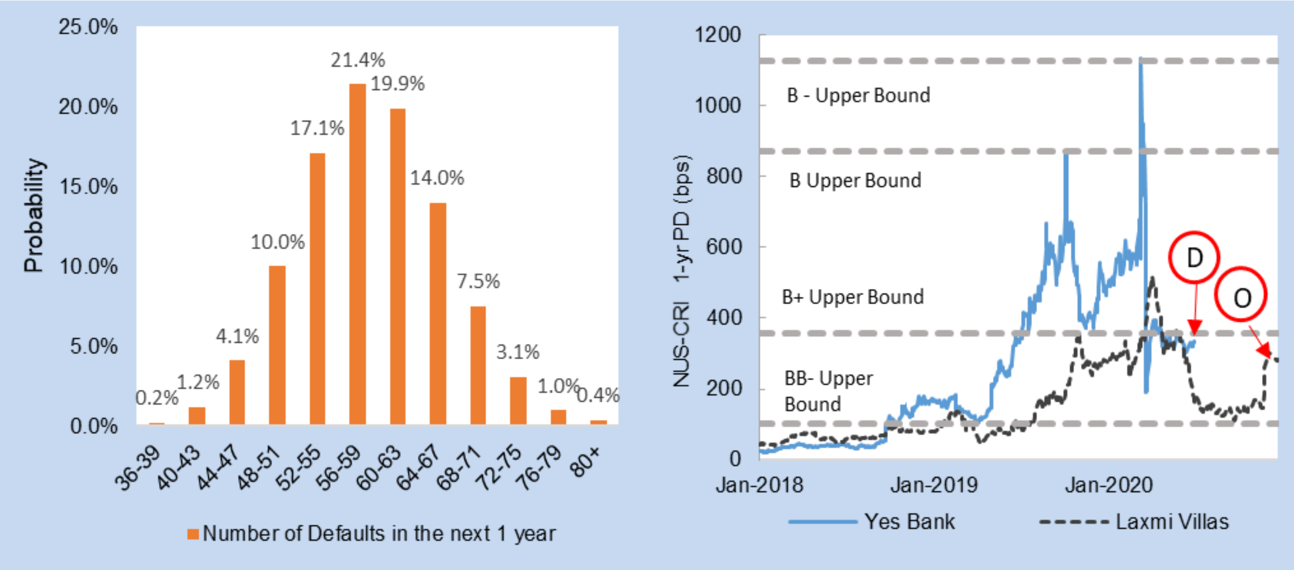

Figure 2a (LHS): A distribution of probabilities that exactly N publicly-listed companies (out of 3,242 companies) in India will default in one year as of Jan 15, 2021. Figure 2b (RHS): NUS-CRI 1-year PD for Yes Bank and Laxmi Vilas with reference to PDiR2.0 bounds; D = Default and O = other exits. *Source: NUS-CRI*

Though the Forward PD may suggest that public banks are more at risk, private banks are also not immune to challenges going forward. For example, as seen in Figure 2b above, Yes Bank Ltd.'s (India's fourth-largest private lender) 1-year probability of default has been significantly increasing since 2019 due to aggressive lending practices. The company defaulted[7] on Jun 29th, 2020 as it did not meet minimum capital requirements set by RBI and, hence, had to miss a coupon payment on its outstanding bond. More recently, another private bank in India faced financial difficulties. After facing years of bad loans (GNPA ratio of 25.4% in 2020) and financial distress, Laxmi Vilas was acquired by DBS bank India and exited the market on Dec 28th, 2020. These two cases demonstrate extreme examples of credit quality deterioration in private Indian banks. Resultantly, the Indian Supreme court will continue deliberating about the further extension of loan moratoriums and debt relief; which, should it succeed, may only add to the snowball effect of even higher potential NPAs in the future.

[7] This event is considered a default under NUS-CRI's definition due to an occurrence of a missed or delayed payment of interest and/or principal, excluding delayed payments made within a grace period.

Credit News

Chinese property developers have huge debts to refinance

Jan 16. The real estate industry is facing up to over USD 53.5bn of non-CNY denominated debt that needs to be repaid in 2021 – double of what the amount was in 2020. As fiscal and monetary support pull back, fulfillment and refinancing are more difficult amidst the tightening conditions. Moving forward, analysts expect to see greater credit differentiation amongst lenders. Today, over USD 34bn worth of USD denominated debt are yielding over 15%. To complicate things, the credit market in China has been increasingly subdued as a result of the ongoing defaults. (WSJ)

Investors race into munis as Biden announces stimulus plan to cash-strapped states

Jan 15. Municipal bonds have seen a surge in demand from investors, as a blue wave was confirmed last week. Junk-rated municipal bonds rose in price, as USD 2.5bn was injected into the municipal debt market. This was largely due to the announcements of further stimulus, as USD 350bn is expected to flow to state and local governments. Overall stimulus measures, such as increased payouts to individuals, are also expected to end up in state revenues. These measures have lowered the cost of funding for junk-rated municipalities, with a return of 0.94% in the first two weeks of the year. Similarly, state debt yield has also fallen, with Illinois-issued debt yielding at 4.2% from 5.9% in November last year. However, risks still remain, as the proposed fiscal policies are not set in stone as of yet. (FT)

Europcar debt investors left empty-handed after CDS 'squeeze'

Jan 15. Around USD 100mn of Credit Default Swaps (CDS) linked to the distressed rental car company Europcar have been wiped out, as the auction to determine payouts to CDS holders determined that they could not claim any outstanding debt. Previous holders to Europcar's outstanding bonds were withheld from trading these securities, keeping over EUR 1bn of bonds away from the hands of CDS holders. Those who insured themselves against these bonds had expected to receive 27 cents on the dollar but were left with nothing as a result. This was made worse as EUR 50 mn in loans lent to Europcar from Credit Suisse was bought over by hedge funds, locking it up from being auctioned off. (FT)

Red-hot markets allow PE groups to load up targets with extra debt

Jan 14. The low interest rate environment has jumpstarted the private equity (PE) sector. Today, these PE firms loaded their already-levered target companies with more debt. This has resulted in uncertainties about the companies' credit health. Women's Care Florida and Protective Industrial Products are some of these new targets, with debt levels shooting up relative to previous levels. PE firms are able to enjoy low funding costs - paying only 6% for their senior loans, which is a level that is drastically lower than the 13% rate in Mar 2020. Collateralized Loan Obligations have also seen new demand, as PE firms look to sell off their present liabilities to the markets. Overall, this is a key indicator that PE firms are planning to ramp up their activity moving forward. (FT)

Wizz Air's debut bond takes off in sign of hot debt markets

Jan 14. After the Covid-19 Pandemic, Wizz Air has been hovering dangerously close to the non-investment grade status. After receiving over EUR 2bn in orders, the budget airline will be able to finance its first-ever bond of EUR 500mn at 1.35%. This is a clear indicator that cash-rich investors are hoping to uncover yield as the virus and lockdowns persist. Even with these significant headwinds, investors remain positive that the central banks' monetary policies and a strong vaccine rollout will stabilize the markets going forward. This has caused yields to fall significantly to 0.38% from 2% at the height of the pandemic last March. (FT)

Bond turmoil on India's cash drain shows market fragility (Bloomberg)

Saudi Arabia's top bank follows UAE rivals to dollar bond market (Bloomberg)

Prophet Capital restructures CLO hedge fund amid market rebound (Reuters)

Regulatory Updates

ECB threatens banks with capital 'add-ons' over leveraged loan risks

Jan 18. As EU banks continually fail to heed the advice from the ECB, the central bank is looking to impose additional capital restrictions. The imperative behind the ECB's push for the banks to be more conservative in the booming leveraged loan market stems from precaution. It is a good industry practice to be enforced as and when interest rate rises, these institutional lenders will be well-guarded against repayment issues. To enforce this practice, ECB will be planning more visits and checks on the banks' risk management procedures. (FT)

Bank of England to flag potential risk of bond buying losses more clearly

Jan 14. After launching its USD 1.22tn bond purchase programme, the Bank of English is looking into carrying due diligence on its potential losses. Thus far, the government has profited over GBP 110bn from BoE's asset purchase initiative. However, the government is to repay the BoE should the Quantitative Easing programme result in significant losses. This scenario is very likely as debt will only be taken off the balance sheet after recovery – the return of higher rates. (Reuters)

PBOC rolls over CNY 500bn of medium-term loans, keeps rate unchanged (Reuters)

Romania unexpectedly cuts EU's highest rate to boost economy (Bloomberg)

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