THE SCANNER

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Time to **'bank'** on the **banking sector**

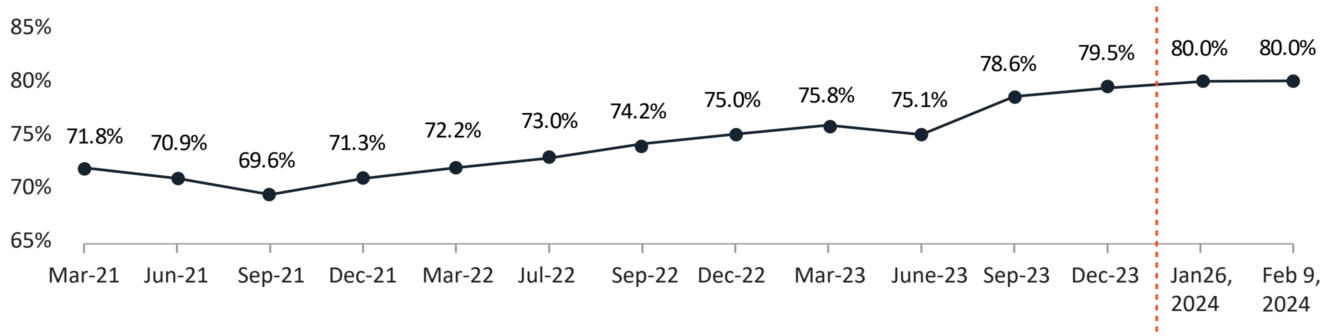
India's dominance on the global economic landscape is strengthening as the country gears up to pole vault its growth curve and become the 3rd largest economy in the world by 2030. Inevitably, the banking sector will play a critical role in not only the functioning but also the economic development of the country. It acts as a bridge between surplus and deficit economic agents, acting as both a custodian as well as a provider of funds. The Indian banking system consists of 12 Public Sector Banks (PSBs), 21 private sector banks, 45 foreign banks, 43 Regional Rural Banks (RRBs), 12 small finance banks, and numerous co-operative banks[1]. Today, banks have diversified their activities and forayed into new products and services that include opportunities in credit cards, consumer finance, wealth management, life and general insurance, investment banking, mutual funds, pension fund regulation, stock broking services, custodian services, etc. In the backdrop of this landscape, the Indian banking sector is undergoing an interesting transition and engendering both challenges as well as opportunities.

Prevailing trends

Elevated Credit-Deposit (CD) ratios

The CD ratio is a metric that gauges the proportion of a bank's lending in relation to the deposits it accumulates. The CD ratio has been generally hovering around 80% since September 2023. However, it is important to note that a higher CD ratio might force banks into margin pressure if they aggressively mobilise deposits or a slowdown in lending growth is observed, or a combination of both scenarios.

Exhibit 1: CD ratio trend



Source: RBI, CARE Ratings

1. Source: https://m.rbi.org.in/scripts/bs_viewcontent.aspx?Id=3657

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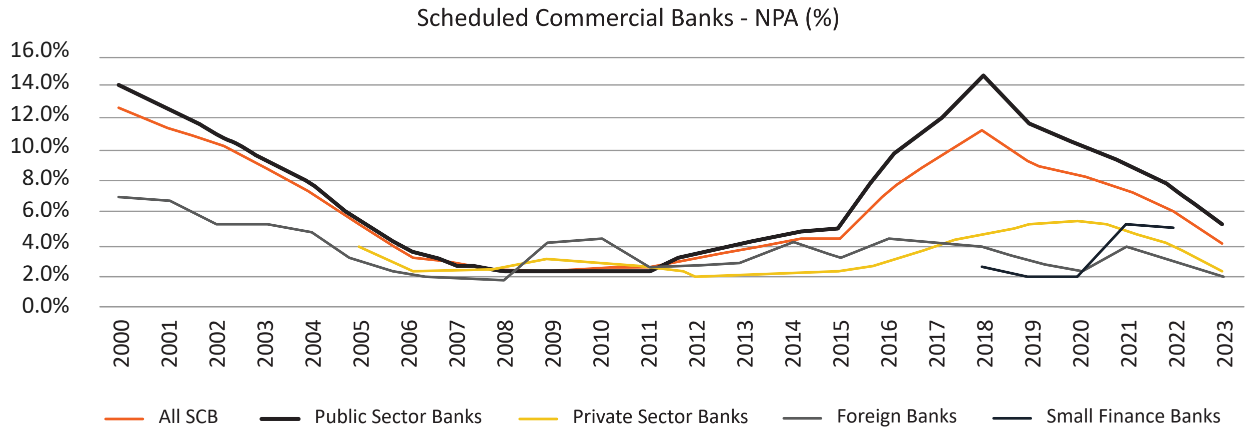
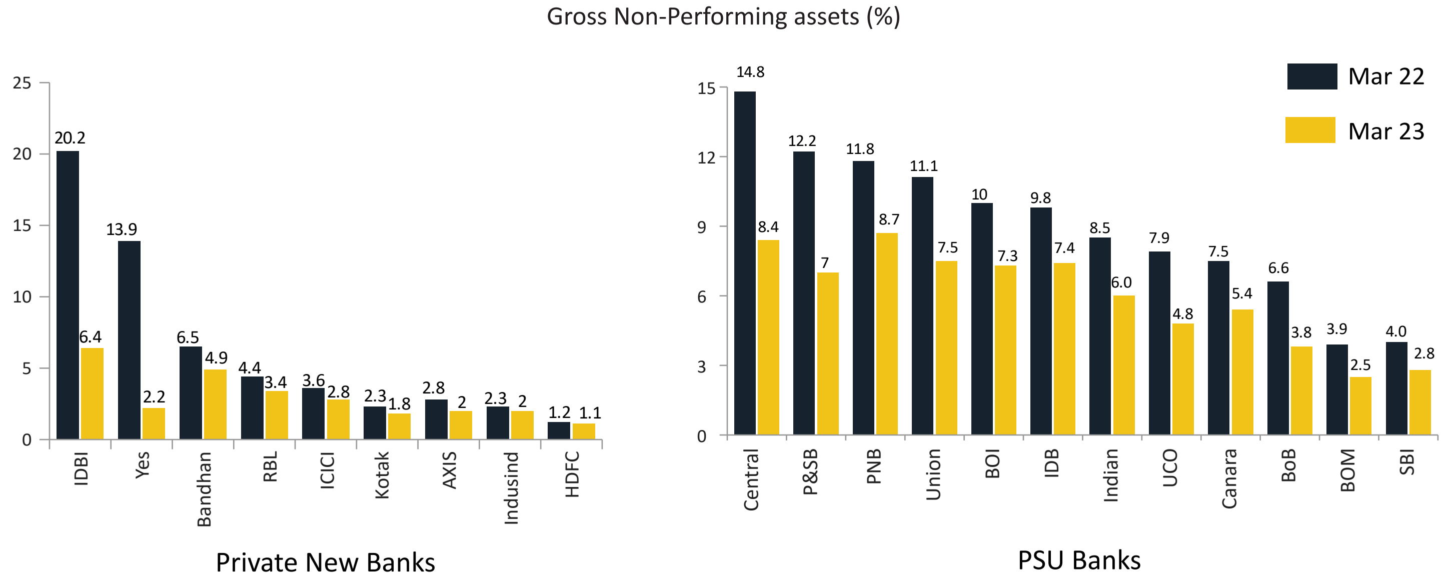
Improving asset quality

Indian banks are now witnessing improved asset quality due to lower slippages and the Gross Non-Performing Asset (GNPA) to total advances ratio of Scheduled Co-operative Banks (SCBs) dropping to a 10-year low. The GNPA ratio of SCBs fell to a decadal low of 3.9% (March 2023) and further to 3.2% (September 2023). With improving asset quality, the Provision Coverage Ratio (PCR) (without write-off adjusted) rose to 75.3% by end September 2023.

Exhibit 2: Improving asset quality of banks



Source: RBI

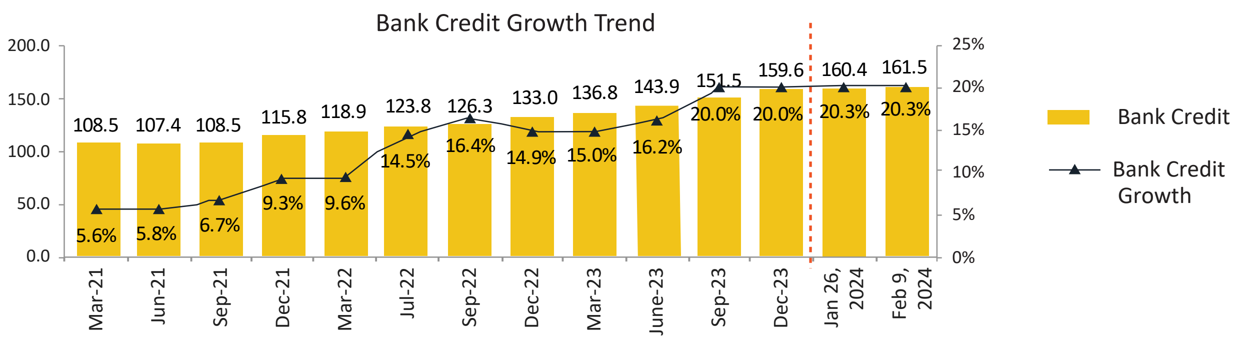


Source: RBI

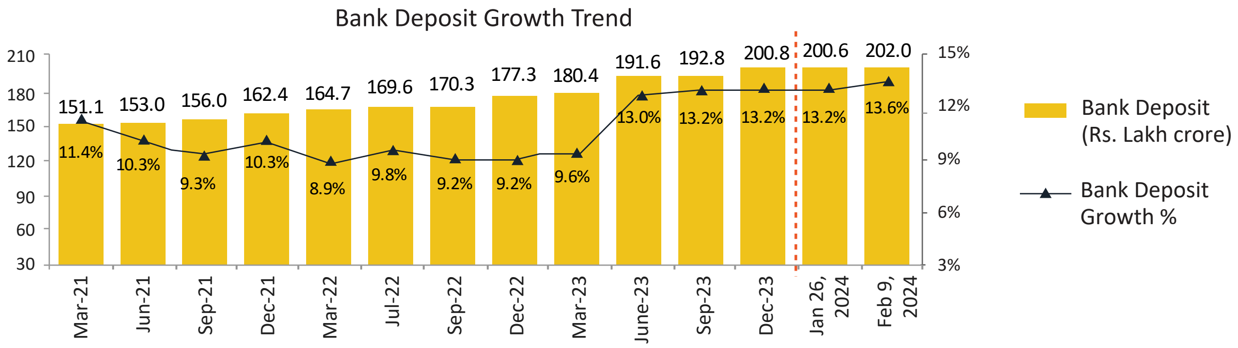
Liability-side challenges

Currently, bank credit growth is outpacing deposit growth. Credit offtake experienced robust growth of 20.3% in Q3FY24 (driven by merger impact and personal loans). Deposit growth continued to lag credit growth with sluggish Current Account and Saving Account (CASA) growth, which was partially offset by the growth in Time Deposits.

Exhibit 3: Bank credit and deposit growth



Source: CARE Ratings

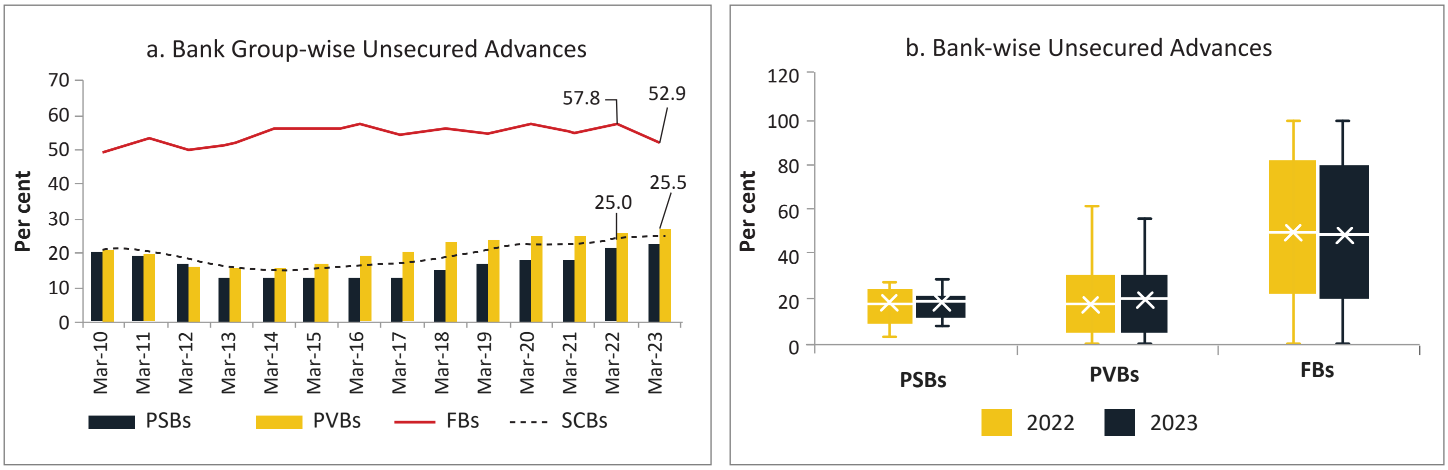


Source: CARE Ratings

Rising share of unsecured credit

The share of unsecured advances in total credit of SCBs has been increasing since end-March 2015 and reached 25.5% in FY23. More than 50% of loans by foreign banks are unsecured, while the share is lower at 27.3% and 22.6% for PVBs and PSBs, respectively. Seeking to rein in an observed rise in unsecured personal loans and credit cards, the RBI directed banks and Non-Banking Financial Companies (NBFCs) to reserve more capital for risk weights. The mandatory risk weight requirement has been increased by 25 percentage points.

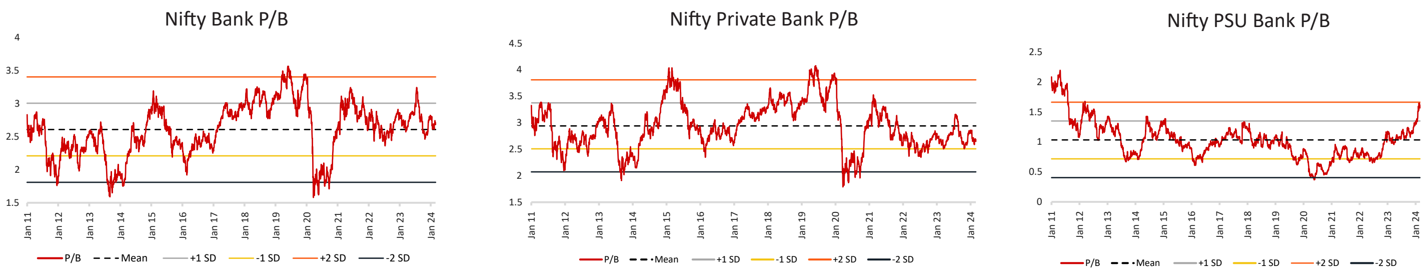
Exhibit 4: Rising share of unsecured credit



Source: RBI

Overall, while short-term pain is evident due to pressure on net interest margins and slower deposit growth, along with the challenge of maintaining loan growth with a higher credit-deposit ratio, over the long-term, stable asset quality, high PCR, strong capital buffers, and lower stressed assets bode well for the future of the banking sector.

Exhibit 5: Banking sector valuation



Source: NSE

Q&A

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Do you think that sectoral diversification, i.e., investing across multiple sectors, is important for a robust portfolio?

During any given point in time, one sector might be doing well and another might be facing some headwind. An important insight about the stock market is that not every sector is buoyant when markets are positive, and not every sector is bearish when markets are negative. It is important to have a diversified portfolio approach, which essentially comprises numerous sectors, rather than focusing on only one or two sectors. This addresses the different headwinds and tailwinds that a certain industry faces.

What are the critical parameters to consider while assessing banking stocks?

Key factors such as loan growth and Net interest Margin (NIM) trends, asset quality trends, contours of the liability side (CASA, Term deposits), operational aspects and efficiency (cost to income ratio), provision coverage, capital adequacy, return ratios (ROA & ROE) need to be considered while evaluating banking stocks.

Do you think that the challenges currently facing the banking sector are temporary?

Yes, short-term pain is evident due to pressure on net interest margins and slower deposit growth, along with the challenge of maintaining loan growth with a higher CD ratio. However, the sector currently benefits from stable asset quality, high PCR, strong capital buffers, and lower stressed assets which bode well for its future.

From a valuation perspective, how are banking stocks currently placed?

The valuation of the Nifty Bank index is close to mean levels. However, a deeper analysis reveals divergence between the valuation of private banks and PSU banks. The PSU Bank Index has risen by more than 85% in the last 1 year, the Nifty Private Bank Index rose by just 12%, and in the same period, Bank Nifty gained by 14%. With this, the Nifty Private Bank Index is trading close to -1SD levels whereas, the Nifty PSU Bank Index is almost close to +2SD levels.

This means that select private banks with good prospects are trading at attractive valuations compared to PSU banks.

What makes banking a compelling investment opportunity at the current juncture?

The banking sector is currently trading at reasonable valuations in comparison to the overall market and other sectors. Select private banks with good prospects are trading at compelling valuations and offer an attractive risk-reward ratio. These banks boast strong fundamentals such as a robust liability franchise, sufficient capitalisation, and strong underwriting practices, as well as a long growth runway in terms of market share expansion and outpacing industry growth.

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