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LIQUIDITY DEFICIT & (IN)ADEQUATE PRICING OF CREDIT RISK, EVEN AS ASCB (SELECT BANKS) PROFITABILITY JUMPS BY CLOSE TO 50% AND MARGINS BY 35 BPS: MOUKA PE CHOWKA?

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Things have changed significantly since the beginning of war and the RBI rate hike cycle. The RBI has been conscious in terms of front-loading rate hikes and calibrating excess liquidity in the system. The average net durable liquidity injected into banking system in Apr'22 that was at Rs 8.3 trillion is now Rs 3 trillion. In fact, with the Government spending a large part of cash balances in the Diwali week, the net LAF in the banking system that was hitherto negative has improved recently on the back of Government spending and salary & bonus payments because of festive season. Even as the banking system has moved closer to a calibrated liquidity coupled with higher signalling rates, one thing has still not changed; that is credit risk not getting adequately priced in, even as credit demand is at decadal highs and liquidity remains significantly downsized.

A back of envelope estimate suggests that the core funding cost of the banking system is currently at around 6.2%, while the reverse repo rate is at 5.65%. No wonder, banks are currently engaged in a fierce war to raise deposits, with rates being offered up to 7.75% in select circumstances. Additionally, banks are currently mobilising certificate of deposits (CD) at rates as high has 7.97%, for a 360 days maturity paper. Further, few banks have raised CD at 7.15% for a 92 days maturity. **A significant part of the funding gap is thus also being made up by the mobilisation of CD**. The outstanding CDs stood at Rs 2.41 lakh crores as of October 21, 2022, as compared to just Rs 0.57 lakh crore a year ago. The CP market is also witnessing significant churn with the primary issuances of the short term paper drastically reducing to Rs 0.78 lakh crore after touching a high of around Rs 2.9 lakh crore during Nov'2021. The yields have increased by 255 bps since April'2022 and is at 6.92% in Oct'2022. It seems, with better rated corporates getting better deal directly from banks for their working capital needs, they have reduced their dependence to the short term paper.

However, what is still intriguing is that even as banking system being witness to deficit net LAF, market sources point out that risk premia over and above core funding cost are not fairly acknowledging the inherent credit risk. **For example, short tenor working capital loans of less than 1 year are given even with finer rates at lower than 6% linking with 1M/3M T Bill rates. 10 year and 15 year loans are being priced at less than 7%. It is to be noted that 10-Yr G Sec is currently trading around 7.46% , while 91 Day T Bill at around 6.44% and 364 Day T Bill at around 6.97%**.

The good thing is that such pricing war is mostly restricted to AAA borrowers and ultimately it should also lower the risk weighted assets thereby lowering the capital requirements. It may be noted that RBI had proposed the concept of **normally permitted lending limit** (NPLL) **for specified borrower, meant to nudge the borrowers to move towards corporate bonds market. The current trend negates such a concept as well as the logic of Tenor Premium. By this convention, benchmark yields should move down if we apply the logic of risk getting underpriced, as of today.**

Interestingly, banks have adjusted deposit rates significantly upwards in October. Also, given that 45% of bank deposits are CASA, it is only the 55% of term deposits that need adjustment and hence ideally, a 190 basis point increase in repo rate could result in 105 basis point increase in deposit rate (190*55%). Separately, bank deposits are either bulk, if it is more than Rs 2 crore or otherwise retail. As per RBI regulations, bulk deposits are not taken into consideration for estimation of HQLA in LCR computation. **Also, there are matters of maintaining operational equilibrium that might explain high CD rates in vogue now. In the ultimate analysis, banks with better franchise and digital orientation will ensure that retail deposits triumph over wholesale deposit mobilization in the long run, coupled with the fact that meeting the LCR norms is the exclusive prerogative of mobilizing only through retail deposits.**

Meanwhile, latest results of banking sector reveal that average y-o-y profit growth close to 50%, and jump in net interest margin by a sharp 35 basis points. Initial results, from around 675 listed entities, show top line growing by 32% with EBIDTA shrinking by 15% in second quarter of FY23. **It is also observed that corporates particularly in select sectors, have increased their cash holding in the half year ended September 2022 by up to 4 times as compared to September 2021**. Conserving liquidity in the time of uncertainty or waiting for opportunity could be the best strategy for these corporates. Sectors such as Refinery, Telecom-Service, Cables, Sugar, Paint/Varnish, Packaging etc. have increased their cash holdings substantially. Also, sectors that had deleveraged significantly like Steel, Chemicals, Minerals in earlier years are increasing their loan funds. **The good thing is that with capex on rise, Nifty PSEs Index market cap has increased by 35.6% in current year as compared to 3.52% of Nifty 50 index.**

We thus believe, it is now the opportune time to revisit the taxation of interest on bank deposits, or at least increase the threshold of exemption for senior citizens. The RBI can also relook at the regulation that does not allow interest rates of bank to be determined as per age-wise demographics. Additionally, while there is no restriction by RBI on benchmarking of loans (as against earlier MCLR) and Banks are free to use any benchmark published by FBIL, continued restrictions on not allowing negative spread on MCLR may also be removed.

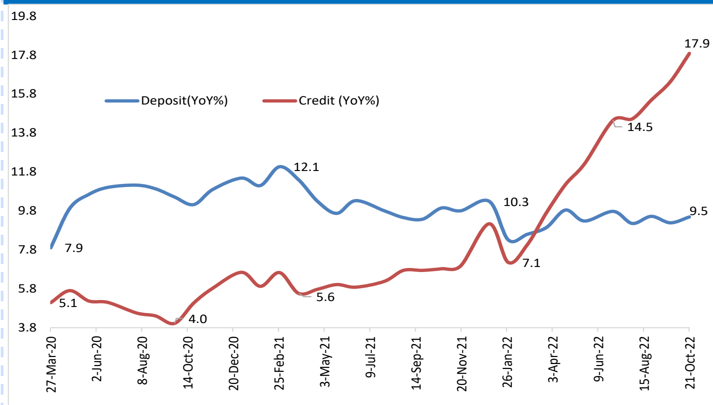
CREDIT GROWTH 9 YEAR HIGH— ROBUST GROWTH ACROSS SEGMENT, INDUSTRY TOO KNOCKING EARLY TEENS

- ASCBs reported 9 year high credit growth of 17.9% for the fortnight ending 21st Oct'22, as per the provisional numbers, to cross Rs 129 lakh crore. Robust credit growth was reported across sectors including, Industry, Services and Personal segment.
- While personal segment and service sector reported growth of around 20%, Industry too reported robust growth of 12.6% as against mere 1.7% growth during last year, as per the latest sectoral deployment numbers as of Sept'2022. A part of this higher teen growth can be attributable to high rate of inflation we are recording in last few months.
- Service sector reported highest YoY growth of 20% driven by 30.6% growth in NBFC sector and 21.3% in Trade segment.
- Industry credit growth was driven by Micro & Small and Medium Enterprises, which grew by around 30% (YoY), while large Industry grew by 7.9% during the same period. Further, the good part is that within Industry, credit growth is reported across the board and is not limited to few industries/sectors.
- Sectors such as Basic Metal, Cement, Glass, Constructions etc. which have reported negative growth during last year also reported excellent credit growth during this year.
- Sectors that reported double digit growth include Wood and Wood products, Petroleum, Coal Products, Chemicals and Chemicals products including Fertiliser, Basic Metal and Metal Products including Iron and steel, Infrastructure including Telecommunications, Roads etc.

BUT YOY DEPOSIT GROWTH (IN SINGLE DIGIT) LAGGING FAR BEHIND

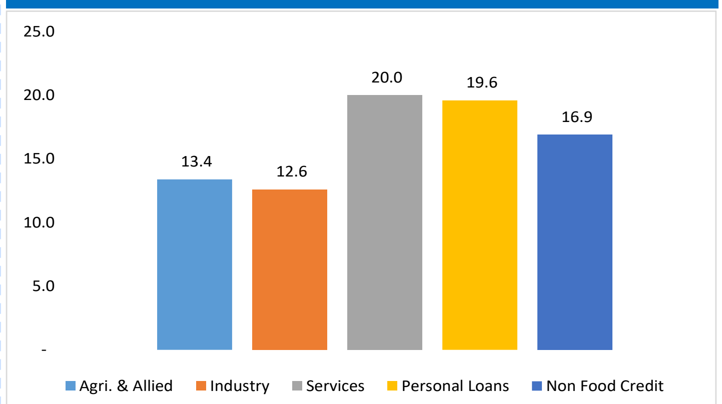
- ASCBs deposits grew by 9.5% on YoY basis (Rs 7.4 lakh crore on incremental basis), compared to last year growth 9.9% (Rs 6 lakh crore), as per the fortnightly number as of 21st October 2022.
- Even though the incremental deposit growth is more by Rs 1.4 lakh crore, looking at the credit demand Banks seem to be not happy with the number as *Ye Dil Mange Mor.* Some Banks have already started special schemes with higher card rates for specific tenors with rates up to 7.75% offered .

ASCB Credit and Deposit growth (YoY) %



Source: RBI; SBI Research

Sector wise credit growth as of Sept'2022 (YoY) %



Source: RBI; SBI Research

Growth in Bank Credit to Industry

Industry (Major)	Variation (Year-on-Year)	
	Sep,2021 / Sep,2020	Sep,2022 / Sep,2021
Food Processing	6.2	8.0
Beverage and Tobacco	1.0	7.3
Textiles	7.3	4.9
Leather and Leather Products	-3.9	7.3
Wood and Wood Products	6.5	14.1
Paper and Paper Products	11.1	7.4
Petroleum, Coal Products and Nuclear Fuels	20.3	75.9
Chemicals and Chemical Products	1.9	22.5
Rubber, Plastic and their Products	18.0	21.3
Glass and Glassware	-13.0	8.5
Cement and Cement Products	-19.9	2.9
Basic Metal and Metal Product	-15.0	10.6
All Engineering	3.2	13.8
Vehicles, Vehicle Parts and Transport Equipment	-6.9	6.0
Gems and Jewellery	14.0	5.4
Construction	-8.7	2.1
Infrastructure	3.4	10.9
Power	1.7	8.1
Telecommunications	-7.6	16.3
Roads	24.0	13.4
Industries Overall	**1.7**	**12.6**

Source: RBI; SBI Research

- With the high credit absorption and resources growing at lower pace, Banks are quoting higher rates for bulk deposits and also mobilizing through Certificates of Deposit (CD) market at a higher rates.
- For example, banks are currently mobilising CD at Weighted Average Yield (WAY) as high as 7.97%, for a 360 days maturity paper. Further, few banks have raised CD at WAY of 7.15% for a 92 days maturity. A significant part of the funding gap has been met by the mobilisation of CD. The outstanding CDs stood at Rs 2.26 lakh crores as of October 07, 2022, as compared to just Rs 0.59 lakh crore a year ago.

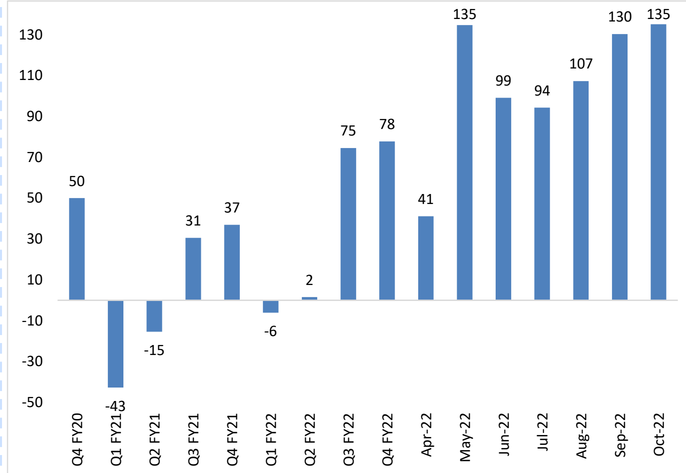
GROWTH IN CREDIT AND DEPOSIT ALMOST AT PAR SINCE COVID, THEN WHY THIS RESOURCE CRUNCH?

- ASCB reported deposit growth of 27.27%, as of 7th Oct'2022 as compared to March'20, while credit grew by 25.2% during the same period. Even the Credit Deposit (CD) ratio is at almost same level of around 75%.
- However, post April'2022 the average incremental CD ratio is around 117%, which is at 135% in October'2022 due to pick up in demand from both personal segment as well as corporates with revival of capex cycle. It is pertinent to mention that for a deposit of Rs 100 Bank can lend only Rs 77.5 after keeping aside regulatory requirement of CRR (4.5%) and SLR (18%).
- Banks are not only expected to keep their CD issuance elevated to meet their short-term need amid the lower liquidity apart from focus on deposits (bulk as well as retail) to meet the rising credit demand, but also dig into their investment portfolio, where the SLR holdings is also at higher level then the regulatory requirement, to fund the credit growth.

SPREAD IN AAA PAPER NOT MOVING DESPITE LIQUIDITY DRIED UP. DOES CURRENT PRICING CAPTURE THE RISK ADEQUATELY OR IT'S A MOUKA PE CHOWKA FOR GOOD RATED BORROWERS

- During and after pandemic, RBI has taken various measures to stabilise the financial system including keeping liquidity in surplus mode.
- The system surplus liquidity has moderated significantly post Apr'22.
- The average net durable liquidity injected into banking system in Apr'22 that was at Rs 8.3 trillion is now at Rs 3 trillion.

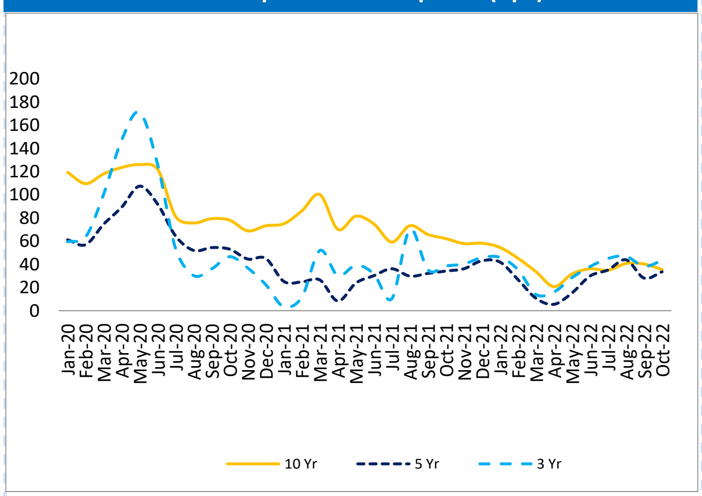
Incremental CD Ratio (ASCB)



Source: RBI; SBI Research

Growth in Credit and Deposit almost at par since Covid (Rs. Lakh Crore)			
Period/Date	Deposit	Credit	C/D Datio
27th March'2020	135.7	102.7	75.7%
21st October'2022	172.0	128.9	74.9%
Growth in absolute terms	36.3	26.2	
Growth in %	27%	26%	
Source: RBI; SBI Research			

AAA Corporate Bond Spread (bps)



Source: Bloomberg; SBI Research

- The spread between AAA corporate bond and 10-year risk free G-sec rates has though started moving upward, since April'2022, is still significantly less than half of the average spread at pre pandemic level i.e. in FY20. The average spread of a AAA 10-year paper was 117 bps in pre pandemic levels over similar tenor G-Sec., which is now only 36 bps.
- This indicates that risk pricing of corporate loans, which was lower during low demand and high liquidity has not moved up commensurately even though the demand picked up and liquidity dried up, reflecting inadequate risk pricing.
- Market sources point out that some of the entities are not completely factoring the inherent credit risk in their pricing. For example, short tenor working capital loans of less than 1 year are given even with more finer rates at lower than 6% linking with 1M/3M T Bill rates. 10 year and 15 year loans are being priced at less than 7%. It is to be noted that 10-Yr G Sec is currently trading around 7.46% , while 91 Day T Bill at around 6.44% and 364 Day T Bill at around 6.97%.

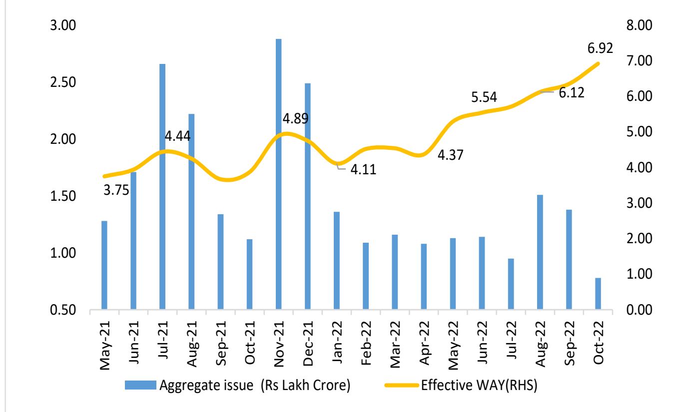
COMMERCIAL PAPER RATES MOVES 255 BPS SINCE APRIL'22

- In Commercial Paper (CP) market, Weighted Average Yield (WAY) has started inching up since April'22. With WAY moving northwards, the primary issuances of the short term paper has drastically reduced to Rs 0.78 lakh crore after touching a high of around Rs 2.9 lakh crore during Nov'2021.
- The WAY has increased by 255 bps since April'2022 and is at 6.92% in Oct'2022. It seems, with corporates getting better deal directly from Banks for their working capital needs, they have reduced their dependence to the short term paper.

CORPORATE—GROWING TOP LINE, SHRINKING EBIDTA

- Initial results, from around 675 listed entities, shows growing top line with shrinking EBIDTA in second quarter of FY23. In Q2FY23 the said corporates reported a top line growth of 28% while bottom line grew by a tad 1% as compared to previous year.
- However, ex-BFSI, the same set reported around 15% degrowth in both EBIDTA and PAT, though top line grew by 32% in Q2FY23. It seems the Banking sector has saved the quarter for the corporate sector, where around 25 banks reported around 50% growth in bottom line in Q2FY23 as compared to the same period previous year.

CP issuances and WAY



Source: CCIL; RBI; SBI Research

Sector reported positive growth in key parameters in Q2FY23 vis-à-vis Q2FY22

Sector	No of Cos.	Net Sales	EBIDTA	PAT
Agro Chemicals	11	32	30	51
Auto Ancillaries	22	26	11	14
Automobile	5	39	99	103
Cables	9	15	34	31
Capital Goods-Non Electrical Equipment	17	32	20	31
Chemicals	36	33	38	42
FMCG	14	17	5	13
IT - Software	56	21	7	2
Paints/Varnish	2	19	26	23
Pharmaceuticals	25	20	56	41

Source: SBI Research; Cline

Sector reported growth in top line but degrowth in EBIDTA / PAT in Q2FY23 vis-à-vis Q2FY22

Sector	No of Cos.	Net Sales	EBIDTA	PAT
Cement	14	14	-49	-67
Fertilizers	2	92	-40	-44
Plastic products	11	6	-89	-89
Power Generation & Distribution	10	44	16	-7
Steel	25	8	-68	-81
Sugar	4	26	-35	-39
Textiles	27	2	-55	-83
Tyres	1	19	-17	-34

Source: SBI Research; Cline

- Despite the margin pressure and increasing cost, some of the sectors which are doing well and reported all round growth in key financial parameters include Automobiles, Chemicals, Capital Goods-Non Electrical Equipment, FMCG, Pharmaceuticals, etc. (list of select sectors given in table)
- However, many sectors either could not pass on the rise in input cost or could not sustain high margin and reported degrowth in EBIDTA/PAT despite reporting growth in top line i.e. Cement, Steel, Textiles, Tyre, Plastic, Sugar etc.

INCREASED CASH HOLDINGS OBSERVED IN CERTAIN SECTORS: SENSING UNCERTAINTY OR WAITING FOR OPPORTUNITY?

- It is observed from the initial results of listed entities that, corporates, particularly in few sectors, have increased their cash holding in the half year ended September 2022 by up to 4 times as compared to September 2021. Conserving liquidity in the time of uncertainty or waiting for opportunity could be the best strategy for these corporates. Sectors such as Refinery, Telecom-Service, Cables, Sugar, Paint/Varnish, Packaging etc. have increased their cash holdings substantially (see table) as of Sept'2022.
- In resource side also, we have observed that after deleveraging for last two years, corporates started reporting increase in loan funds in the balance sheet probably to fund the increasing capex requirements.
- Some of the sectors that reported increase in loan fund as of Sept'2022, as compared Sept'2021, include Refinery, Telecom-Service, Power Generation, Steel, Mining & Mineral products Chemicals etc.

NIFTY PSE OUTPERFORM NIFTY 50 IN MARKET CAP GROWTH WITH STRONG CAPEX

- With capex on rise, Nifty PSEs Index outperformed Nifty 50 in current financial year. Nifty PSE index market cap increased by 35.6% in current year as compared to 3.52% of Nifty 50 index.

EXCEPTIONAL PERFORMANCE BY BANKING SECTOR

- Indian Banking sector has reported exceptional performance in Q2FY23. Almost all banks have not only reported improvement in NIM and growth in Profit, but also reduction in NNPA (see table in next page).

Sector reported growth in Cash and Bank Balance (Rs crore)

Sector	No of Cos.	Sep-21	Sep-22	Growth %
Refineries	4	6277	30943	393
Mining & Mineral products	3	2579	3846	49
Alcoholic Beverages	7	706	1614	129
Telecomm-Service	3	666	1360	104
Consumer Durables	13	1994	2679	34
Entertainment	18	1516	2133	41
Cables	9	354	953	169
Retail	3	629	1157	84
Petrochemicals	4	760	1145	51
Sugar	3	78	451	476
Agro Chemicals	8	480	829	73
Textiles	28	330	648	97
Realty	10	433	707	63
Paints/Varnish	2	195	435	124
Packaging	4	44	242	444

Source: SBI Research; Cline

Growth in Market Cap of Nifty 50 and Nifty PSE (Rs Trillion)

Index	31-03-2020	31-03-2022	03-11-2022	Change% (Mar 22-Mar 20)	Change %(Latest-Mar 22)
Nifty 50	66	140	145	110.23	3.52
Nifty PSE	7	13	17	81.15	35.26

Source: SBI Research; Cline

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Major Banks Performance in Q2FY23										
Name of Bank	YoY Growth			Key parameters as of Sept'22 vis-a-vis Sept'21						
	Deposit	Advances	Net Profit	GNPA		NNPA		NIM		
	YoY%	YoY%	YoY%	Q2FY22	Q2FY23	Q2FY22	Q2FY23	Q2FY22	Q2FY23	
Axis Bank	10.1	17.6	70.1	3.53	2.50	1.08	0.51	3.39	3.96	
Bandhan Bank	21.3	17.4	107.0	10.82	7.20	3.04	1.90	7.60	7.00	
HDFC Bank	19.0	23.4	20.1	1.35	1.23	0.40	0.33	4.30	4.30	
ICICI Bank	11.5	22.7	37.1	4.82	3.19	0.99	0.61	4.00	4.31	
Indusind Bank	14.6	17.8	57.4	2.77	2.11	0.80	0.61	4.07	4.24	
Kotak Bank	11.5	25.1	27.0	3.19	2.08	1.06	0.55	4.45	5.17	
Yes Bank	13.2	11.3	-32.0	15.00	12.90	5.55	3.60	2.20	2.60	
IDBI Bank	3.1	17.4	46.0	21.85	16.51	1.71	1.15	3.02	4.37	
Bank of India	5.6	17.9	-8.7	12.00	8.51	2.79	1.92	2.42	3.04	
Bank of Maharashtra	7.9	28.6	102.7	5.56	3.40	1.73	0.68	3.27	3.55	
Canara Bank	9.8	20.0	89.4	8.42	6.37	3.21	2.19	2.77	2.86	
Central Bank of India	2.0	12.2	27.2	15.52	9.67	4.51	2.95	2.97	3.44	
Punjab National Bank	7.0	12.8	-62.8	13.63	10.48	5.49	3.80	2.39	3.00	
UCO Bank	10.0	17.0	146.3	8.98	6.58	3.37	2.40	2.79	2.84	
Union Bank of India	14.1	21.9	21.1	12.64	8.45	4.61	2.64	2.95	3.15	
Bank of Baroda	13.6	19.0	58.7	8.11	5.31	2.83	1.16	2.85	3.33	
State Bank of India	10.0	19.9	73.9	4.90	3.52	1.52	0.80	3.24	3.32	

Source: SBI Research, Banks Analyst Presentations

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