India Capital
GROWTH FUND

HOODnote: Indian Banks - 3Rs- Resilient, Resolute and Regulated

With the SVB crisis hitting the United States (US), questions have arisen on the possible effects it may have on the Indian banking sector and India Capital Growth Fund's (ICGF) substantial 25% exposure to this sector. This short note highlights the team's thoughts on the reasons for the crisis and how the Indian banks have already been through a clean-up process leading to a much sounder system today.

The Indian banks may not be immune to the volatility in the global banking system, though are better placed aided by the 3Rs (Resilient, Resolute and Regulations) and the decoupled Indian banking system. Over the last 15 years, the Indian banks have learnt from the global financial crisis of 2008, the domestic asset quality crisis of 2015-16 and the domestic liquidity crisis of 2018-19. These learnings led to the regulator strengthening the regulations to avert similar crises in the future and it was these regulations that protected the sector in the current global banking crisis. Further, the ratio of foreign claims to domestic claims is the lowest globally; and the share of foreign banks is a nominal 6% of the total banking assets. This broadly decouples the banking and financial system from its global counterparts, making the risk of any international balance sheet contagion starting from India virtually out of the question.

India vs US regulations- RBI a playbook for the world

The genesis of the SVB crisis in the US is broadly due to oversights both internally and externally. This could have been avoided if certain checks and balances had been in place. The spiralling impact of the reversal of interest rates and liquidity on the bank's Asset Liability Management (ALM), its investment book, the concentrated deposit/lending base, and a varying regulation across banks in the US appears to be at the core of the SVB crisis which is unlike the case in India.

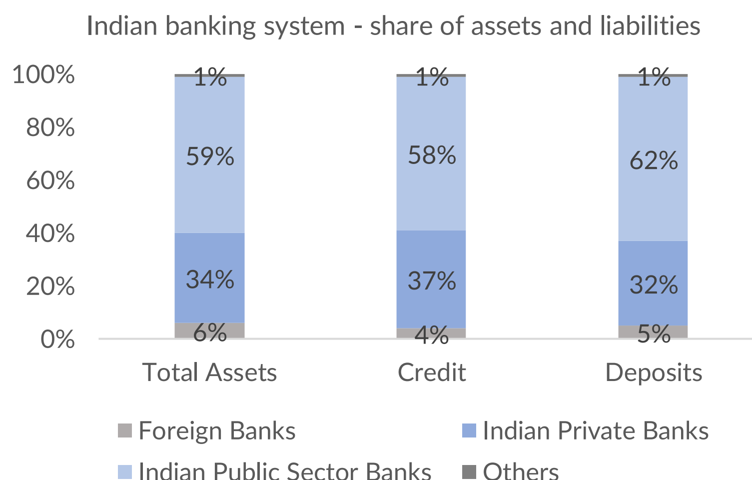
To begin with, the banking regulations in India are applied uniformly and encompass the non-bank lenders and fintech's which have also been brought under the Reserve Bank of India's (RBI) fold. This is distinct from the dual regulation structure in the US, where banks can be formed either under central law or state specific laws. The Indian banking regulatory architecture, under the co-operation of the RBI and the Indian government is much sounder and more prudent.

- On the Liability Side-
    - The BASEL regulatory framework requires banks to set aside cash which is adequate to cover cash outflows for 30 days, called the Liquidity Coverage Ratio (LCR). **Indian Banks have been maintaining more than the required LCR since the implementation of the BASEL regulations.** In India, even large non-bank lenders need to adhere to the above LCR. In the US, the LCR requirement is only applicable to Category I (G-SIB) banks and Category II institutions with balance sheet size of over $700 bn. As such, the LCR compliance was not mandatory for SVB, which otherwise would have aided in meeting the sudden withdrawals.
    - **Indian law comprehensively covers 98% of the deposit accounts.** The small/regional/local Banks are insured at 82.9%, 66.5%, and 76.4% respectively. In the US, the largest banks have deposits insured at 50-55% and small bank deposits insured at 30-45% only.
    - **The deposits in India are granular with over 60% of the deposits being sticky retail assets** which can withstand a potential run-on deposit that we are witnessing in global banks at present.

- On the Asset Side-
    - The Asset Liability Management (ALM) controls and tools specified by the RBI are very specific, such as the Maturity Mismatch Report (MMR) and Interest Rate Sensitivity Monitor (IRSM). The held to maturity (HTM) limits are defined and 80% of the HTM book comprises government securities, which can be placed with the RBI to provide liquidity. The RBI has also asked banks to create an investment fluctuation reserve to take care of the volatile interest rate environment which too has helped in the current crisis. Both the above were missing in the case of SVB.
    - The exposure framework is well-defined, with Single Counter Party exposure of up to 20% of Tier 1 Capital of any group and its connected counterparties restricted from exceeding 25% of Tier 1 Capital. This again reduces concentration risk which was the case with SVB on both sides of the balance sheet.

Foreign linkages - India is de-coupled!

Foreign banks have only 6% share of total banking assets, 4% in loans and 5% in deposits in India. However, their market share is significant in the derivatives market (over 50%). On the regulatory front, they adhere to the same regulations that are applicable to Indian Banks (as highlighted earlier). Furthermore, the top five foreign banks in India (by assets under management) are HSBC, Citibank, Standard Chartered, Deutsche Bank and J.P. Morgan. The impact of the Credit Suisse fallout has been felt more by the insurance companies who have some counterparty risk rather than the domestic banking system. On the counterparty risks, the insurance companies had already been reducing or diversifying exposure prior to the crisis.



Source: Reserve Bank of India as at 31 March 2022

In addition, the exposure of Indian banks to foreign borrowers is limited to lending to Indian corporates with global operations. Also, of the $32 trn of global foreign claims, the share of Indian banks stands at $104 bn on immediate counterparty basis and $81 bn on guarantor basis. Of the above, claims worth $59 bn have a maturity of less than one year which is only 10% of the forex reserves. India is bound to catch a cold if the world sneezes but is expected to recover faster due to the antibodies built over time.

Indian Banks – still bullish on the sector

We remain bullish on Indian banks given their high relative earnings visibility. Credit growth is expected to normalise from FY23 highs of 15-16% to 12-13%, and so are margins. However, earnings growth should be well supported by operating efficiency and improving asset quality. In the portfolio, the entire exposure is to mid-sized banks, which are less resilient to interest rates and liquidity shocks compared with the larger banks, predominantly due to their size. However, the mid-sized banks in the portfolio do have several buffers in place to avert possible crises (Table 1). We continue to prefer the mid-sized banks due to their higher share of retail lending, higher growth, continuous improvement in asset quality aided by the domestic resilience and valuations at well below historical averages.

Table 1: ICGF portfolio holdings in the banking sector - safeguards in place.

Parameter	Indian Regulatory requirement	IDFC first Bank	Federal Bank	City Union Bank	Indusind Bank
Liquidity Coverage Ratio (LCR)	100% of estimated cash outflow for next 30 days	122%	145%	180%	117%
Net Stable Funding Ratio (NSFR)	100%	120%	145%	158%	128%
Share of retail deposits	Not prescribed	57%	78%	64%	40%
Capital Adequacy – Tier 1	8%	13.67%	12.62%	19.40%	16.47%
Exposure of Top 20 depositors	Not prescribed	16%	3.35%	11.54%	17%
Exposure of Top 20 borrowers	Total exposure to any particular company or group of companies can't exceed 20/25% of Tier 1 capital respectively	10%	9.26%	4.79%	10.64%
Held to maturity as % of investment book	Not prescribed	51%	78%	79%	80%

Investment fluctuation reserve	Banks carry reserves to the extent of 2% of the aggregate Held to maturity (HTM) and Available for sale (AFS) portfolio and can use the fund in case of sudden losses. This reserve is allowed to be counted for capital adequacy purpose.	7%	2%	2.12%	2.30%
Overseas lending % of overall lending	Not prescribed	0%	1%	0%	3%

Source: Ocean Dial Asset Management

The banking system in India is in a sweet spot as the system has already been cleaned up and stress tested. The worst of the asset quality is firmly in the past and high growth with revival in capital expenditure on deleveraged corporate balance sheets lies ahead.

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