Are Indian banks and NBFCs ready to absorb COVID-19 impact?

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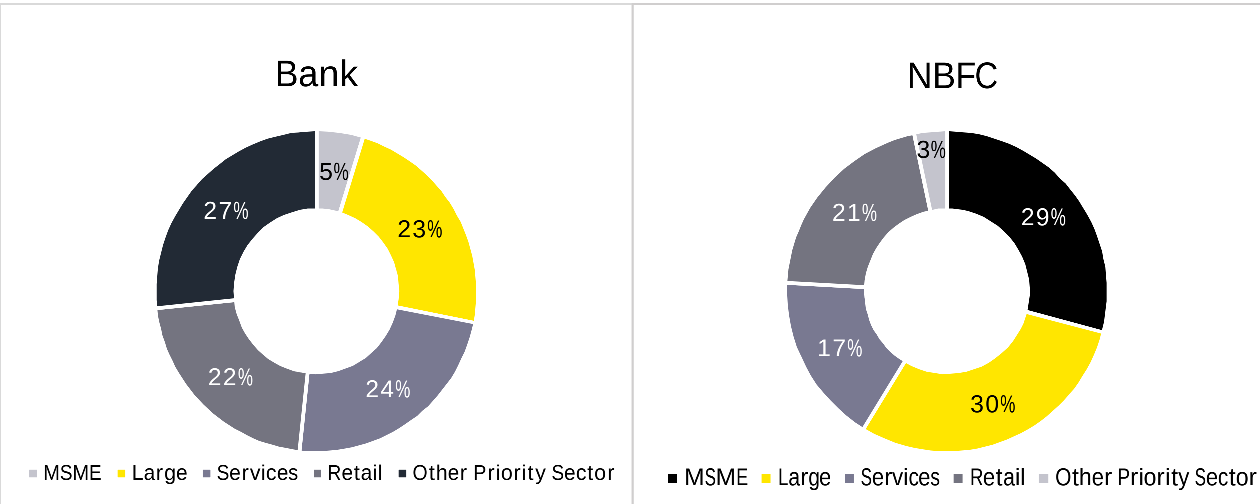
India Inc credit quality Impact of Covid-19

The Indian financial services sector had just started seeing a gradual recovery from slow credit off-take and increased distressed assets, when fresh challenges have emerged. Recently, financial services non-performing assets (NPAs) declined from its peak of over 10% of advances and improved their profitability. However, soon afterwards, the telecom AGR (adjusted gross revenue) liability and private sector bank stress impacted market sentiment and caused loss in market valuations.

The Covid-19 pandemic was like a bolt from the blue. The sudden lockdown experienced by businesses ranging from airlines and hotels to automobiles could mean heightened credit risk for companies in these sectors even after the three-week lockdown imposed by authorities is lifted.

Re-ignition of business post the lockdown is lifted would be a major challenge for especially corporate and SME borrowers. This would have a downstream stress on repayment and credit off-take for the financial services sector. With this backdrop, it is important to analyze how prepared the financial services sector is to weather this unprecedented storm, which is playing out in full force globally as we analyze current exposure of banks and NBFC below:



Current exposure of Indian banks and NBFC as per RBI data[1]

1 RBI data for Banks: https://www.rbi.org.in/Scripts/Data_Sectoral_Deployment.aspx
RBI data for NBFC: https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=19367#TB6

Now: Banks and NBFC ready to absorb Covid-19 impact?

- Public sector banks in consolidation mode
- Four banks under RBI's PCA
- Private sector banks not out of woods
- NBFC recovering from crisis post IL&FS and DHFL impact

Amidst these issues, the current lockdown and social distancing measures may further escalate the stress in the corporate and SME portfolio. While this impact will be across portfolios, it is expected to be more pronounced in a few sectors like airlines, hotels, malls, multiplexes, restaurant services, and other businesses completely shut down. It is evident that lower footfalls and occupancies will decline business volume and sub-optimal operating efficiencies will impact cash flows of the companies in these sectors affecting their creditworthiness.

Impact on these sectors will be affect the entire value chain, Hence, financial sector profitability in fiscal 2021 will be centrally dependent on how asset quality, and earning ability, pan out. With slower credit growth, pre-provisioning operating profits would be impacted reducing the cushion to absorb credit costs. In this context, the ability to improve "credit monitoring" will gain importance in managing asset quality and proactive steps for improving "collection" with lead to profitability. As per RBI publication, asset quality and earnings of banks and NBFC is mentioned below

As on March 2019[2]	Corporate exposure	SME exposure	RoA (%)	RoE (%)	NIM (%)	Gross NPA (%)
Bank	Rs. 24 Lakh Crores	Rs.4.81 Lakh Crores	-0.09 ↑	-1.85 ↑	3.1 ↑	9.08 ↓
NBFC	Rs. 6.32 Lakh Crores	Rs. 6.22 Lakh Crores*	1.5 ↓	6.6 ↓	5.1 ↓	6.01 ↑

With negative earnings (Return on Assets (RoA), Return on Equity (RoE) for the banking sector for overall exposure of Rs 86.74 lakh crore^ including corporate and SME which contributes approximately 33% of overall exposure, the banking sector cannot afford further slippages and may strengthen credit monitoring and provide regulatory relief to COVID-19 impacted sectors. Further, improvement in GNPA from 11% in FY 18 to 9.08% in FY 19 (Arrow signifies Y-o-Y trend in table), indicates that the utmost priority and focus for banks will remain on "collections".

The NBFC sector is more SME and large corporate oriented, with these sectors contributing approximately 59% of overall exposure. The lockdown is expected to affect this sector harder than banking. The extent of this impact on asset quality and collections for NBFCs will vary and depend on four factors in the near term – asset class, income source of the customer, level of field work in operations and proportion of cash collections. As the lockdown restrictions are lifted and business comes back to rails, what will also be important is government spending and pickup in economic activity.

Regulatory measures

RBI has permitted lenders to offer a three-month moratorium on term loans and deferment of interest payment for working capital facilities. There would be no change in asset classification where such moratorium is applied, thereby limiting the impact on reported NPAs. The same instruction is provided by SEBI to Credit Rating Agency (CRA) for "Recognition of Default" as per a circular dated 30th March 2020. Post assessment if CRAs observe a delay in interest/principle arising solely due to the lockdown, the same will not be considered as default.

To ease pressure on cash flow across various sectors for near term, the Finance ministry has announced extension for filing direct and indirect tax and Government to bear the 24% contribution of both employee and employer combined to the Employees' provident fund for three months. It is applicable to the businesses having up to 100 employees and 90% of them earning less than Rs 15,000 per month.

Today: how COVID-19 is impacting corporate sectors in India[2]

Post doing the initial steps of moratorium and portfolio checks in place, banks and NBFCs should look at what preparation can they do to contain the impact of COVID-19 pandemic on their NPA, capital and growth. The staggered opening of the lockdown may continue to impact their functioning including collections for some more time.

- High impact - sectors facing:
  - Significant loss of revenue and profit.
  - High dependency on labor (movement of labor post lockdown may impact manufacturers)
  - Expected high impact in near term, exposed to risk emanating from liquidity stress
- Moderate impact - sectors facing
  - Limited supply disruptions for a couple of quarters but having strong balance sheets
  - Expected moderate impact on credit profiles
- Low impact - sectors that
  - Are domestically reliant and not exposed to significant demand pressures may not be impacted significantly owing to COVID-19 hence would see low impact

Sector	COVID impact	Labour flow[3]	Supply chain	Goods trade	Commodity price	Domestic consumption	Regulatory relief
Airlines	High	Low	Not a relevant parameter	International freight traffic constitutes 70-75% of total freight. Top infected countries account for 40%.	ATF constitutes 30-40% of total cost. Crude oil price crash beneficial.	Domestic freight consists of only 30%.	Can be obtained
Automobiles	High	High	Dependency on import of raw materials, from top 10 infected countries	Exports of two wheelers and passenger vehicle will be impacted	Imports of body parts from infected countries.	Two-wheelers and passenger vehicles dominate the domestic demand.	Can be obtained
Auto components	High	High	Dependency on import of raw materials, from top 10 infected countries	Of total production 18% is exported. Of this 50% is the share of Top 15 infected countries.	Some steel is imported from Japan for body parts	OEM and replacement account for 80% of the auto component market	Can be obtained
Consumer durables	High	Low	India imports 45-50% completely built units of consumer durables	Net importer, No major impact on exports.	Raw material (Copper, aluminium & plastic) form 75% share	Expected drop in demand due to elevated price.	Can be obtained
Paper	Moderate	Low	40% of pulp requirement is imported	11% of total production is exported, may impact adversely	Dependency of price for imported pulp	Largely domestic focussed	May require as per COVID impact

[2] https://www.crisil.com/en/home/our-analysis/views-and-commentaries/2020/03/the-covid-19-fallout.html

[3] impact on movement of labours due to Lockdown of 21 days *added Other industries in SME exposure

Sector	COVID impact	Labour flow[3]	Supply chain	Goods trade	Commodity price	Domestic consumption	Regulatory relief
Premium hotels	High	Low	Not a relevant parameter	No Direct linkage with global trade	Not a relevant parameter	Business and leisure occupancy declined	Can be obtained
Textile (cotton yarn)	High	High	Net exporter of cotton yarn.	Almost 20% of total production is exported.	Cotton price expected to drop	Demand for readymade garments observed slow down	Can be obtained
IT services	Low	Low	Export form 80% of total revenue	Not a relevant parameter	Not a relevant parameter	Domestic revenue forms only 20%	Not required as per COVID impact
Pharma	Moderate	Low	Raw material dependency on China (70% of bulk and API)	Export to US and Europe accounts to major share of overall exports	Raw material cost increased	Domestic consumption is impacted due to shortage in supply	May require as per COVID impact
Construction	High	High	Not a relevant parameter	Not a relevant parameter	Price of steel, cement, sand may increase	Delay in project may impact repayment capacity	Can be obtained
Steel	High	Low	8% of steel ingots is imported	6% is exported of total production of steels	Prices to be under pressure owing to weak demand	Domestic consumption to construction and automobile may slow down	Can be obtained
Telecom	Low	Low	Not a relevant parameter	Not a relevant parameter	Not a relevant parameter	100% Domestic consumption	Not required as per COVID impact

Ripple effect on SME Sector

Shortfall in sourcing raw material will lead to a sharp increase in prices and have a ripple effect on SMEs. SMEs dependent on large corporations for sourcing of raw material may find difficulty to absorb the high cost of raw material sourcing. Further, SMEs may find operational difficulty post lockdown owing limited cushion to last a pandemic like this one. This situation is further magnified through ongoing expenses like salaries to employees and other operational costs like power and utilities.

Maximum impact would be observed on below category companies

- All ancillaries' sectors which are dependent on large corporates for supply of raw materials
- Borrower types who saw a temporary stress post demonetization
- Borrowers who do approach the Bank for WC Finance or increase in drawing power post RBI announcement

Strategy for credit monitoring and collections: Covid impact sectors

- Financial institutions should revisit their risk and credit policy to prepare themselves to adapt to the changed circumstances. For fund base and non-fund base limit calculation and assessment, there is no clear regulatory announcement and the borrower may find difficulty in adhering to the obligations that arrived out of the non-fund base limit in this quarter.
- The methodology should be redefined, on the assessment for the recalibration of drawing power to the sector which may see a major impact of COVID-19.
- The financial institutions should revisit the existing portfolio, come up with monitoring and collection strategies which can be segmented into the below 4 categories:
  - The borrower who had not missed any payments or never in more the 10 DPD bucket last 12-18 months
  - The borrower who was under 11-30 DPD in last 12-18 months
  - The borrower who was under 31-60 DPD in last 12-18 months
  - The borrower who is under 60-90 DPD or whose loans were restructured/rescheduled or cured in the last 24 months

Tomorrow: triage approach to tackle Covid-19

Looking at the current fall-out of COVID 19, moratorium/deferment is being provided by the RBI will help borrowers tide over the economic uncertainty. However, banks may need to identify industries/sector which would be impacted the most and develop policies and frameworks as experienced during demonetization. Many profiles may have a high intention to pay and may bounce back as the lockdown gets lifted and demand begins to rise again. Banks and NBFCs need to spend the next 2 months to identify customer segments and develop a triage approach and identify

1. A borrower with high intentions and ability to repay and may run a scenario-driven analysis to assess the impact and take pro-active measures to ensure that the accounts are not rolling forward to higher delinquent buckets.

Scenario: Covid-19	Definition of scenarios of crisis evolution in terms of duration and dissemination		
Business: To estimate forward looking P&L/BS and calculation of stressed ratios	Identification of sectors and geographic areas more to affected in terms of revenues at risk	Identification of sectors at increased risk with respect to the supply chain	Identification of sectors based on dependency on trade or domestic consumption
Impact	Revenue ↓	Cost of goods sold ↑	Revenue ↓
Risk: Analyzing sustainability of Corporate and SME	Modelling of sector/geography scenarios impacts on single name solvency; estimation of the potential impact on revenues and costs across identified geographies/sectors.		
	Calculation of prospective cash flows, P&L, balance sheet, and other risks/sustainability ratios.		
	Ad-hoc analysis on a few selected counterparties and individual plans definition/ implementation; such as, amount of new debt that allows the client to survive the crisis.		
Credit monitoring and risk:	Early Warning Signal (EWS) framework to be redefined: 1) A bank must perform Behavioral analysis to identify stressed accounts		

<table>
<tr><td></td><td colspan="3">2) A bank must leverage Machine Learning (ML) enabled EWS to ensure a complete picture of the borrower, external data sets to be onboarded (e.g.: Bureau data)
3) Regulatory stress testing, and supplemental stress testing, layout specific hypothetical scenarios to assess their potential impact
4) Building off the financial scenarios to determine the level of action that may be required on the cost base of the organization in each of the outcomes
5) Examine performance assumptions built into existing models
6) Incorporate implications of near-term actions, including on expenses
7) Usage of external & alternate data into their EWS mechanism specifically for the customers who don’t hold current accounts with Bank and NBFCs where the data availability is minimal</td></tr>
<tr><td>Collection and monitoring: Bucketing and prioritization of clients</td><td>Category A: Low risk clients able to manage the crisis across scenarios</td><td>Category B: Healthy clients before the crisis and able to sustain extra-debt once the crisis is over</td><td>Category C: Non-healthy clients before the crisis or not able to sustain extra-debt once the crisis is over</td></tr>
<tr><td>Collection</td><td colspan="3">1) Soft collection strategy for Category B, speaking to borrowers and understanding liquidity stress and restructure current debt for borrowers understanding chances of revival and willingness of the borrower to repay debt.
2) Customer already under stress,
- Bank to follow traditional approach viz, call, e-mail and SMS reminder.
- Restructuring- Understanding revival strategy
- Exit- if nil chances of revival but borrower have other sources of income
- Approach IBC- if nil chances of revival/No other source of income.</td></tr>
<tr><td rowspan="4">IT: demand for digital</td><td colspan="3">The financial institutions to adopt digital interface, may help SME and Large corporate to apply online and FIs can seek digital document for these loans,</td></tr>
<tr><td colspan="3">The FIs should rapidly develop and roll out an awareness/education campaign around digital capabilities and ramp up call-center support for less tech-savvy SME clients as they transition from traditional banking to digital channels</td></tr>
<tr><td colspan="3">The FIs to be prepared for a sudden surge in digital channel (Internet/Online Banking) usage to ensure that the systems will remain online if they experience a tentative 100% increase in traffic</td></tr>
<tr><td colspan="3">The FIs to enable cybersecurity, for strong and practical security standards and practice</td></tr>
</table>

2. Borrower with low intentions and habituate to delay can be assess in below mentioned segment and financial institution may take pro-active measures to ensure that these accounts are not rolling forward to higher delinquent buckets,

The borrower who had not been defaulted in the last 12-18 months and the borrower who was under 11-30 DPD in the last 12-18 months: If borrowers in such categories are opting for payment holiday there may be two scenarios.

1. First could be that the borrower wants to ensure enough liquidity if the crisis extends. This can be the case for borrowers who will like to ensure enough cash flows at their end.

2. The second scenario could be that the borrower is expecting a temporary slump in business, considering bank may or may not provide enhancement in drawing power and the borrower has to make payment to the supplier, borrowers opt for regulatory holiday and priories payment to the supplier.

<u>The borrower who were under 30+ DPD but less than 60 DPD in the last 12-18 months:</u> There could be scenarios where the borrower had shown signs of delay in installment repayment history and/or servicing of interest and was captured under 30-60 DPDs bucket. Such borrowers could use this opportunity to delay the payment hence it is imperative for banks to keep a track of such borrowers and monitor them strictly once the payment holiday ends.

<u>The borrower who is under 60 - 90 DPD:</u> This category of borrowers is on the verge of being classified as NPA. However, they will most likely use the payment holiday given by the RBI. As per the directive of the regulatory, banks will not be able to classify those borrows under the NPA category. However, there is a high chance that once the payment holiday ends then these categories of borrowers may be reluctant to service the interest/pay the EMIs within the stipulated timeframe. These borrowers should be closely monitored and proactively follow up approach may help in advance to understand the intention and ability of such borrowers

Timely restructuring/rehabilitation in deserving cases should be envisaged by the bank to ensure that accounts do not slip into the NPA category. To do this, banks should track the movement of accounts that are about to be moved to another stage post the completion of the moratorium period and accordingly amend the policy to ensure that accounts are not getting further downgraded. Such accounts may also be eligible for asset classification benefits.

Beyond: action plan for financial institutions

Credit and collections would remain integral functions of any lending institution. Digitization of systems and reduction in manual interventions is the key to long term success. As we state action plans for financial institutions' stability, we need to focus on four broad parameters viz business position, risk management, funding and liquidity and capital and earnings. These are parameters to rate any financial institution and impact on these parameters may reflect in the ratings of financial institutions.

Business position	▸ Work with relevant departments and units globally to develop an understanding of potential revenue hits and outline steps for mitigation.
Risk management	▸ Find out which sectors/regions/clients are most at risk. ▸ Reach out to clients with communications and information requests to provide temporary help as appropriate. ▸ Loan loss provisions under different economic scenarios should be re-examined. ▸ Amending the Lending and Credit Risk Management policies, focusing more on scenario driven analysis and stress analysis.

	- Factoring extreme scenarios such as Demonetization and CoVID 19 into their pricing models as a component in Credit Risk Premium specifically for the firms who may be vulnerable to these events
Funding and liquidity management	- Adequate liquidity across the enterprise globally should be ensured. Banks should be closely reviewing and monitoring daily liquidity stress testing reporting, limit/threshold monitoring, liquidity coverage ratio (LCR) results, etc. They should be monitoring market activity against their liquidity stress indicators for triggers that would activate the CFP. - Analyses should be conducted to determine the size and impact of any liquidity shortfall if liquidity stress indicators are being triggered regularly. Impacts to secured funding/asset sales (including market access) should be included in the analysis. This information should be presented to management across liquidity and liquidity risk (liquidity crisis team) as part of the CFP being activated. - Liquidity preservation actions should be part of banks' CFPs and would include options for ensuring liquidity if the CFP has been invoked. - Requirements should be recalibrated based on emerging market conditions and likely future scenarios. - Banks should go beyond the LCR requirements when communicating their liquidity status to regulators. Regulatory relations teams should be part of the liquidity crisis management team/committee under the CFP.
Capital and earning management	- Assumptions driving the valuation of asset values should be revisited. - Additional stress tests with different underlying scenarios specific to COVID-19 should be conducted.
Trading/hedging strategies	- Capital allocations and hedging strategies across trading books should be revisited.

If the impact of Covid-19 pandemic prolongs, banks may have to deploy more capital for provisioning and may create a huge impact on NBFCs and MFIs due to additional higher provisions. This may further impact their exposure to NBFCs, and they may end up losing money causing significant impact on financial institutions.

Considering current capital and liquidity position of financial institutions (FI), FIs have to be extra cautious for new loan book and have to include five main factors in amended credit lending policy, which broadly focus on below mentioned points

Resolve

Address the immediate challenges that COVID-19 represents to institutions, workforce, customers and business partners

Resilience

Address near term cash management challenges, and broader resiliency issues during virus-related shutdowns and economic knock-on effects

Return

Create a detailed plan to return the business back to scale quickly, as the virus evolves and knock on effects become clear

Reimagination

Re-imagine the next "normal", what a discontinuous shift looks like, and implications for how the institution should reinvent

Reform

Be clear about how the regulatory and competitive environment in the industry may shift

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