MOODY'S
INVESTORS SERVICE

BANKING SYSTEM OUTLOOK

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India

Our outlook for the Indian banking system is negative. The outlook expresses our expectation of how bank creditworthiness will evolve in this system over the next 12-18 months.

Summary Opinion

Our outlook for the Indian banking system is negative, as it has been since November 2011. The negative outlook reflects our views that economic growth will be weak, banks' asset quality will deteriorate, and profitability will decline because banks need to increase loan loss reserves and will not be able to fully pass on rising funding costs or offset these through loan growth. As a result, public-sector banks will remain dependent upon government injections to maintain their capitalization levels. The banks' stable funding and strong systemic support only partly offset the negative drivers.

Our negative outlook on the Indian banking system pertains mainly to the public-sector banks. Public-sector banks represent more than 70% of total banking system assets. They have also experienced larger growth in nonperforming and restructured loans, as well as greater weakening in profits. These trends are likely to continue for public-sector banks. In contrast, private-sector banks have stronger margins, reserves, and capital levels, which will serve as buffers in a more challenging environment.

Economic growth will be the weakest in over a decade. We recently lowered our forecast for Indian economic growth for the fiscal year ending March 2014 (FY2014) to 4.5% from 5.5%, the lowest since the FY2003.[1] The downward adjustment was driven by the increase in inflation risk in conjunction with the rupee's depreciation. The Reserve Bank of India (RBI) has raised policy rates to contain rising inflation at the expense of growth.

Asset quality will deteriorate. Nonperforming loans (NPLs) and restructured loans will rise in particular at public-sector banks that lend heavily to infrastructure projects. A combination of higher costs for imported inputs and inflexible tariffs will prompt more delays and restructuring of infrastructure projects. While recent reforms, such as Coal India's plans to increase domestic production and moves to lift the ban on iron ore mining, will help sectors such as power and steel, the full benefit of reforms will take time. Weaker prospects for growth and higher inflation also add to the challenges for highly leveraged corporate sectors.

[1] Moody's Investors Service, Central Statistical Organization India: Real GDP growth during FY2003 was 3.99%.

Capitalization levels will remain relatively low, with public-sector banks dependent on government injections. Indian banks, especially public-sector banks, have low capitalization levels compared with global peers. We estimate that public-sector banks' capital requirements could easily top the INR140 billion the Indian government (Baa3 stable) has budgeted for the current fiscal year, and are likely to be higher still next fiscal year. The need for additional capital will come at a time when the government will be under pressure to better manage the budget deficit.

Profitability will fall. Net interest margin (NIM) will compress further since it will be difficult in the weaker operating environment for banks to raise lending rates to match higher funding costs. The NIM pressure will be higher on banks that have less low-cost current- and savings account (CASA) deposits. At the same time, credit costs should rise as asset quality weakens.

Government capital injections will continue for public-sector banks. In October, the Indian government announced allocations to individual banks from the INR140 billion budgeted for capital infusions to public-sector banks. As with the budgeted capital injections in FY2011 and FY2012, the capital injections allow banks to meet their targeted Tier 1 ratios. The government's willingness and ability to continue providing annual capital infusions underpin our positive view on systemic support and the uplift received in many banks' ratings.

Liquidity remains stable. Indian banks continue to enjoy sound liquidity, with our rated banks enjoying an asset-weighted average loan-to-deposit ratio of 86%. Funding is largely deposit-based, with relatively low reliance on wholesale funds. Moreover, the RBI has been supportive of liquidity by lowering rates for the central bank's short-term facilities, while raising base rates in an effort to tackle inflation.

Our negative outlook on the Indian banking system is consistent with the negative rating outlooks we have on the bank financial strength ratings (BFSR) of eight of the 15 rated banks. The Indian banking system's asset-weighted standalone credit profile of ba2 is two notches below the asset-weighted average long-term bank deposit rating of Baa3, meaning we have on average two notches of uplift based on systemic support considerations.

EXHIBIT 1

Overview of Key Drivers for India's Negative Banking System Outlook

Operating environment	Deteriorating	-	Expectations for domestic economic growth have fallen as rupee depreciation exacerbates inflationary risks
		-	Government may be cautious in tackling difficult policy choices ahead of elections in May 2014
Asset quality and capital	Deteriorating	-	Asset quality to weaken further as the economic cycle turns to weaker growth and infrastructure delays continue, on top of already high and under-provisioned balances of NPLs and restructured loans
		-	Internal capital generation is insufficient to sustain the public-sector banks' capital ratios, thereby necessitating repeated injections of equity from the government
		-	Corporate sectors are highly leveraged, and face additional challenges as growth slows and inflation rises.
Funding and liquidity	Stable	+	Deposit funding dominates, with minimal reliance on market funding
		–	Cost of funds is rising in response to RBI policies targeted at inflation and the exchange rate
Profitability and efficiency	Deteriorating	-	Net interest margin (NIM) compression likely to worsen as lenders face higher funding costs and weaker loan demand
		-	High credit costs continue to impede net income growth
Systemic support	Stable	+	Budgeted amounts for support of public-sector banks and ongoing capital injections by the RBI demonstrate high levels of support
		+	RBI leadership has acted decisively on interest rates and shown a strong commitment to structural reforms
		-	Though current regulations are weak, India's status as G20 and Financial Stability Board (FSB) member has led to initial drafting of resolution-regime legislation

EXHIBIT 2

Key Indicators for Moody's-Rated Banks in India

	FY2013	FY2012	FY2011	FY2010
Pre-Provision Income (PPI) / Average Risk Weighted Assets (RWA)	2.7%	2.9%	3.0%	2.8%
Net Income / Average RWAs	1.3%	1.3%	1.4%	1.4%
(Market Funds - Liquid Assets) / Total Assets	-13.2%	-13.9%	-15.9%	-18.6%
Liquid Assets / Total Assets	28.3%	28.3%	29.5%	31.8%
Cost-to-Income Ratio	45.2%	44.2%	45.3%	46.0%
Tier 1 Ratio	8.5%	8.5%	8.0%	8.5%
Tangible Common Equity / RWAs	8.6%	8.5%	7.8%	8.7%
Problem Loans / Gross Loans	3.3%	2.9%	2.4%	2.5%
Problems Loans / (Shareholders' Equity + Loan Loss Reserves)	26.9%	23.9%	20.6%	19.8%

Note: data is asset-weighted for the 15 Moody's-rated banks.

FY refers the financial year ending in March. For instance, FY2013 refers to the period between 1 April 2012 and 31 March 2013.

Source: Moody's Investors Service, Banking Financial Metrics - Publicly adjusted data

Rating Universe

» We rate 15 banks in India, including 11 public-sector banks and four private-sector banks

» Government must maintain its ownership levels in public-sector banks above the 51% minimum[2]

EXHIBIT 3

Rating Universe

Public-Sector Banks	Total Assets (INR trillion, Mar-13)	Domestic Market Share Loans (Mar-13)	Domestic Market Share Deposits (Mar-13)	LT LC / FC Deposit Rating and Outlook	Standalone Credit Strength* and Outlook	Notches uplift for external support
State Bank of India (SBI)	15.66	18.3%	15.7%	Baa3 / Baa3 / STA	D+ / ba1 / NEG	1
Bank of Baroda (BOB)	5.47	5.6%	5.4%	Baa3 / Baa3 / STA	D / ba2 / NEG	2
Punjab National Bank (PNB)	4.79	5.4%	5.1%	Baa3 / Baa3 / STA	D- / ba3 / STA	3
Bank of India (BOI)	4.53	5.0%	4.6%	Baa3 / Baa3 / STA	D / ba2 / NEG	2
Canara Bank (CAN)	4.12	4.1%	4.6%	Baa3 / Baa3 / STA	D / ba2 / NEG	2
IDBI Bank Ltd (IDBI)	3.23	3.4%	2.7%	Baa3 / Baa3 / STA	D- / ba3 / STA	3
Union Bank of India (UBI)	3.12	3.6%	3.4%	Baa3 / Baa3 / STA	D / ba2 / NEG	2
Central Bank of India (CBI)	2.68	3.0%	3.0%	Baa3 / Baa3 / NEG	E+ / b1 / STA	4
Indian Overseas Bank (IOB)	2.45	2.8%	2.7%	Baa3 / Baa3 / NEG	D- / ba3 / NEG	3
Syndicate Bank (Syn)	2.15	2.5%	2.2%	Baa3 / Baa3 / STA	D / ba2 / NEG	2
Oriental Bank of Commerce (OBC)	2.01	2.2%	2.4%	Baa3 / Baa3 / STA	D / ba2 / NEG	2
Private-Sector Banks						
ICICI Bank Ltd (ICICI)	5.37	5.1%	3.8%	Baa2 / Baa3 / STA	D+ / baa3 / STA	1
HDFC Bank Ltd (HDFC)	4.00	4.1%	4.0%	Baa2 / Baa3 / STA	D+ / baa3 / STA	1
Axis Bank Ltd (Axis)	3.41	3.4%	3.2%	Baa2 / Baa3 / STA	D+ / baa3 / STA	1
Yes Bank Ltd (Yes)	0.99	0.8%	0.8%	Baa3 / Baa3 / STA	D+ / ba1 / STA	1

Note: * Long-Term Bank Deposit Ratings reflect a bank's standalone credit strength and support considerations. A bank's standalone credit strength reflects its creditworthiness without considering support. The table shows the banks' standalone credit strength as indicated by our Bank Financial Strength Ratings (BFSR) on a scale from A to E, the corresponding trend, and the standalone BFSR mapped to our long-term scale (in small letters). For more detail, see Rating Methodology: Global Banks, published on 31 May 2013.

LC = Local Currency, FC = Foreign Currency; Assets, loans and deposits are based on unconsolidated data.

Source: Moody's Investors Service, Indian Banks'Association, Banks' Annual Reports

[2] The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.

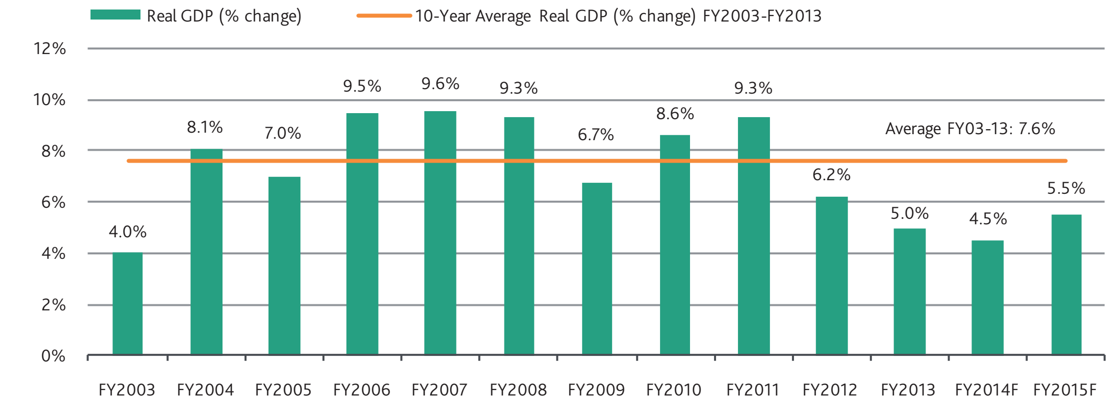
Operating Environment

Exchange-rate depreciation increases inflation risk, creating upward pressure on interest rates and dampening prospects for economic growth.

» We forecast GDP growth of 4.5% for FY2014, the lowest since FY2003 (Exhibit 4). Anticipation of the US winding down quantitative easing led to fears of capital outflows over the summer and an approximate 20% depreciation in the rupee against the US dollar between May and August. This heightened inflationary risks and led the RBI to tighten policy at the expense of growth (Exhibit 5). While the depreciation has made some sectors more competitive, capacity constraints and higher input prices limit India's ability to boost exports.

EXHIBIT 4

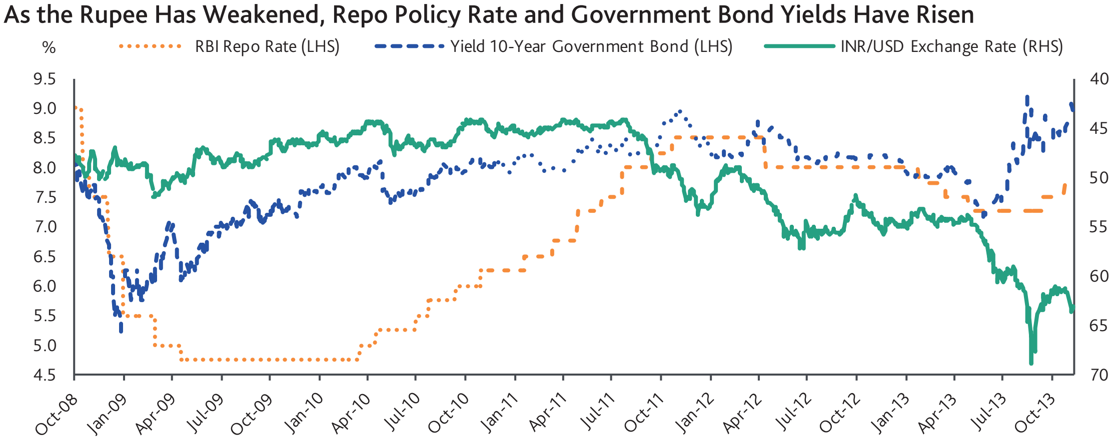
Economic Growth Will Slow This Year to the Lowest in a Decade



Source: Moody's Investors Service, Central Statistical Organization India

EXHIBIT 5

As the Rupee Has Weakened, Repo Policy Rate and Government Bond Yields Have Risen



Source: RBI, Bloomberg

Progress on Structural Reforms Hindered by Elections

» The upcoming general elections in May are likely to slow efforts by the government to undertake structural reforms needed to address roadblocks and inefficiencies in several sectors that have experienced asset-quality problems. These include reforms of tariffs in the power sector, streamlining approvals in industrial sectors, and reforming subsidies for imported inputs such as diesel. Partial implementation of reforms heightens risk that inefficiencies will continue to cause asset-quality problems for banks lending to structurally challenged sectors.

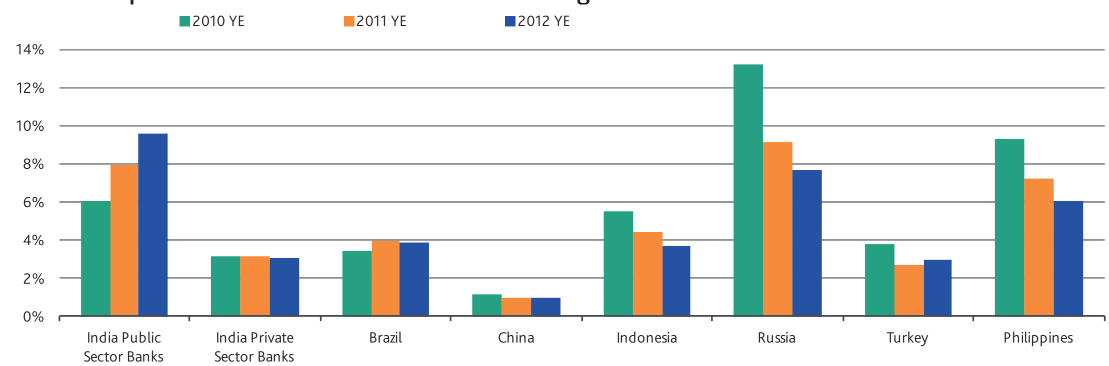
Asset Quality and Capital

Asset quality is likely to weaken further as infrastructure project problems continue and the highly leveraged corporate sector faces a harsher economic environment.

» Indian public-sector banks' asset quality is weaker than bank asset quality in other large emerging markets (Exhibit 6), with asset-weighted average gross NPLs representing 3.7% of total gross loans in FY2013 for rated public-sector banks, a ratio that we expect to rise further over the outlook horizon. Key contributors to the increase will be infrastructure project loans and corporate sectors stressed by high leverage and adverse business conditions, including slower growth, higher interest rates and higher inflation. The asset-weighted average gross NPL ratio for private-sector banks was 1.8% in FY2013, which compares relatively well against global peers, but they too will be affected by stressed corporate borrowers over the outlook horizon.

EXHIBIT 6

Ratio of "Impaired" Loans to Gross Loans Is Increasing at Indian Public-Sector Banks



System aggregate data is asset-weighted average for Moody's rated banks.

Note 1: Impaired loans are based on gross NPLs; For banks in India, Indonesia and Russia, restructured loans are also included. For banks in the Philippines, foreclosed properties are also included. No additional adjustments made for banks in Brazil, China and Turkey.

Note 2: for Indian banks 2012 YE is the financial year ending March 2013.

Source: Moody's Investors Service Banking Financial Metrics

Infrastructure Sectors Remain Weak

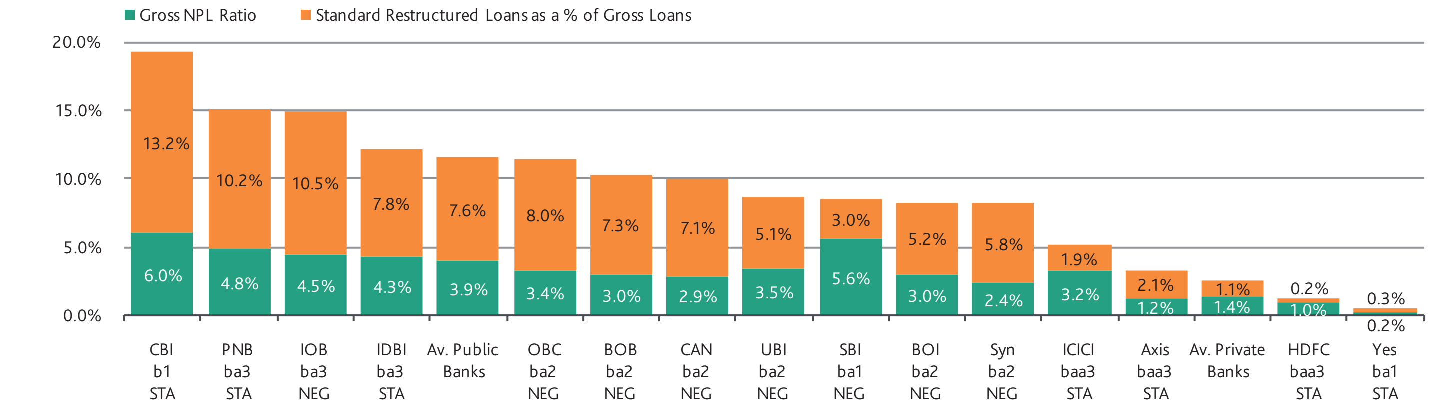
» Public-sector banks will face greater asset-quality deterioration from sectors such as power and other infrastructure. Structural inefficiencies (including difficulties in securing inputs and obtaining regulatory approvals) have led to project delays and cost overruns, which will continue or worsen due to exchange rate volatility and weaker growth expectations.

» The poor performance of infrastructure loans has been reflected not only in the levels of NPLs, but also in the levels of restructured loans (Exhibit 7). Restructured loans -- which include those that have materially revised terms and are not classified as non-performing -- account for 5.8% of total system loans as of end-March 2013.[3] We have observed in recent years among those rated banks that periodically report the amount of newly restructured loans that 15%-30% of restructured loans have turned into NPLs within 12 months of restructuring. Hence, we expect a similar percentage of restructured loans to become NPLs.

[3] Source: RBI Annual Report 2012-2013, page 41, Table II.4, August 2013

EXHIBIT 7

Public-Sector Banks Have More NPLs and Restructured Loans (June 2013)



Note: the average for public and private banks is a simple average of the gross NPL ratio and restructured loans as a percent of gross loans ratio.
Source: banks' quarterly reports Jun-2013

Higher Leverage in the Corporate Sector

» While continued problems in infrastructure projects will mostly affect public-sector banks, high and expanding corporate leverage is a problem for the whole banking system. The weighted average ratio of net debt to equity has risen to 257% in FY2013 from 193% as of FY2011. Therefore, not only are interest rates rising, but borrowers must also service a larger stock of debt.

» At the same time, the weaker economy will depress corporate revenues. Interest coverage is declining across sectors, not just sectors such as utilities and infrastructure that are especially challenged by infrastructure project delays. (Exhibit 8).

» Asset quality for mid-sized corporate borrowers will continue to suffer, as they are negatively affected by the impact of aggressive expansion before the cycle turned and pressure from large corporates to extend working capital cycles. While large corporates have therefore so far avoided significant loan delinquencies, they may in turn face more difficulties if the rebound in economic growth is weak or significantly prolonged,

» Corporate borrowers with substantial foreign exchange liabilities face upward revaluations of debt in rupee terms. Exchange rate depreciation also hurts the profit margins of companies with domestic revenues and heavy reliance on imported inputs.[4]

» Many Indian corporate borrowers can offset foreign exchange liabilities with overseas operations or assets, including corporate groups that borrowed for overseas expansion. Other large borrowers include oil products producers, who primarily sell to a domestic market but can adjust prices to rising input costs. These two factors mitigate foreign exchange risk for the large corporates we rate, though smaller corporates without these mitigants may face heightened foreign exchange risk.

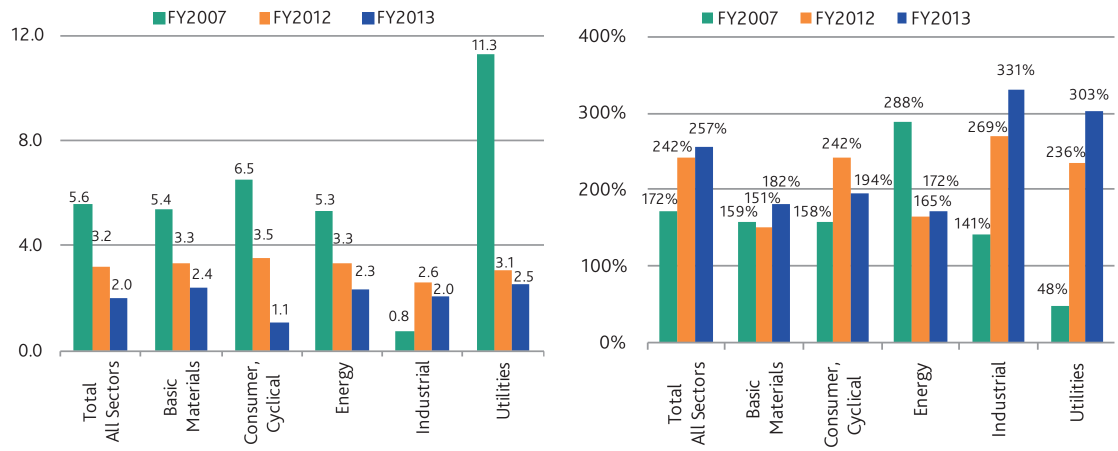
[4] Moody's Investors Service, Indian Coporates, Special Comment: "Higher Borrowing Costs, Weak Rupee Will Pressure Indian Corporate Credit Metrics"

EXHIBIT 8

Financial Stress in Indian Corporates

Weighted average interest coverage ratio by key sectors

Weighted average net debt to equity by key sectors



Source: Bloomberg: Data for listed companies on Bombay Stock Exchange; net debt weighted average per sector.

» In contrast to the corporate sector, retail loan quality remains sound, demonstrating the continued strength of domestic demand. At the same time, banks have adopted a more conservative approach to retail lending, after the aftermath of overly aggressive growth in the last decade. The Credit Information Bureau (India) Limited (CIBIL), India's consumer credit bureau, has also benefited lenders after establishing its own operating history. We expect current asset quality to sustain, as employment has not been negatively impacted by the recent market volatility.

» Above average rainfall in the monsoon season has also contributed to stronger incomes in the agricultural sector and some relief on the consumer price index.

» For private-sector banks, the relative strength of large corporate and retail borrowers, as well as a smaller exposure to problematic infrastructure projects, contribute to the stronger asset quality. We expect private-sector banks to maintain better asset quality, since they continue to pursue retail loan growth in a more measured fashion than that observed in the years leading up to 2008.

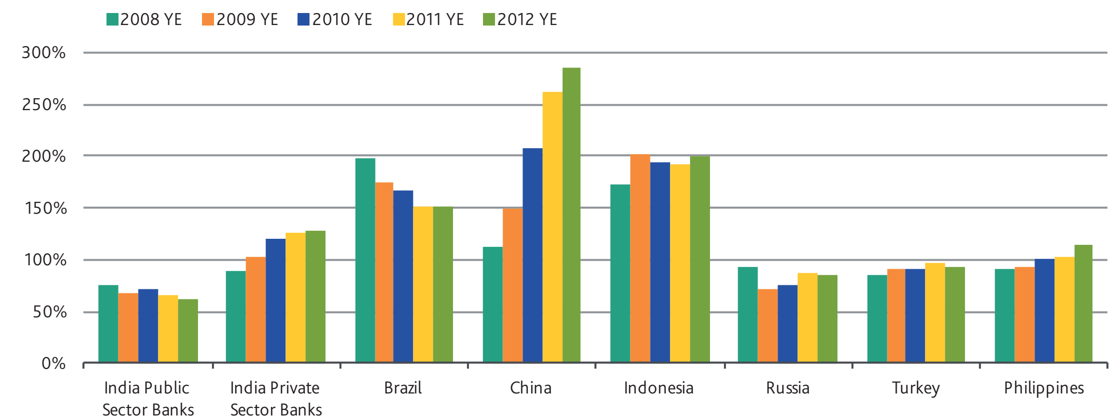
Provisioning and Capital Are Relatively Low for Public-Sector Banks

» Bank provisions have weakened relative to the higher level of NPLs and restructured loans, particularly for public-sector banks. Asset-weighted average loan loss reserves coverage was 61% of gross NPLs (excluding restructured loans) in FY2013 down from 66% in FY2012 for rated public-sector banks, a level weaker than those of comparable systems (Exhibit 9). The asset-weighted average for private-sector banks was 127% in FY2013 compared to 125% in FY2012. Many public-sector banks have loan loss reserves below 70% of reported NPLs, which is the assumed expected loss given default ratio we use in our stress tests for Indian banks.[5]

[5] Our assumption is consistent with the RBI's 70% loss given default assumption used in its own stress tests: Reserve Bank of India, Discussion Paper on Introduction of Dynamic Loan Loss Provisioning Framework for Banks in India, page 18–20.

EXHIBIT 9

Ratio of Loan Loss Reserves to Gross NPLs Is Declining at Indian Public-Sector Banks



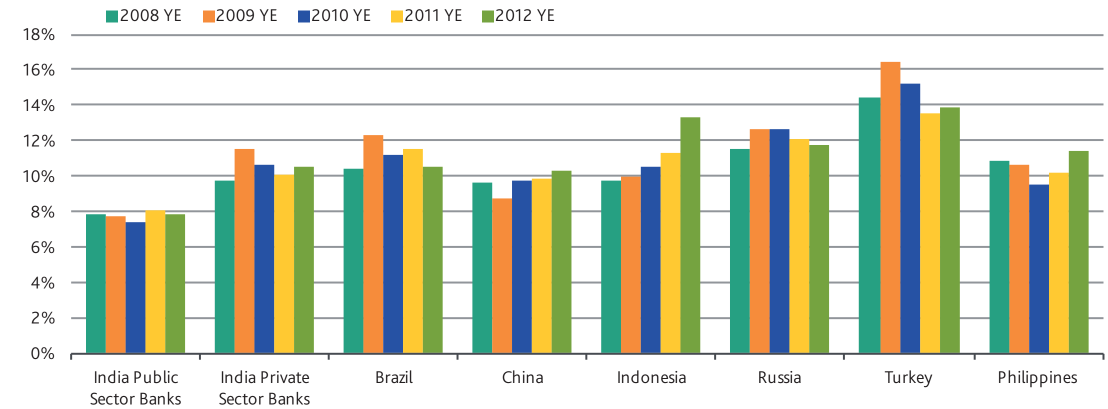
System aggregate data is asset-weighted average for Moody's rated banks.
Source: Moody's Investors Service Banking Financial Metrics

- If we reclassify 25% of restructured loans as NPLs, the weighted average coverage ratio would effectively stand at 44% for public-sector banks compared with 61% without adjusting for restructured loans. We note that in the recent past, the average write-down taken by banks on restructuring has been at a modest 1%-2%. This implies that previous restructurings have not been severe and may result in further non-performance post-restructuring.
- Indian banks reported asset-weighted average Tier 1 ratios of 9.7% on a reported basis and 8.5% on an adjusted[6] basis as of March 2013. On an adjusted basis, the asset-weighted average Tier 1 ratio for rated public-sector banks is significantly lower at 7.9% compared with 10.6% for rated private-sector banks in FY2013.
- These levels are comparable to our own calculations of tangible common equity to RWA (which we view as a proxy for core Tier 1 capital under Basel III) of 9.9% on a reported basis and 8.6% on an adjusted basis. While these levels exceed minimum Basel III requirements, they appear low in comparison with global peers (Exhibit 10).

[6] To ensure globally consistent capital ratios, Moody's applies a risk weight to government securities with a rating below Aa. Indian government securities are 50% risk weighted. We similarly risk weight banks holdings of Government securities in Brazil, Indonesia, Russia, Turkey and Philippines. See "Moody's Adjustment to Increase the Risk Weightings of Sovereign Debt Securities in the Analysis of Banks: Frequently Asked Questions"

EXHIBIT 10

Tier 1 Ratios in India Are Below Other Emerging Markets, Particularly for Public-Sector Banks



System aggregate data (asset-weighted average for Moody's rated banks) for Tier 1 ratio is risk-weighted for government securities.
Source: Moody's Investors Service Banking Financial Metrics

» Given that we expect nominal loan growth of 15%-16% for the FY2014, the Tier 1 ratio of most rated banks (especially public-sector banks) will decline, even taking into account capital retention.

» However, the government has provided capital to Indian banks over the past three fiscal years (Exhibit 11), and a total of INR140 billion has been allocated for capital injections in FY2014.

EXHIBIT 11

Public-Sector Banks Rely on Capital Injections

Public-Sector Banks	Reported Tier 1 Capital (INR billion, Mar-13)	Reported Tier 1 ratio (Mar-13)	Capital Injections by Government of India or Life Insurance Corporation of India (LICI) (INR billion) FY2011	FY2012	FY2013	Allocated FY2014[7]	Government Ownership (excl. LICI) (Jun-13)
State Bank of India	949.5	9.5%	-	79.0	30.0	20.0	62.3%
Bank of Baroda	308.6	10.1%	24.6	16.5	8.5	5.5	55.4%
Punjab National Bank	316.6	9.8%	1.8	22.5	12.5	5.0	57.9%
Bank of India	230.2	8.2%	10.1	10.4	8.1	10.0	64.1%
Canara Bank	237.8	9.8%	-	-	-	5.0	67.7%
IDBI Bank Limited	199.6	7.7%	31.2	11.9	5.6	18.0	71.7%
Union Bank of India	167.9	8.2%	6.8	6.5	11.1	5.0	57.9%
Central Bank of India	143.7	8.1%	-	9.5	24.1	18.0	85.3%
Indian Overseas Bank	120.9	7.8%	10.5	17.4	10.0	12.0	73.8%
Syndicate Bank	100.4	9.0%	6.3	3.3	-	2.0	66.2%
Oriental Bank of Commerce	126.1	9.2%	17.4	-	-	1.5	58.0%
Total capital injections by GOI			**108.8**	**120.0**	**109.9**	**102.0[8]**	
Total capital injections by LICI			**-**	**75.6**	**-**	**-**	

Tier 1 capital and Tier 1 ratio are under Basel II.

Source: Moody's Investors Service Banking Financial Metrics, National Stock Exchange

[7] Press Information Bureau, Government of India, Ministry of Finance. Press Release: "Capitalisation of Public Sector Banks During 2013-14," 23 October 2013.

[8] The total amount budgeted for government capital injections in FY2014 was INR140 billion, including INR38 billion allocated to banks not rated by Moody's.

» Based on our estimates, capital injections required by public-sector banks for FY2014 would exceed INR140 billion if profitability and asset quality deteriorate further and additional provisions are taken to raise coverage. Required capital injections for FY2015 could be higher still.

» Exhibit 12 estimates the total external capital requirement across rated Indian banks, assuming median loan growth of 16.5% for FY2015. The total external capital requirement represents the sum of any shortfalls in internally generated capital to meet a minimum 8% Tier 1 ratio (on a reported basis) for rated banks. Moody's-rated banks represent 67% of the total assets of the banking system.

» The target Tier 1 ratio assumes loan loss reserves are kept at a minimum of 70% of NPLs. We also increased reserves to cover expected losses on 25% of restructured loans.

» Exhibit 12 also incorporates a range of assumptions around asset quality and profitability. In terms of asset quality, we assume NPL deterioration in the range of 40 to 70 basis points (bps) annually for FY2014 and FY2015, which was the increase in median ratios in FY2012 and FY2013.

» In terms of profitability, we assume PPI/average RWA in the range of 3.0% to 2.9% for each forecasted year, which assumes profitability at or slightly below that of FY2013.

» For example, if NPLs increase by 50 bps per year from FY2013, and PPI/RWA are at 3.0%, the external capital requirement for our rated public-sector banks would stand at about INR280 billion for FY2015.

Projections for Potential Capital Requirements at Various Earnings and NPL Levels

EXHIBIT 12

Potential Capital Requirements at Various Earnings and NPL Levels

INR, billion

	Avg PPI/RWA: 3.00%	Avg PPI/RWA: 2.95%	Avg PPI/RWA: 2.90%
Annual NPL Growth	FY2015	FY2015	FY2015
40 bps	256.2	267.1	279.3
50 bps	281.5	294.4	307.3
60 bps	309.6	322.5	335.4
70 bps	337.6	350.5	363.4

Note: Assumes loan growth of 15.5% for FY2014 and 16.5% for FY2015

Source: Moody's Investors Service

» The external capital requirement shown in Exhibit 12 largely represents shortfalls in a few specific banks, such as Central Bank of India (CBI, Baa3 negative, BSFR E+/BCA b1 stable)[9], Indian Overseas Bank (IOB, Baa3 negative, BFSR D-/BCA ba3 negative), and Union Bank of India (UBI, Baa3 stable, BFSR D/BCA ba2 negative). These mid-sized public-sector banks each represent about 3% of total system assets, but received a combined 25% of FY2014's INR140 billion capital infusion.

» In our estimate, mid-sized public-sector banks in particular will continue to require external capital due to low operating margins and inadequate provisions. To sustain capitalization at these banks, our projections show the required amount in FY2015 could be double the INR140 billion

[9] The bank ratings shown are the banks' local currency deposit ratings, their stand alone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks.

budgeted for FY2014. Alternatively, the government may consider consolidations or mergers focused on these specific banks.

» Arguably, Exhibit 12 could underestimate the amount of capital required. Larger NPL increases may result from non-performance in the restructured loan book. Loan growth may be higher than expected. Future capital requirements would also need to account growth, as well as the full implementation of additional buffers and deductions under Basel III.

» Weakness in Indian equity markets also challenges the ability of banks to raise capital without any dilution of the holdings of their existing shareholders. Many Indian banks traded at a price-to-book ratio below 1.0 as of 14 November 2013. Indian banks are exploring the market for Basel III-compliant Additional Tier 1 and seem likely to focus initially on the US dollar offshore market, largely due to restrictions in domestic institutions' mandates from investing in such paper.

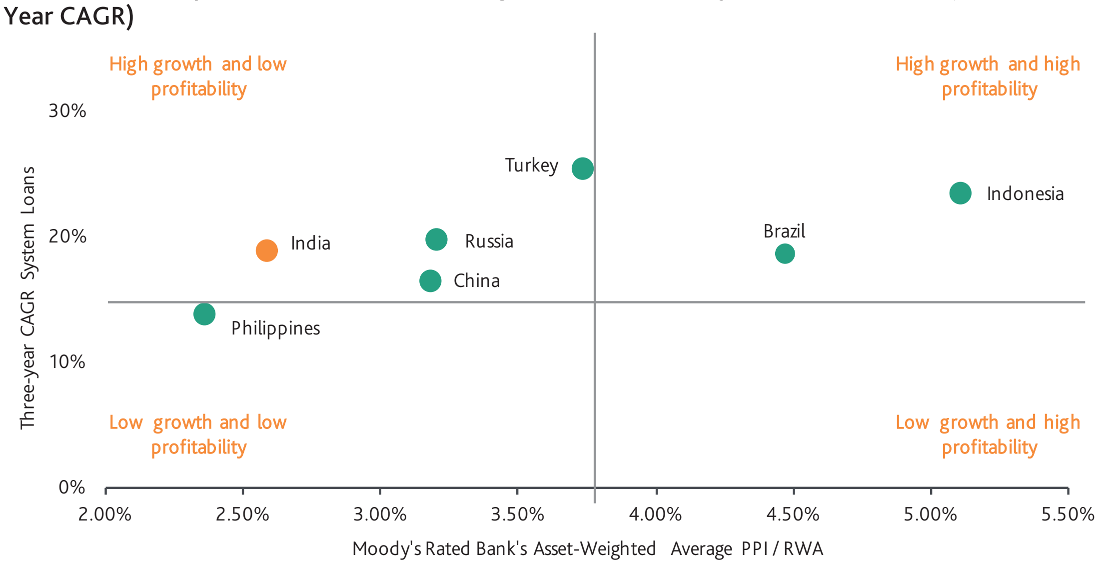
Profitability And Efficiency

Margin pressure to impact core profitability, and credit costs are likely to increase.

» On a regional basis, returns in the Indian banking sector are relatively low when compared to other banking systems with similar loan growth (Exhibit 13).

EXHIBIT 13

Global Peer Comparison – PPI As a Percentage of RWA Versus System Loan Growth (Three-Year CAGR)



Note: CAGR = Compound Annual Growth Rate

Source: Moody's Investors Service Banking Financial Metrics, Central Bank data

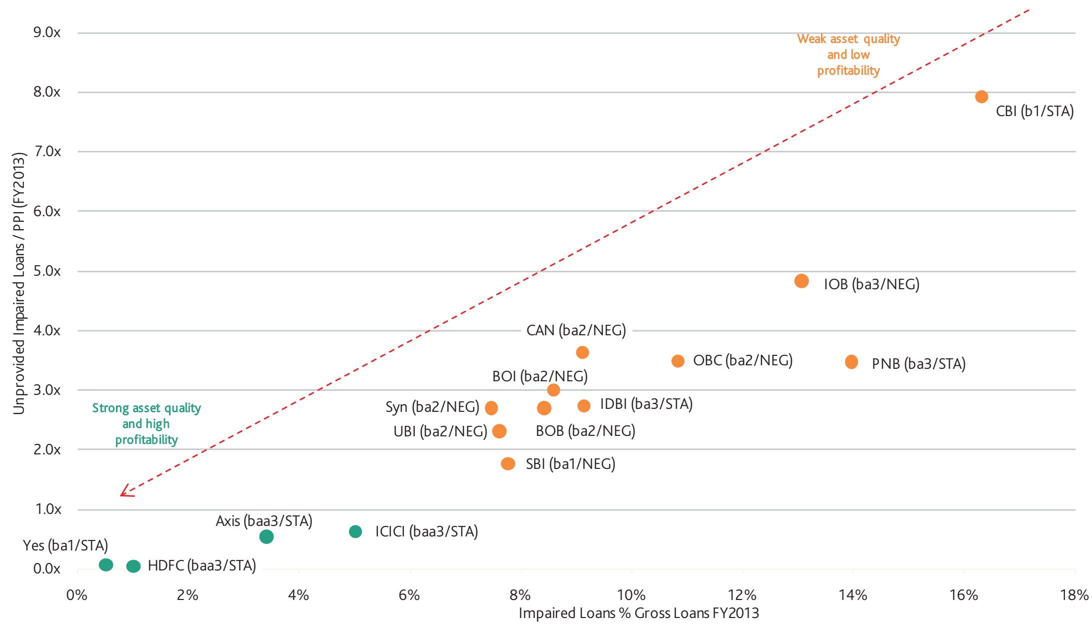
Credit Costs to Increase and Internal Capital Generation to Fall

» Further deterioration in asset quality will lead to a rise in credit costs. The current low level of provision buffers means that the banks' profits are sensitive to even a modest worsening in credit trends.

» Exhibit 14 shows that several banks lack the PPI required to make a significant improvement in their loan loss provisions or maintain provisions against further increases in impaired assets. The y-axis shows the unprovided impaired loans (including restructured loans) as a multiple of PPI for FY2013, so that a lower ratio means better profitability and a higher ratio means weaker profitability. The x-axis shows impaired loans as a percentage of gross loans, so that a higher percentage means weaker asset quality and a lower percentage means stronger asset quality. Banks such as CBI that appear in the upper right quadrant have weak asset quality and lack the PPI to sustain provisions.

EXHIBIT 14

Unprovided Impaired Loans/PPI Versus Impaired Loans As a Percentage of Gross Loans



Private-sector banks are represented by dots in green, public-sector banks by dots in orange.

Source: Moody's Investors Service Banking Financial Metrics

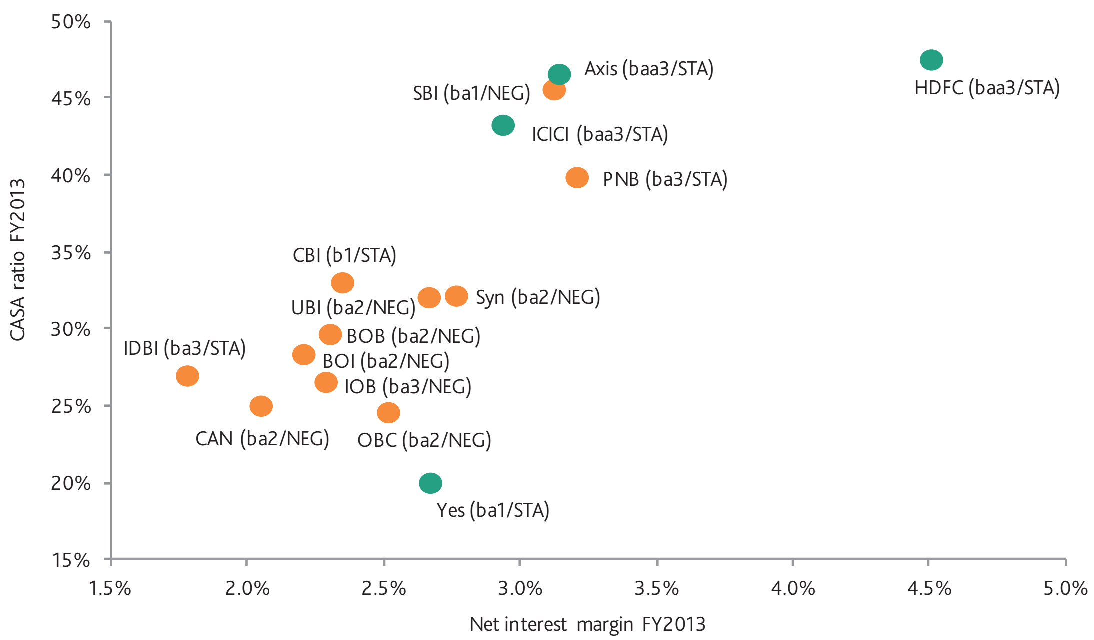
Limited Ability to Pass On Rising Funding Costs

» NIM will compress further since lending rates have not risen to match higher funding costs, and loan growth is not likely to be enough to cover the difference.

» Negative pressure on NIM will be most acute for banks with a smaller proportion of CASA deposits. On the other hand, private-sector banks ICICI Bank Ltd (Baa2 stable, BFSR D+/BCA baa3 stable)[10], HDFC Bank Ltd (Baa2 stable, BFSR D+/BCA baa3 stable), and Axis Bank Ltd (Baa2 stable, BFSR D+/BCA baa3 stable) have stronger deposit platforms. Among the public-sector banks, State Bank of India (SBI, Baa3 stable, BFSR D+/BCA ba1 negative) and Punjab National Bank (PNB, Baa3 stable, BFSR D-/BCA ba3 stable) have stronger CASA ratios (Exhibit 15).

[10] The bank ratings shown are the banks' local currency deposit ratings, their standalone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks.

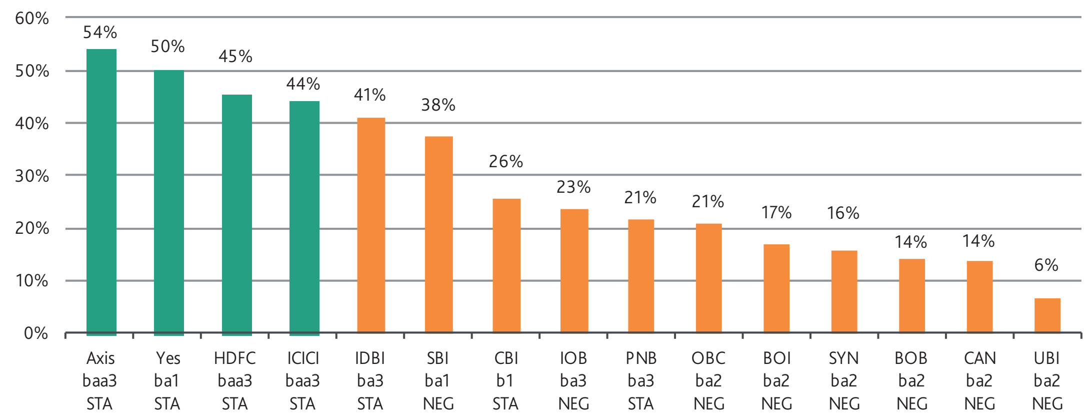
EXHIBIT 15
CASA Ratios and NIM



Private-sector banks are represented by dots in green, public-sector banks by dots in orange.
Source: Moody's Investors Service, Publicly adjusted ratios

» Another advantage that private-sector banks have is stronger pre-provision returns on RWA (PPI/RWA) owing to higher margins and fees, which contribute an average 48% of total income, compared to an average 22% for public-sector banks (Exhibit 16).

EXHIBIT 16
Net Fee Income As a Percentage of PPI



Private-sector banks are represented by bars in green, public-sector banks by bars in orange.
Source: Moody's Investors Service Banking Financial Metrics

Funding And Liquidity

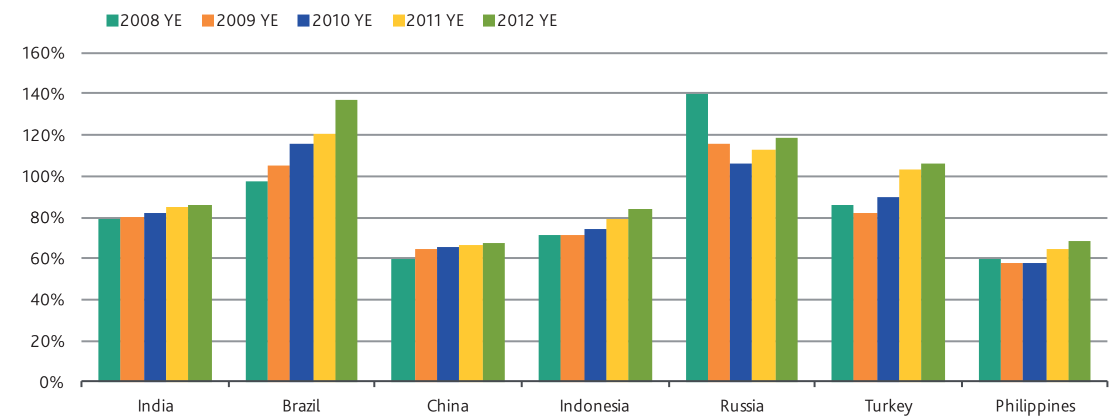
Despite rising interest rates, deposit funding continues to dominate with manageable levels of exposure to external borrowings.

Sound Domestic Liquidity with Low Reliance on Market Funding

» Funding is a source of strength for Indian banks. They show relatively low loan-to-deposit ratios when compared to global peers (Exhibit 17). Customer deposits continue to account for over three quarters of total deposits, and are supported by the high savings rate of Indian households. Deposit growth for FY2013 was 15%, relative to loan growth of 16%.

EXHIBIT 17

LDR Ratio Is Relatively Low Compared With Other Emerging Markets



System aggregate data is asset-weighted average for Moody's rated banks.
Source: Moody's Investors Service Banking Financial Metrics

» Indian banks have relatively low dependence on market funding, including the interbank market and fixed-income securities. Domestic currency liquidity has been comfortable, with liquid assets accounting for nearly 30% of total assets, because of the high levels of government securities held by the banks (on average about 21% of total assets for rated banks) to meet the RBI-prescribed norm of 23% for their statutory liquidity ratio. Under stress scenarios, we would expect the central bank to provide funding against that liquidity cushion.

Low Exposure to Foreign Currency Liabilities Limits Negative Foreign Exchange Impact

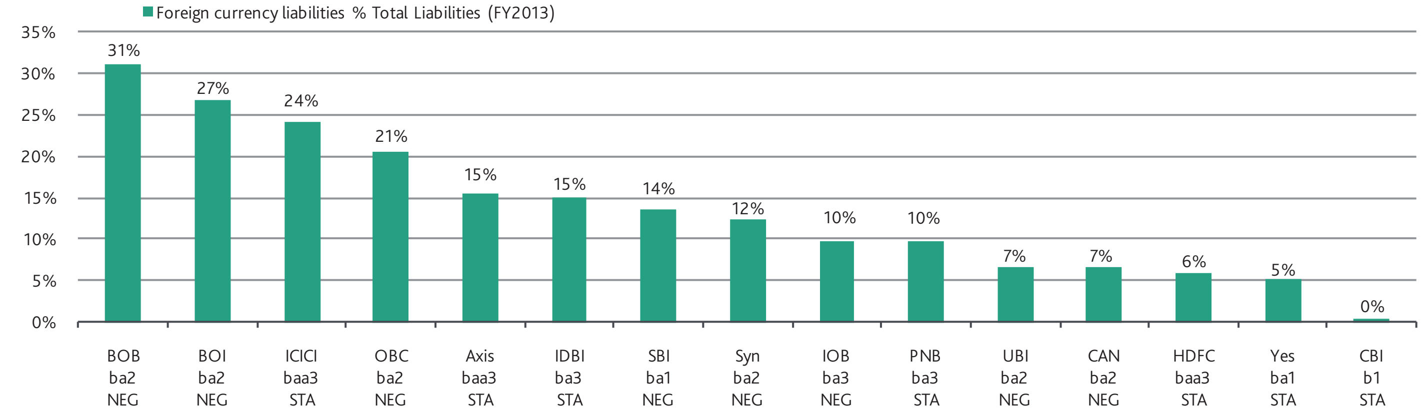
» The system also features low net exposures to foreign exchange shocks as foreign currency liabilities account for only 15% of total liabilities of Moody's rated Indian banks (Exhibit 18)

» The relatively low proportion of foreign exchange liabilities illustrates the banking system's largely domestic focus, though this focus alone does not imply a rating strength. Banks with the lowest proportion of foreign exchange liabilities include better-rated private-sector banks with a domestic retail focus (HDFC), as well as weaker public-sector banks with large infrastructure exposures (CBI).

» Banks with higher proportions of foreign currency liabilities, such as Bank of Baroda (BOB, Baa3 stable, BFSR D/BCA ba2 negative), Bank of India (BOI, Baa3 stable, BFSR D/BCA ba2 negative), and ICICI, typically hold these liabilities through off-shore branches, where the offsetting foreign exchange assets mitigate the risk of mismatch.

EXHIBIT 18

Foreign Currency Liabilities to Total Liabilities for Moody's-Rated Banks



Source: Moody's Investors Service Banking Financial Metrics, Banks' Annual Reports

Systemic Support

Degree of systemic support remains high, although moves to a bail-in regime may be forthcoming.

» The government remains active in supporting the banking sector, primarily through its annual capital injections to public-sector banks. We expect further fiscal appropriations after March 2014 for the banking sector, regardless of the outcome of the May 2014 elections. Our view is supported by the public-sector banks' 73% market share by total assets[11] and their role in funding critical sectors of the economy (e.g. power, infrastructure) and state-owned enterprises.

» In recent years, these capital injections have been regular and predictable, since they are budgeted at the start of each government fiscal year (though distributions are decided later in the year). As a result, we do not consider these to be extraordinary capital injections, executed to prevent non-viability. Rather, they are part of the public-sector banks' operating models and factored into the standalone ratings.

» Recent statements by the RBI also signal a positive commitment to further reforms that could increase transparency and governance, as well as improve recovery rates on bad assets. However, significant reforms will require some time to take effect.

» The RBI has provided guidance on point of non-viability (PONV) requirements for Basel III-qualifying capital instruments, which do not require the development of bail-in mechanisms and resolution regimes. There is also increasing interest among Indian banks in raising Basel III capital in order to meet Tier 1 and total CAR requirements.

» As a member of the Financial Stability Board (FSB), India may come under pressure to introduce bail-in features that require the creditors of non-viable banks to absorb losses as part of a renewed bank resolution framework. These features could be similar to those adopted by governments in major developed economies.

» However, we note that such regulations seem to be moving at a fairly slow pace, while the government continues to provide capital directly to public-sector banks. As a result, we maintain a degree of systemic support for significant banks in the system, as well as one notch of support for legacy subordinated debt issued by public-sector banks.

[11] Source: Indian Banks' Association.

» We expect strong interest by banks in issuing Basel III-compliant, addition tier 1 securities with contractual non-viability terms. If rated, these securities would not benefit from systemic support.

Moody's Related Research

Rating Methodology:

» Global Banks, May 2013 (154255)

Banking System Profile:

» India, August 2012 (144625)

Banking Statistical Supplement:

» India, October 2012 (146353)

Credit Opinion:

» India, Government of

Analysis:

» India, November 2012 (147441)

Credit Focus:

» FAQ: Why We Continue To Have A Stable Outlook On Indian Private-Sector Bank, November 2013 (160077)

» Deep Dive: Potential Weaknesses in State Bank of India's Capitalization Levels, September 2013 (157643)

Sector Comments:

» Indian Government's Capital Injection into Public-Sector Banks Is Credit Positive, October 2013 (159776)

» Reserve Bank of India's Measures to Bolster Exchange Rate Are Credit Negative for Banks, July 2013 (156622)

» Reserve Bank of India's Higher Provisioning for Restructured Loans Is Credit Positive, June 2013 (154863)

» India Union Budget, March 2013 (151226)

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Rate this Research »

Appendices

Definition of Banking System Outlook

Banking system outlooks represent our forward-looking assessment of fundamental credit conditions that will affect the creditworthiness of banks in a given system over the next 12-18 months. As such, banking system outlooks provide our view of how the operating environment for banks, including macroeconomic, competitive and regulatory trends, will affect asset quality, capital, funding, liquidity and profitability. Banking system outlooks also consider our forward-looking view of the systemic support environment for bank creditors.

Since banking system outlooks represent our forward-looking view on credit conditions that factor into our bank ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average.

Appendix 1: Excerpt from Sovereign Credit Opinion

Credit Strengths

» The credit strengths of India are:

» Large and diversified economy

» Healthy domestic savings rate

» Competitive private corporate sector

Credit Challenges

The credit challenges for India are:

» Large government debt and deficits

» Physical and social infrastructure limitations

» Policy uncertainty and administrative inefficiency

» Sustained inflationary pressures

Rating Rationale

India's Baa3 government bond ratings incorporate credit strengths such as a diversified economic structure, a relatively high domestic savings rate and an adequate international reserves position. The rating also incorporates challenges such as weak government finances, a policy process often hamstrung by domestic politics, susceptibility to inflationary pressures and infrastructure constraints on future growth.

We assess India's economic strength as 'moderate' on a relative basis, incorporating the large size, sectoral diversity and growth record of the economy, as well as the still low levels of per-capita income, the limitations of weak social and physical infrastructure and the susceptibility to inflationary pressures. India's average GDP growth rate has outperformed similarly rated peers in the last decade, although the gap in growth rates has narrowed significantly in recent years.

The World Bank's survey indicators for India on government effectiveness and rule of law point to 'moderate' institutional strength. Our own assessment encompasses strengths such as the long-standing tradition of checks and balances between the executive, legislature and judiciary. Transparent monetary policy and vigilance in financial supervision also provide institutional support. However, challenges such as a slow policy-making and implementation process as well as corruption persist.

Government finances are the weakest aspect of India's macro-economic profile. Moody's assesses its government financial strength as 'low', since India's government debt ratios and fiscal deficits are higher than those of similarly rated peers and we expect the government's fiscal position to remain weaker than peers over the medium term. However, thanks to a high private sector savings rate, and a banking system that is mandated to hold a certain proportion of government securities, the government is able to finance its significant annual gross borrowing requirement domestically, and has also managed to extend the average maturity structure of its debt. There was a reduction in the government debt/GDP ratio over the last few years, largely due to high inflation, rather than fiscal consolidation. However, as fiscal deficits have remained wide in the last few years, this ratio is likely to rise again. Interest payments absorb almost a quarter of government revenues, a much higher ratio than most countries rated by Moody's.

Recent measures to reduce fuel and fertilizer subsidy payments are too modest to compensate for high global commodity prices and currency depreciation, and therefore the government's subsidy bill continues to exceed budget targets. Meanwhile, social welfare measures, including the Food Security Bill, raise the government's medium-term expenditure commitment. In the near term, slower growth suggests that government revenue growth will remain modest, whereas volatile equity market conditions preclude substantial gains from public sector divestment.

India's susceptibility to event risk is assessed as 'low'. A growth downturn is underway and is unlikely to reverse in the next few quarters. This will keep the government's deficit and gross borrowing requirement high, but the financing risk is mitigated by the government's access to the domestic savings pool. Global trade and capital market conditions have increased pressure on the balance of payments, although official foreign exchange reserves are adequate to cover current account and external debt repayment needs. Although the government's own exposure to foreign currency debt is low, the private sector's foreign currency debt has been rising, and rupee depreciation has raised the cost of external debt service for the private sector. Over the medium term, a rise in external debt without a commensurate increase in reserves and export earnings could increase vulnerability to event risk.

Rating Outlook

The stable outlook on India's rating balances Moody's assessment of its credit strengths and weaknesses, relative to other rated sovereigns. Resilience to balance of payments volatility comes from the size and diversity of the economy, the level of foreign exchange reserves and the sovereign's limited external debt. On the other hand, large government deficits and debt ratios as well as supply constraints in the form of infrastructure, policy and administrative inefficiencies constrain the sovereign credit profile.

What Could Change the Rating - Up

A significant and sustained fall in fiscal deficit and government debt ratios, as well as a decline in their vulnerability to growth and political cycles would improve India's credit metrics relative to peers. This, coupled with enhancements to the investment climate, improvements in project implementation processes and a reduction in infrastructure bottlenecks, would likely raise future growth potential and competitiveness, and could lead to the rating being considered for an upgrade.

What Could Change the Rating - Down

A downgrade would be triggered by a continued, material increase in government debt ratios and government contingent liabilities, an enduring loss of international competitiveness or an anticipated worsening of the balance of payments.

Recent Developments

Real GDP grew 4.4% in Q1 FY2014 (Q2 2013), and underlying data showed continued weakness in consumption and investment growth. High frequency indicators such as the Purchasing Managers Index and Index of Industrial Production indicate that industrial growth remains a drag on growth in Q2 FY2014 (Q3 2013). High capital and input costs, negative investor sentiment and anticipated political uncertainty ahead of 2014 national elections will combine to keep growth subdued through the rest of the year. Given still high headline inflation and exchange rate volatility, monetary stimulus is unlikely to fuel growth. Fiscal spending has supported growth in Q2 2013, however as slower growth and higher subsidy expenditures already pose risks to the government's deficit target, there is limited fiscal space to institute additional fiscal measures to revive growth.

A revival in global growth could provide some support to the near term outlook, through an improvement in sentiment and demand for exports. A good agricultural harvest may alleviate food price inflation, while supporting growth through increased agricultural supply and higher rural demand. On the other hand, risks to growth stem from continued capital outflows, higher global oil prices due to geopolitical developments, or a petering out of recent signs of global growth revival.

We estimate that the FY2012/FY2013 current account deficit was around 4.8% of GDP, with the Q4 2012 current account deficit at 6.8% of GDP. The deterioration in the current account was driven largely by oil and gold imports - which together account for about 40% of total imports. Moreover, continued muted growth in prime export markets and higher than trading partner inflation have limited export growth despite currency weakness. Reflecting these current account dynamics, as well as uncertainty regarding the impact of tapering of quantitative easing by the US Federal Reserve, the rupee has depreciated by about 20%% between May and early September. The impact of depreciation will be increasingly evident in inflation, in debt servicing costs for individual firms, and the rising costs of government subsidies. However the government's own balance sheet has relatively low foreign currency liabilities, thus insulating it from the direct impact of depreciation on debt repayment costs.

The central government's fiscal deficit was estimated to be 4.9% of GDP for FY2013, below the government's mid-year target of 5.3%. Government revenues, which grew by about 15.4%, were less than the government's projections (which assumed revenue growth of 23.9%), capital expenditure growth was limited to 5.8% (against a budgeted 29%), thus limiting overall expenditure growth to 9.7% compared to the budgeted 14.3%. For FY 2013/14 fiscal year, the government is targeting a deficit of 4.8% of GDP. Slower growth, a resurgence in inflation or continued currency depreciation would increase the challenges of meeting the fiscal deficit target.

Banking System Outlook Table

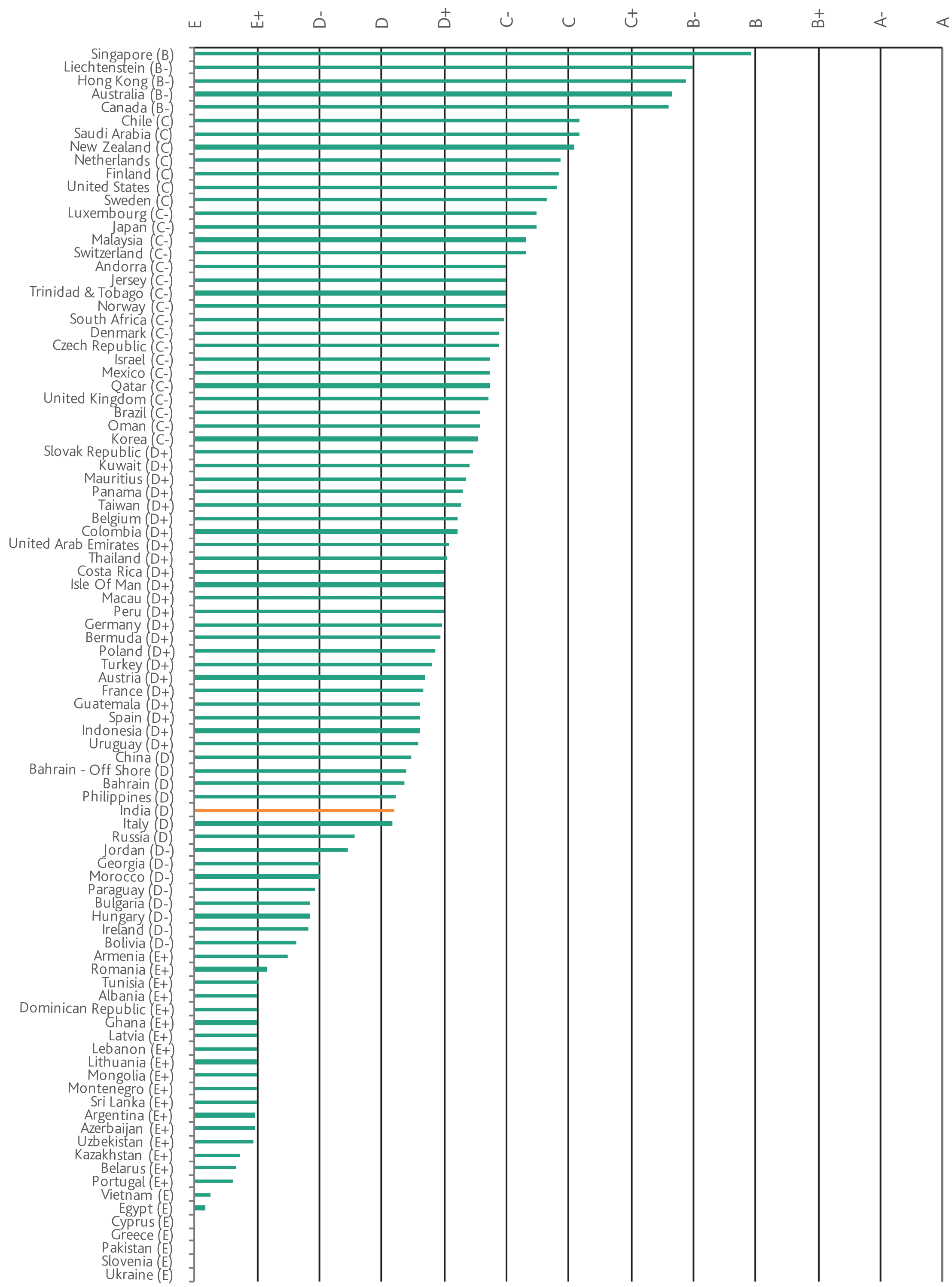
As of 13 November 2013

Banking System	Positive	Stable	Negative
Argentina			Negative
Australia		Stable	
Austria			Negative
Azerbaijan		Stable	
Bahrain			Negative
Baltic Countries		Stable	
Belarus			Negative
Belgium			Negative
Bolivia		Stable	
Brazil		Stable	
Bulgaria			Negative
Canada		Stable	
Chile		Stable	
China		Stable	
Colombia		Stable	
Cyprus			Negative
Czech Republic			Negative
Denmark			Negative
Egypt			Negative
Finland			Negative
France			Negative
Germany		Stable	
Greece			Negative
Hong Kong			Negative
Hungary			Negative
India			Negative
Indonesia		Stable	
Ireland			Negative
Israel			Negative
Italy			Negative
Japan		Stable	
Kazakhstan			Negative
Korea		Stable	
Kuwait		Stable	
Lebanon			Negative
Luxembourg			Negative
Malaysia		Stable	
Mexico		Stable	
Mongolia			Negative
Netherlands			Negative
New Zealand		Stable	
Norway		Stable	
Oman		Stable	
Pakistan			Negative
Peru		Stable	
Philippines	Positive		

Banking System	Positive	Stable	Negative
Poland		Stable	
Portugal			Negative
Qatar		Stable	
Russia			Negative
Saudi Arabia		Stable	
Singapore			Negative
Slovakia			Negative
Slovenia			Negative
South Africa			Negative
Spain			Negative
Sweden		Stable	
Switzerland		Stable	
Taiwan		Stable	
Thailand		Stable	
Turkey		Stable	
Ukraine			Negative
United Arab Emirates		Stable	
United Kingdom		Stable	
United States		Stable	
Uruguay		Stable	
Uzbekistan		Stable	
Vietnam			Negative

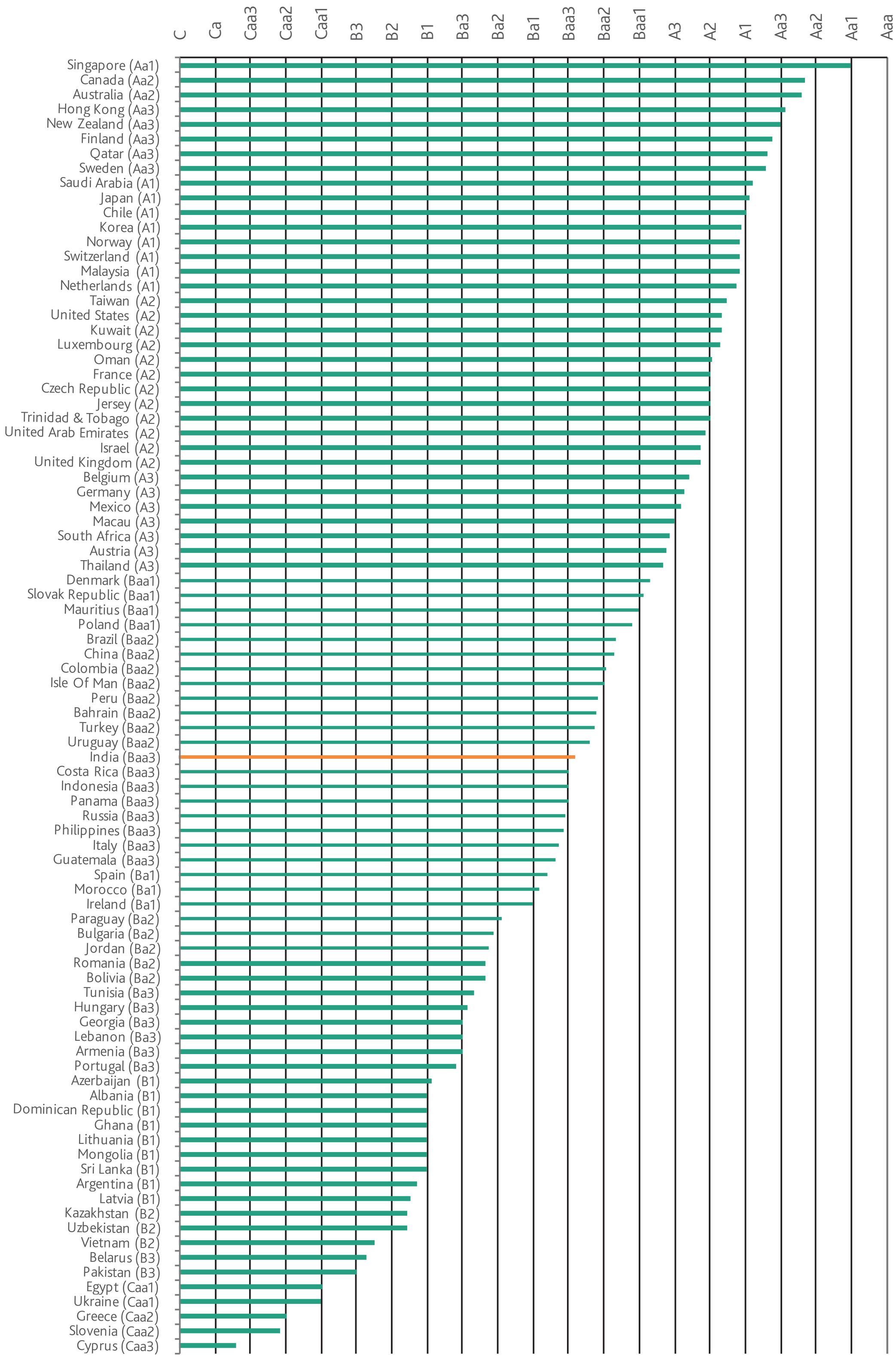
Global Comparison Charts

Asset-Weighted Average Bank Financial Strength Ratings (as of 7 October 2013)



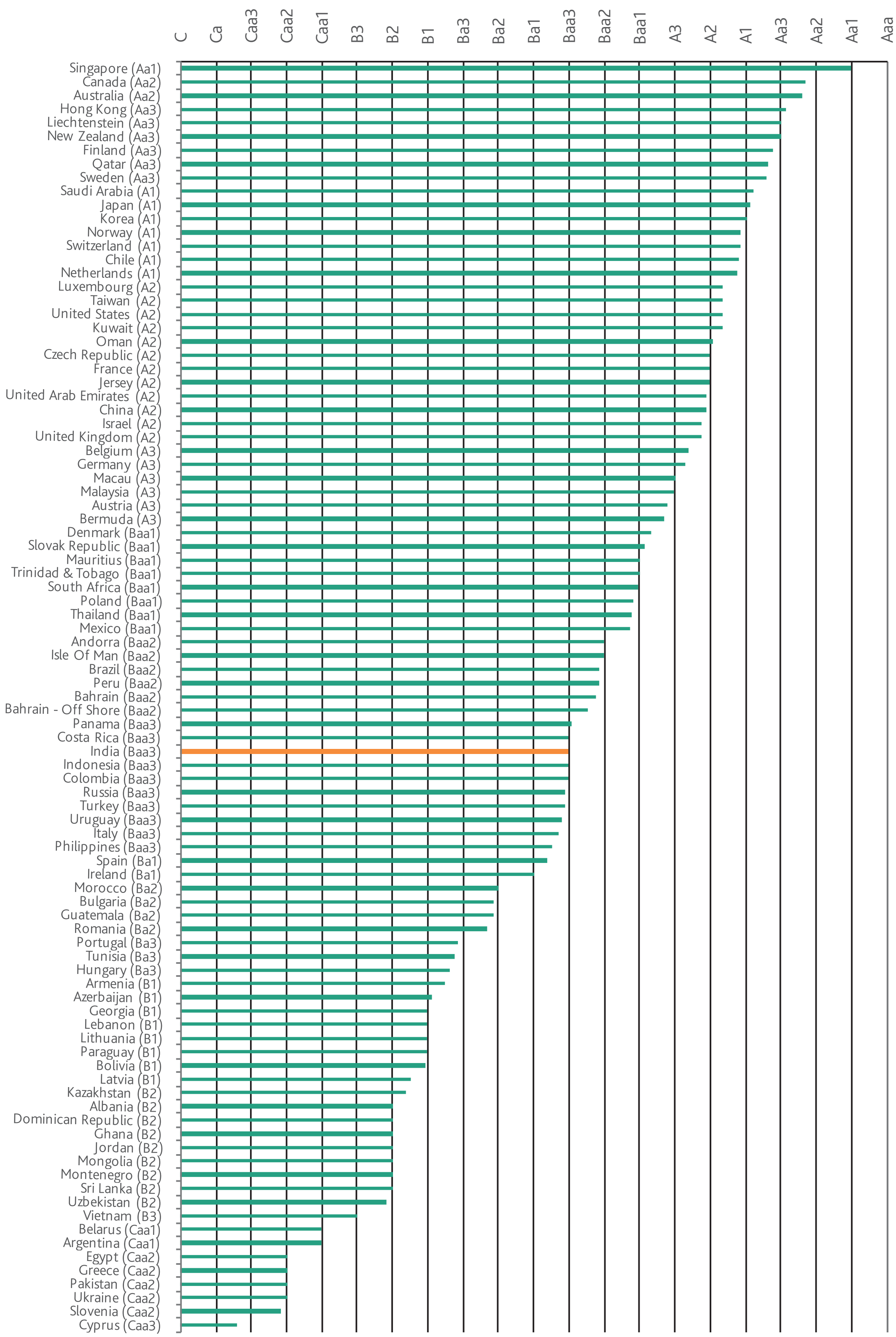
* Chart shows asset-weighted average standalone Bank Financial Strength Rating (BFSR) of all banks in each specified domicile. The rating next to each domicile is the rounded asset weighted average BFSR for banks in that domicile. The number next to each domicile is the number of banks with active BFSRs in that domicile.

Asset-Weighted Average Local Currency Long-Term Bank Deposit Ratings (as of 7 October 2013)



* Chart shows asset-weighted average local currency Deposit Rating (LCDR) of all banks in each specified domicile. The rating next to each domicile is the rounded asset weighted average LCDR for banks in that domicile. The number next to each domicile is the number of banks with active LCDRs in that domicile.

Asset-Weighted Average Foreign Currency Long-Term Bank Deposit Ratings (as of 7 October 2013)



* Chart shows asset-weighted average foreign currency Deposit Rating (FCDR) of all banks in each specified domicile. The rating next to each domicile is the rounded asset weighted average FCDR for banks in that domicile. The number next to each domicile is the number of banks with active FCDRs in that domicile.

BFSR / BCA Mapping Table

BFSR/Baseline Credit Assessment Mapping

BFSR	Baseline Credit Assessment (BCA)
A	aaa
A-	aa1
B+	aa2
B	aa3
B-	a1
C+	a2
C	a3
C-	baa1
C-	baa2
D+	baa3
D+	ba1
D	ba2
D-	ba3
E+	b1
E+	b2
E+	b3
E	caa1
E	caa2
E	caa3

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