Banks

India

Sector View: **Attractive** NIFTY-50**: 23,329** **April 16, 2025**

Working through a period of uncertainty and high volatility

Given the uncertainties that we are currently surrounded with, it is likely that we may have to rely on two probable paths: (1) valuation and (2) charting the probable course of action but having a flexible view on the possible range of outcomes. In this report, we shall give a perspective on how we are looking at the issues at hand.

Valuation, if inexpensive, can obliterate near-term business performance

In an uncertain world, an inexpensive valuation can always provide comfort, especially in a cyclical business. Exhibits 1-10 show the valuation of private and public banks. We are not at cyclical lows that we had tested during Covid or during the corporate NPL cycle. PSU banks have underperformed large private banks in recent times despite no concerns about asset quality. SBI's outperformance with its public bank peers suggests a general preference to stay with better quality names—a thesis that is worth assessing.

Have a flexible outlook on growth and asset quality in a period of slowdown

As growth and NPLs have some degree of correlation, it would be a reasonable assumption to make that managements are probably undecided on the pace of growth and places to grow that can offer relatively safer outcomes. We could potentially see scenarios where (1) PSU banks gain market share as they could potentially be a lot more confident than private banks, (2) the government could look to give confidence and comfort to lenders to build growth in certain areas through credit guarantee mechanisms such as what we witnessed during Covid through schemes such as ECLGS, (3) cash flow mismatches create growth opportunities, especially in the corporate sector where credit consumption has been weak, as the ability to raise equity or manage cash flow through internal accruals has been strong. The issue with these types of growth, especially those funding cash flow mismatches during the current period, is likely to be scrutinized intensely even when the risk-reward is favorable to lenders and (4) loan growth slows but deposit growth accelerates, which implies that the opportunity to improve NIM comes through liability mix rather than assets. Notwithstanding newer ideas to boost growth, it is fairly certain that the wide range of outcomes creates its own set of payoffs on growth, NIM, credit cost and profitability. Having a strong view on one particular path could result in missing the theme that might eventually dominate the next few years.

Axis and SBI well-positioned; microfinance plays possible around the corner

We don't see any reason to change our view currently. We would want to believe that system credit could potentially grow slower than system deposits. We also believe that asset quality deterioration, despite fears, is unlikely to materialize immediately. This would imply that Axis Bank would be positioned best among the large private banks. SBI is likely to be well-positioned in this leg of the cycle, where concerns are primarily on NIM.

Full sector coverage on KINSITE

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Valuations are not inexpensive, as yet

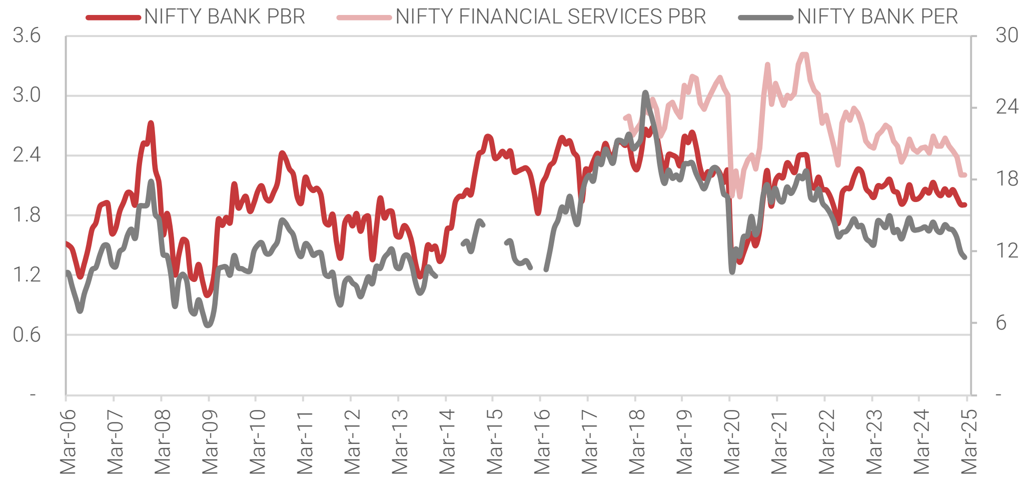
In our previous report, we have highlighted that the performance from frontline private banks is possibly explained by a flight of safety argument. Large private banks outperforming breaks the traditional argument of a need of a strong financial metric to explain its outperformance. We observe the following trends for large private banks: (1) loan growth has slowed with no signs of recovery, (2) deposit growth still remains sluggish, and (3) despite rate cuts, banks have been relatively slow in cutting deposit rates, suggesting that near-term NIM may face potential disappointment.

Since the previous report, we are now facing an additional challenge on possible global slowdown. The sustained outperformance of large private banks gives more credence to the flight of safety argument. Hence, in this section, we shall present a perspective to observe the situation.

Exhibits 1-5 show the valuation history of banks. We have seen a significant contraction in multiples over the past year. Much of this is seen in public banks as compared to private banks. However, private banks too have seen a moderate correction in multiples as well. As a consequence, the premium between private banks and public banks has expanded from historically low levels seen in FY2024. Barring the recent dislocation witnessed in IIB, the rest of banks are trading at inexpensive valuations for the return ratios that they are likely to deliver (see Exhibit 6).

Nifty Bank valuation is near historical mean

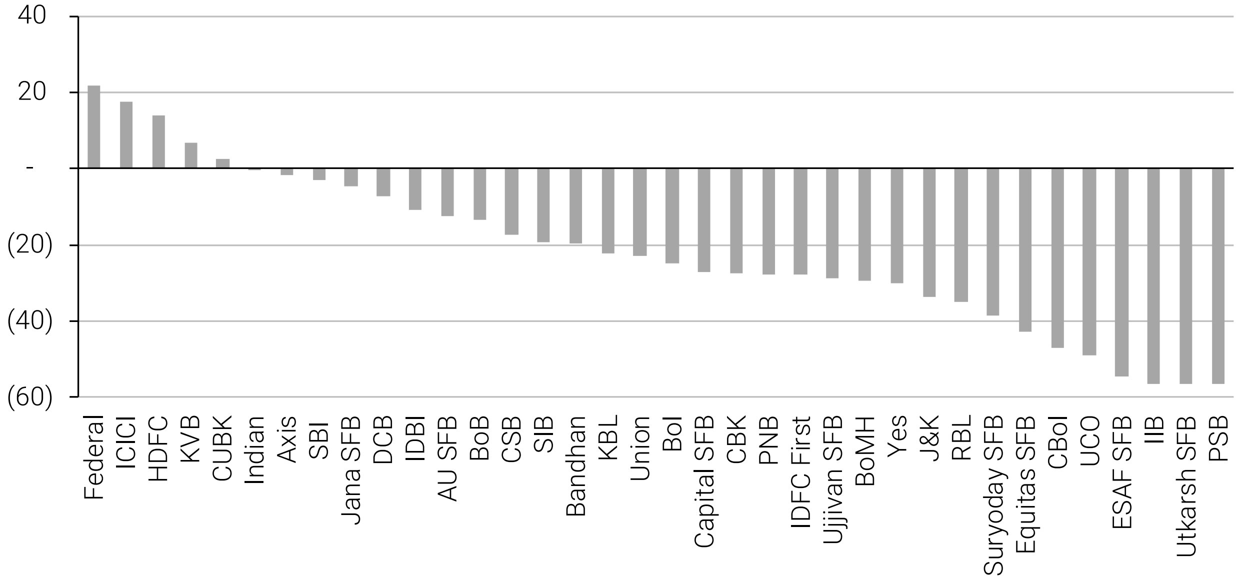
Exhibit 1: PER and PBR (12-month forward) for BANK NIFTY (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Frontline private banks have done relative well among all banks

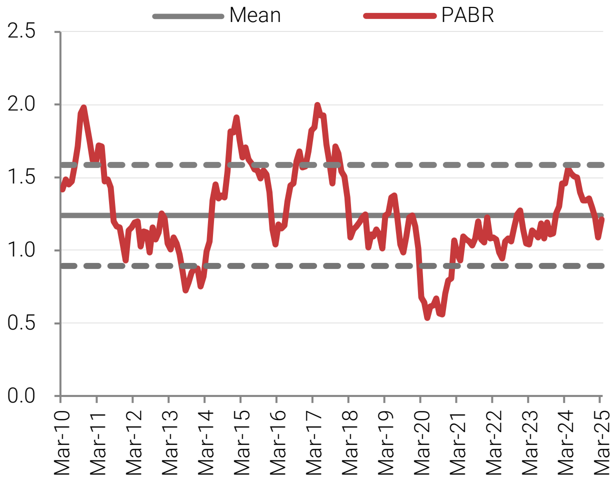
Exhibit 2: 1-year price performance across banks, March fiscal year-ends (%)



Source: Company, Kotak Institutional Equities

Valuations of public banks have recovered recently

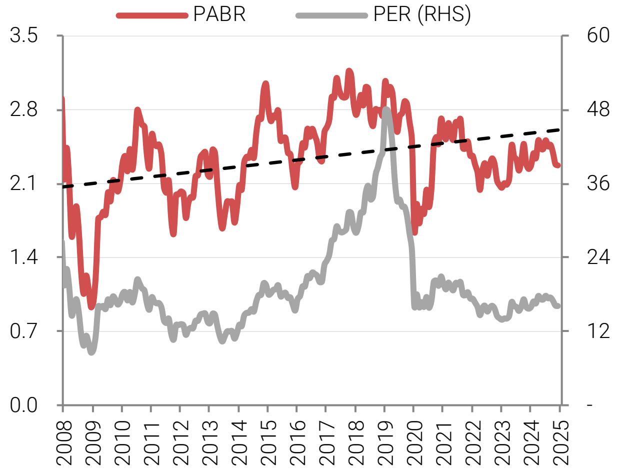
Exhibit 3: 1-year forward PBR for public banks (adjusted book) (X)



Source: Bloomberg, Kotak Institutional Equities

Private banks valuations have struggled with HDFC derating

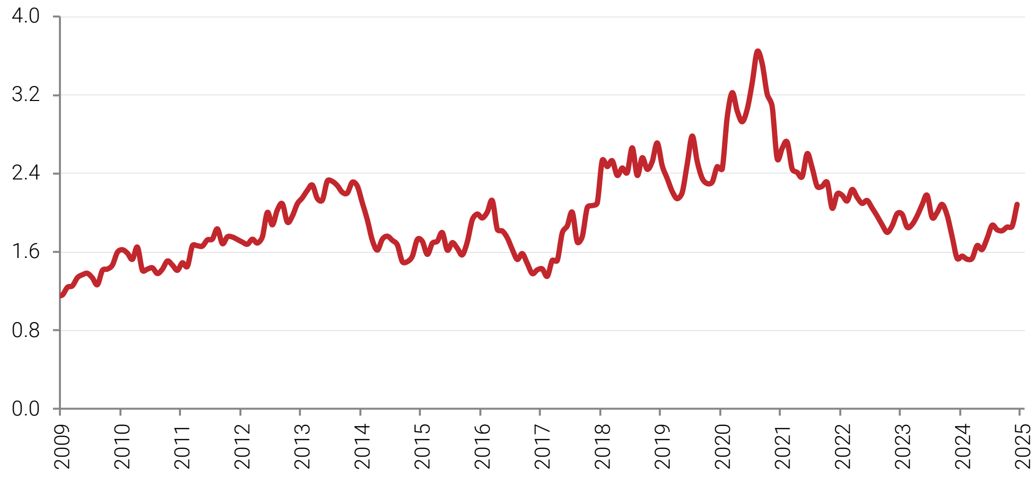
Exhibit 4: 1-year forward rolling PBR and PER for private banks (X)



Source: Bloomberg, Kotak Institutional Equities

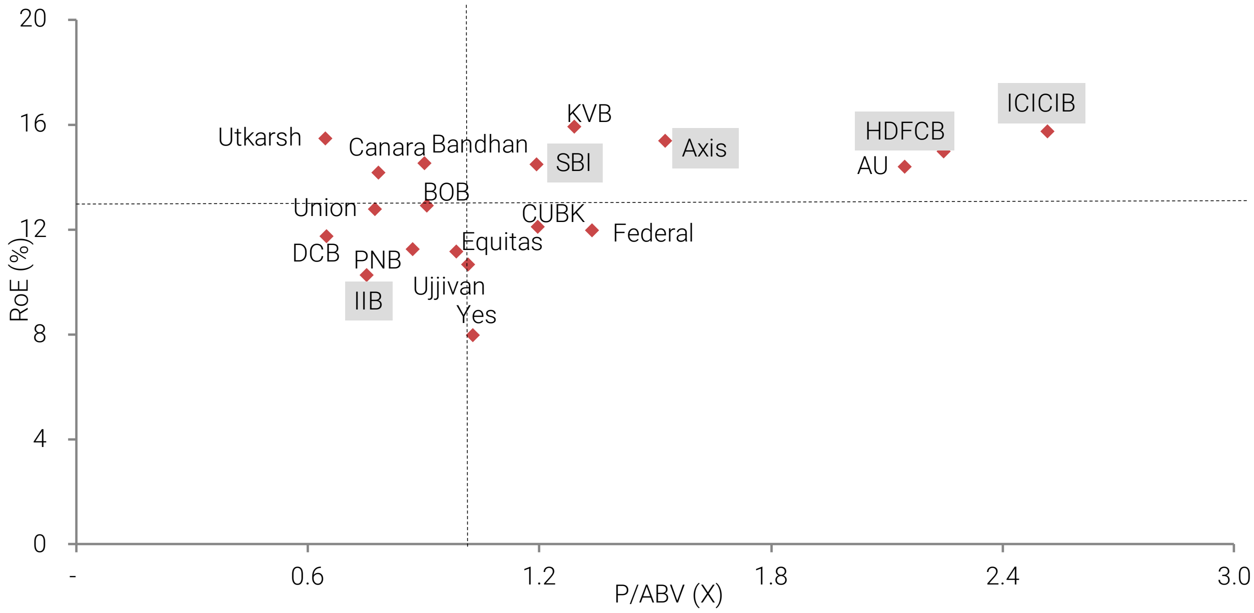
Valuation premium of private banks over PSU banks has declined

Exhibit 5: PBR (adj.) of private banks relative to public banks (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Exhibit 6: RoE versus PABR (FY2025E forward) for banks under coverage



Source: Bloomberg, Company, Kotak Institutional Equities

We look at the investment argument as follows: (1) build an investment thesis and back the ideas with the same, (2) valuations are inexpensive from a historical standpoint and gives room for cyclical errors and (3) have a flexible investment argument considering the uncertainties.

Building a convincing investment thesis is less convincing at this stage

We do want to build a convincing investment thesis as a base case. However, in the wake of global uncertainty from tariff wars and macroeconomic situation, we are dealing with several unknown variables that can likely have a material impact on earnings, thereby derailing our core investment thesis.

A solid investment thesis is easier to build when there are fewer variables to solve. For example, the recovery in PSU banks post the corporate NPL cycle challenge was entirely a function of lower slippages, reduction in credit costs and recovery in loan growth. Most of these variables were a function of asset quality and, hence, easier to build an argument. Another example is the long-term investment argument in HDFC Bank has always been a function of strong liability franchise, sustainable higher-than-industry growth and superior asset quality, leading to best-in-class profitability metrics. When these arguments break down, the reversal could extend for a much longer period.

We are not building a convincing investment thesis as our base case.

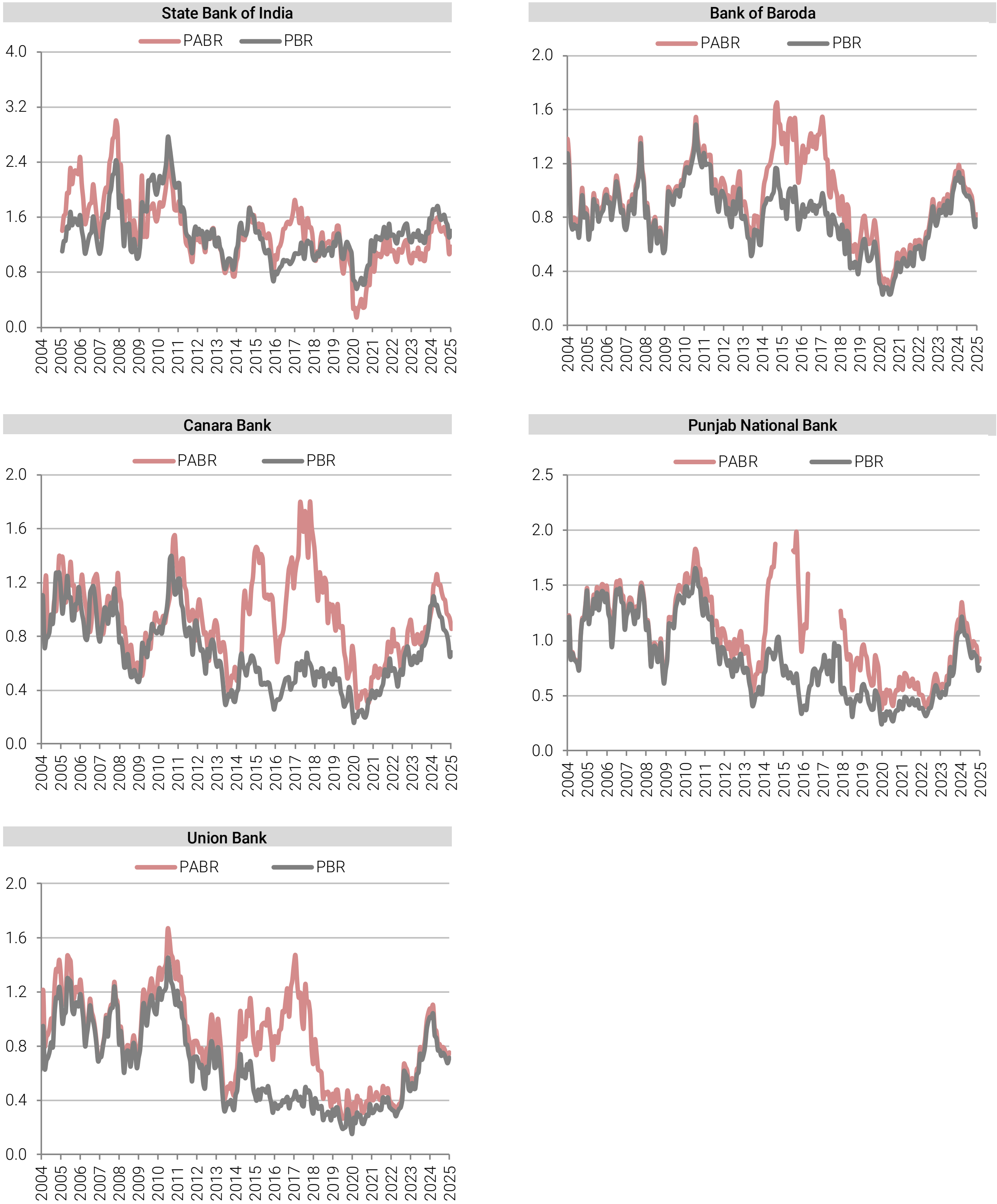
Valuations, if closer to lowest points in history, make a very convincing argument despite uncertainties

We have had several points in history where valuation multiples are at its lowest. These would include: (1) post the South East Asian/tech bubble/high NPL in Indian banks in 2000-04, (2) Global Financial Crisis in 2008, (3) corporate NPL cycle (2015-18) and (4) the initial period of global lockdown during Covid in 2020.

The exhibits below show that current valuations remain significantly above bearish multiples or worst-case scenarios. Constructing a scenario where these valuations are reached would necessitate a severe economic disruption, which we consider unlikely. Therefore, we do not intend to use such an outcome as our base case.

Valuations for PSU banks are not at rock-bottom levels

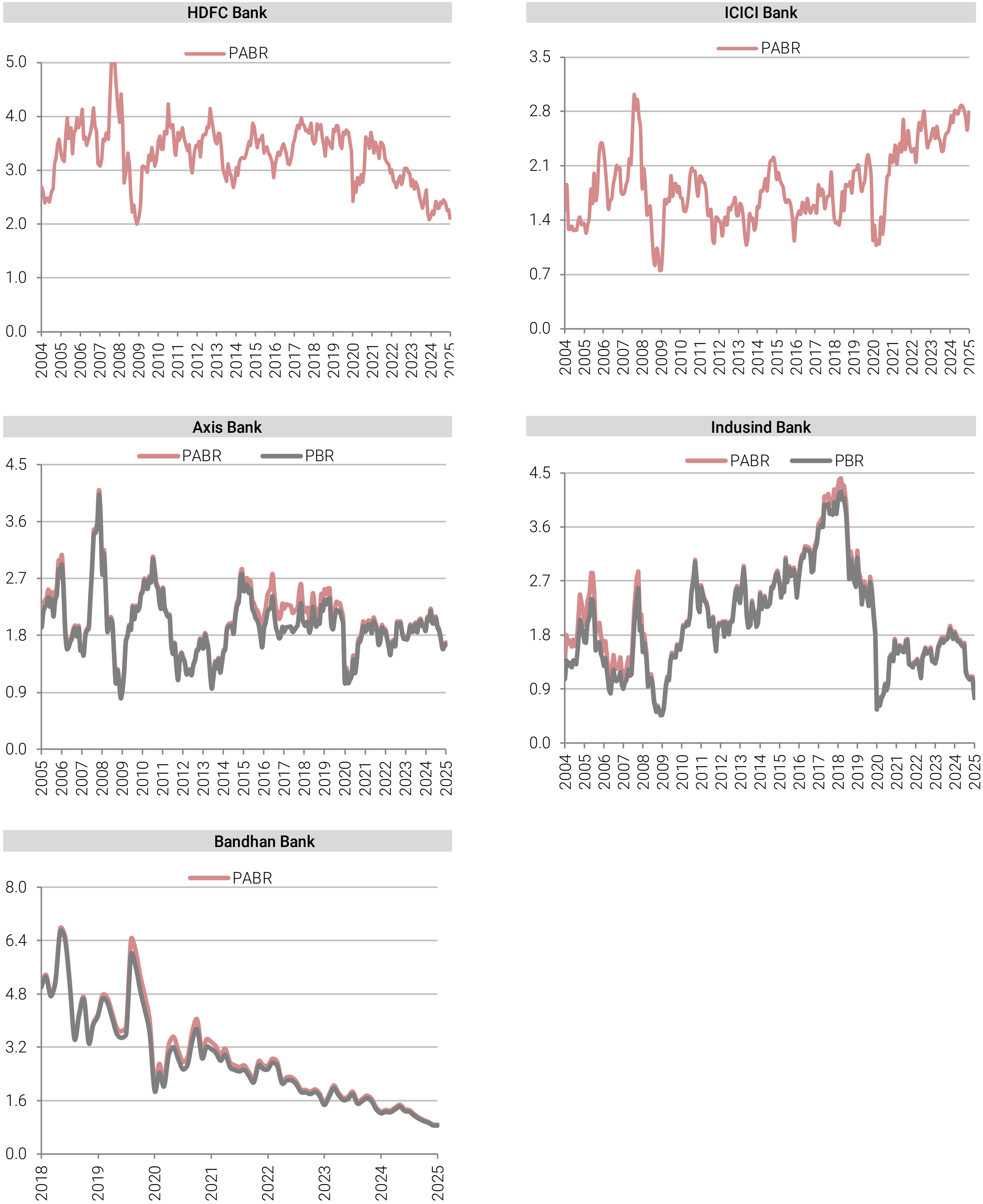
Exhibit 7: 12-month rolling forward PABR for PSU banks, March fiscal year-ends, 2004-25



Source: Company, Kotak Institutional Equities estimates

Recent rerating of frontline private banks except Axis can be seen as a flight to safety

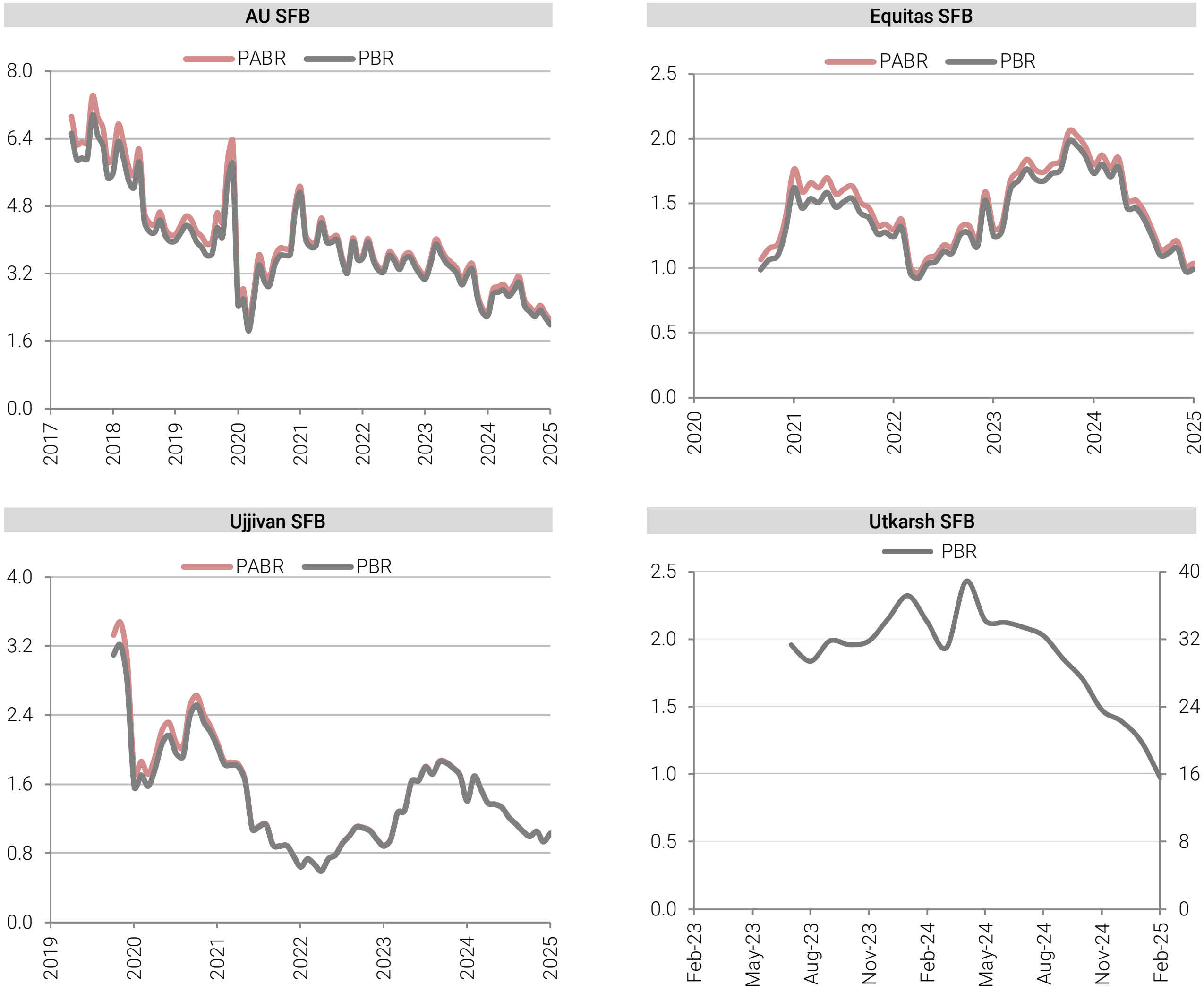
Exhibit 8: 12-month rolling forward PABR for frontline private banks, March fiscal year-ends, 2004-25



Source: Company, Kotak Institutional Equities estimates

A turn in MFI cycle can lead to re-rating of the SFBs

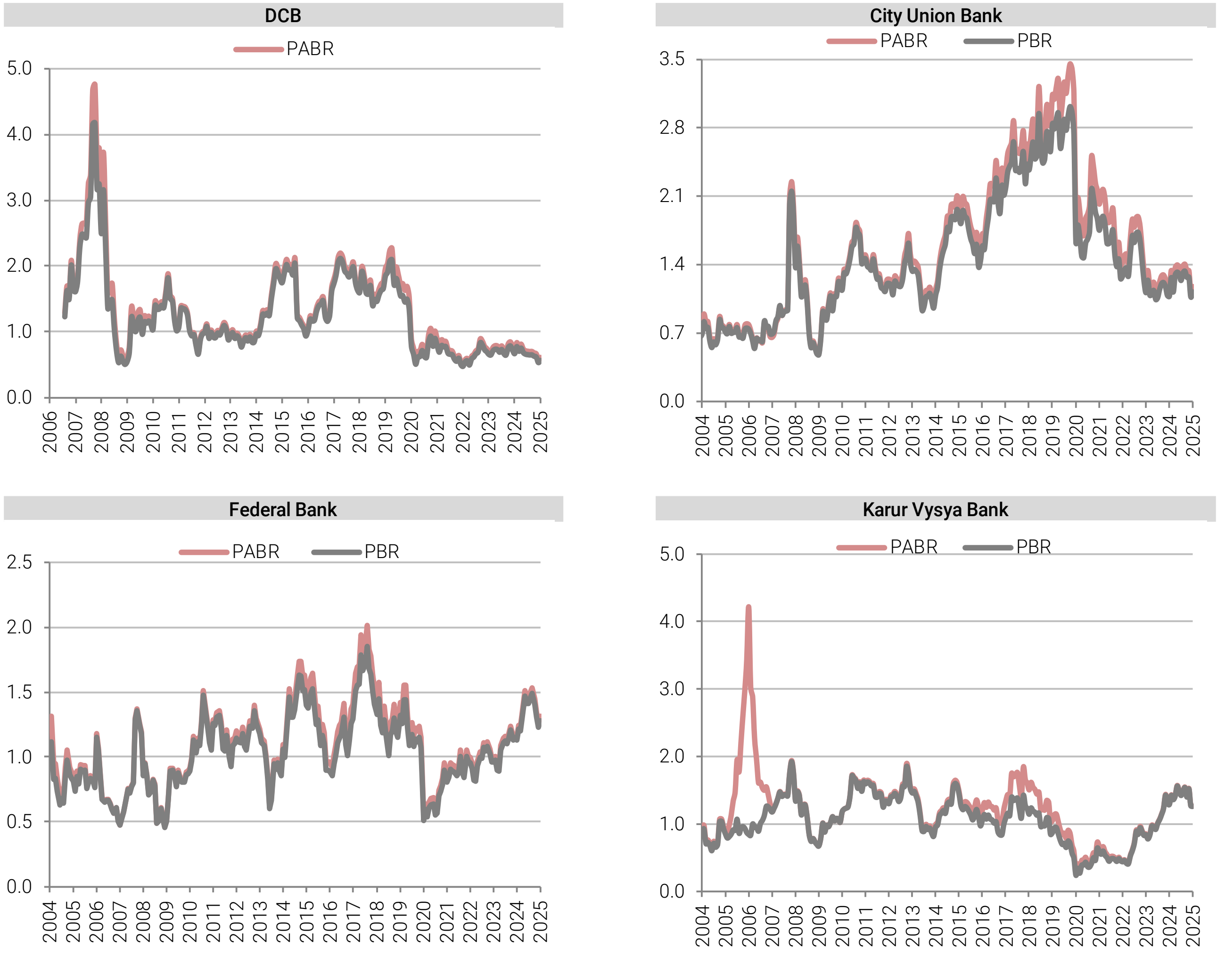
Exhibit 9: 12-month rolling forward PABR for SFBs



Source: Company, Kotak Institutional Equities estimates

Pressure on margins and historically low credit costs requires regional banks to pursue growth

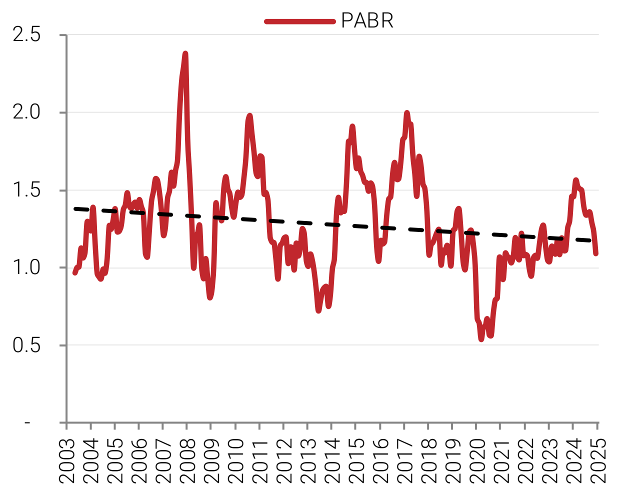
Exhibit 10: 12-month rolling forward PABR for regional private banks, March fiscal year-ends, 2004-25



Source: Company, Kotak Institutional Equities estimates

Public banks are trading well below their valuation peak

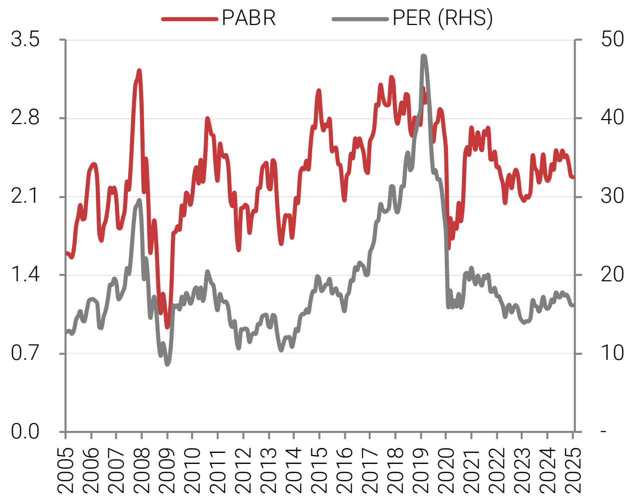
Exhibit 11: Public banks – one-year forward PBR (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Private banks have also seen a drop in valuation multiple

Exhibit 12: Private banks – one-year forward PBR and PER (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

A flexible investment thesis is the best thesis, in our view

We anticipate volatility in earnings and inconsistency in news flow, which will require us to frequently reassess our model assumptions. As discussed in the following sections, factors such as growth and NIM may evolve differently based on external influences. Each potential path carries a significant probability, adding to the challenges in forecasting.

For example: we anticipate that banks under our coverage will face near-term pressure on NIMs due to the delayed effects of deposit repricing and increased liquidity. However, the extent and intensity of this NIM decline remain uncertain. A deeper rate cut cycle could negatively impact NIM for those banks with a higher proportion of EBLR-linked loans. Conversely, a significant slowdown may lead lenders to adopt a more cautious approach to loan growth, potentially resulting in deposits outpacing loans. This scenario could provide room for aggressive deposit rate cuts by banks, making the liability side a potential tool for NIM protection. However, constructing these scenarios is extremely challenging.

With the above issues at hand, we would want to build the following scenario:

- **Probability of further multiple expansion in large banks looks unlikely**. Exhibit 13 shows the valuation premium between the frontline private banks and others. We have seen a significant expansion in the premium in recent months. It is harder to extend this thesis considering that the frontline banks have issues on earnings growth. We would want to believe that some of the recent fears pertaining to what played at IndusInd Bank is unlikely to be pervasive. Hence, the flight of safety for this specific argument is unlikely to play through for longer. However, we understand from our conversation with investors that banks can offer reasonably strong support at a time when the risk of earnings cut and derating of multiples are higher in other sectors. While this argument has its merits, we must note that this is applicable for the sector and not specific to a few banks. Hence, we would want to believe that the entire BFSI space, specifically lending set of entities, would be a beneficiary of this argument.

Frontline bank index has outperformed other banks since 2018, but underperformed in the past 2 years

Exhibit 13: Ratio of frontline bank index to other bank index (X)

Notes:
(1) Index ratio = Frontline bank index/ Other bank index. Both series indexed at 100 in Jan-2000.
(2) Frontline bank index includes HDFCB, ICICIBC, AXSB.
(3) Other bank index includes IIB, RBK, YES, FB, DCBB, KVB, CSBBANK, IDFCB, CUBK.

Source: Bloomberg, Kotak Institutional Equities

- **Recovery in microfinance or players operating in the lower income segment is likely to be a simpler theme**. We have seen significant deterioration in asset quality for players who have microfinance in their portfolio over the past year. However, we are now starting to see a scenario where incremental data on forward flows, collections and SMA book is showing an improvement. History tells us that it is only a matter of time when slippages and credit cost also decline closer to historical average. There do exist a few risks to the recovery timeline (because of potential credit tightening due to 3-lender cap, for example). However, one can take comfort from the fact that the worst part of the cycle is behind and lenders' appetite to resume disbursements is improving. This can make the asset quality recovery theme a relatively simpler theme to play out over the next year.

RoA and RoE of private and regional banks will be pressured due to margin strain from deposit pricing competition and low credit costs. Effect on margins in the current rate cycle will be dependent on the amount and timing of the deposit rate cuts that the banks are willing to take. Recoveries and upgradations will continue to support the profitability of PSU banks.

Valuations are not so attractive

Exhibit 14: Valuations of key financial companies, March fiscal year-ends, 2024-27E

		Fair Value	Price (Rs)	Market cap.	EPS (Rs)				PER (X)				ABVPS (Rs)				APBR (X)				RoE (%)			
	Reco.	(Rs)	4/8/2025	(US$ bn)	2024	2025E	2026E	2027E	2024	2025E	2026E	2027E	2024	2025E	2026E	2027E	2024	2025E	2026E	2027E	2024	2025E	2026E	2027E
Public banks																								
Bank of Baroda	ADD	270	236	14	34	35	33	33	7	7	7	7	197	226	253	276	1.2	1.0	0.9	0.9	16.9	15.4	12.9	11.5
Canara Bank	ADD	105	89	9	16	17	17	16	6	5	5	6	76	97	111	125	1.2	0.9	0.8	0.7	18.1	16.7	14.2	12.2
PNB	ADD	110	97	13	7	14	13	13	13	7	7	7	85	100	109	118	1.1	1.0	0.9	0.8	8.0	14.0	11.3	10.7
SBI	BUY	975	769	80	68	70	70	87	11	11	11	9	377	433	491	559	2.0	1.8	1.6	1.4	17.3	15.6	13.8	15.4
SBI (core bank)			579	60	66	69	66	83	9	8	9	7	353	409	468	535	1.6	1.4	1.2	1.1	19.3	17.2	14.5	15.8
Union Bank	BUY	155	121	11	18	22	20	21	7	5	6	6	112	136	153	168	1.1	0.9	0.8	0.7	15.6	16.1	12.8	11.8
Old private banks																								
City Union Bank	ADD	180	162	1	14	15	16	19	12	11	10	9	104	119	132	149	1.6	1.4	1.2	1.1	12.8	12.5	12.1	12.6
Federal Bank	BUY	225	191	5	15	16	17	20	12	12	11	10	116	129	143	158	1.6	1.5	1.3	1.2	14.7	12.5	11.9	12.6
Karur Vysya Bank	BUY	260	211	2	20	23	24	27	11	9	9	8	122	141	158	177	1.7	1.5	1.3	1.2	17.2	17.4	15.9	15.8
New private banks																								
Axis Bank	BUY	1,500	1,078	39	81	84	91	104	13	13	12	10	482	551	626	711	2.2	2.0	1.7	1.5	18.0	16.0	15.1	15.3
Axis Bank (core lending)		1,390	968	35	81	84	91	104	12	12	11	9	472	541	615	700	2.1	1.8	1.6	1.4	18.4	16.3	15.4	15.5
Bandhan	BUY	225	150	3	14	18	23	25	11	9	7	6	128	141	161	184	1.2	1.1	0.9	0.8	10.8	12.4	14.5	14.2
DCB Bank	BUY	160	114	0	17	19	22	32	7	6	5	4	142	157	175	201	0.8	0.7	0.7	0.6	11.1	11.2	11.7	14.9
HDFC Bank	BUY	1,900	1,769	157	80	87	101	114	22	20	18	15	568	630	705	790	3.1	2.8	2.5	2.2	16.9	14.3	14.9	15.0
HDFC Bank (core lending)			1,559	138	78	85	99	113	20	18	16	14	551	613	688	773	2.8	2.5	2.3	2.0	14.8	14.4	15.0	15.1
ICICI Bank	BUY	1,500	1,300	107	58	66	67	74	22	20	19	18	330	385	437	493	3.9	3.4	3.0	2.6	18.6	18.0	16.1	15.6
ICICI Bank (core bank)			1,070	88	55	62	63	70	19	17	17	15	314	368	420	476	3.4	2.9	2.5	2.2	18.5	17.8	15.7	15.2
IndusInd Bank	REDUCE	850	680	6	115	52	91	113	6	13	7	6	787	827	901	997	0.9	0.8	0.8	0.7	15.2	6.3	10.3	11.6
Yes Bank	SELL	17	17	6	0	1	1	2	39	23	13	9	14	15	16	18	1.2	1.1	1.0	0.9	3.0	4.9	7.9	10.4
Small Finance Banks																								
AU SFB	ADD	650	546	5	23	29	36	50	24	19	15	11	183	221	252	299	3.0	2.5	2.2	1.8	12.4	13.4	14.4	17.4
Equitas SFB	BUY	85	56	1	7	2	6	9	8	33	9	6	50	51	56	63	1.1	1.1	1.0	0.9	14.4	3.2	11.2	15.1
Ujjivan SFB	BUY	50	38	1	7	4	4	6	6	10	11	6	29	32	35	39	1.3	1.2	1.1	1.0	26.6	12.7	10.6	16.1
Non-banks																								
Bajaj Finserv	ADD	2,100	1,903	35	51	66	81	101	37	29	24	19	255	299	359	433	7.5	6.4	5.3	4.4	18.7	23.9	24.6	25.6
Bajaj Finance	ADD	9,000	8,822	63	234	260	322	406	38	34	27	22	1,241	1,471	1,751	2,106	7.1	6.0	5.0	4.2	22.1	19.6	20.6	21.3
Cholamandalam	ADD	1,500	1,463	14	41	50	61	76	36	29	24	19	233	282	357	427	6.3	5.2	4.1	3.4	20.2	19.5	19.4	19.5
LIC Hsg Fin	BUY	750	566	4	87	100	100	106	7	6	6	5	503	603	690	781	1.1	0.9	0.8	0.7	16.3	16.2	14.2	13.3
L&T Finance Holdings	ADD	155	154	4	9	12	14	16	16	13	11	9	95	103	112	123	1.6	1.5	1.4	1.3	10.3	12.0	12.4	14.3
Mahindra Finance	ADD	320	259	4	14	19	21	25	18	14	12	10	147	158	169	183	1.8	1.6	1.5	1.4	10.0	12.5	13.0	14.1
Muthoot Finance	BUY	2,400	2,293	11	101	130	169	193	23	18	14	12	605	704	833	980	3.8	3.3	2.8	2.3	17.9	19.9	22.0	21.3
Shriram Finance	BUY	730	641	14	38	53	52	65	84	12	12	10	253	297	340	393	12.7	2.2	1.9	1.6	15.7	18.7	16.0	17.3

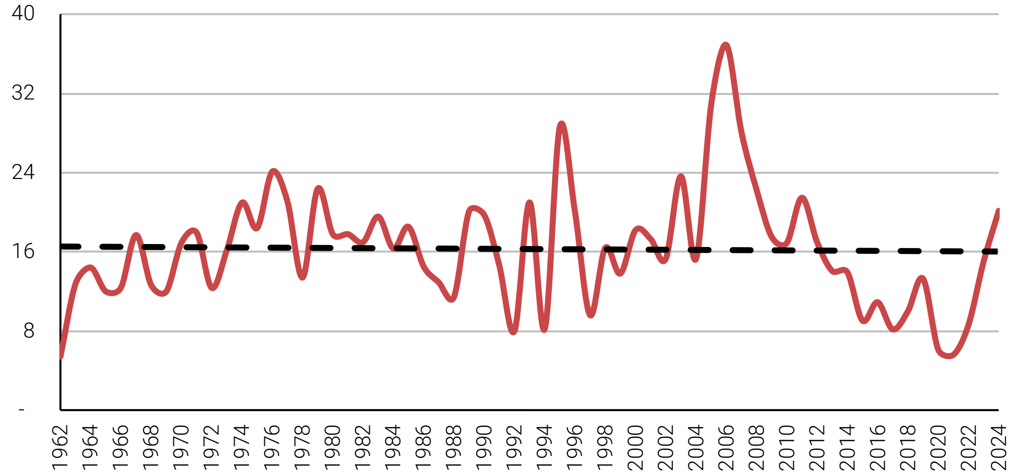
Source: Company, Kotak Institutional Equities estimates

Growth has headwinds, but the path can vary depending on choices taken

In a period of uncertainty, the path that is eventually likely to be taken is harder to forecast as the probabilities for each outcome is likely to be even. We shall present the various scenarios while noting that we may have still missed many other outcomes. We shall look at disbursements from the perspective of a lender and consumption of credit from the perspective of the borrower. Disbursements can be broken down by sectors (corporate/retail/SME), risk preference of the lender (low risk to high risk) and suppliers of credit (public banks, private banks, small finance banks and NBFCs). From a consumer of credit, we would look at the ability to repay (confidence of income and savings) and bridging cash flow mismatches.

We have experienced one of the slowest loan growth in recent years

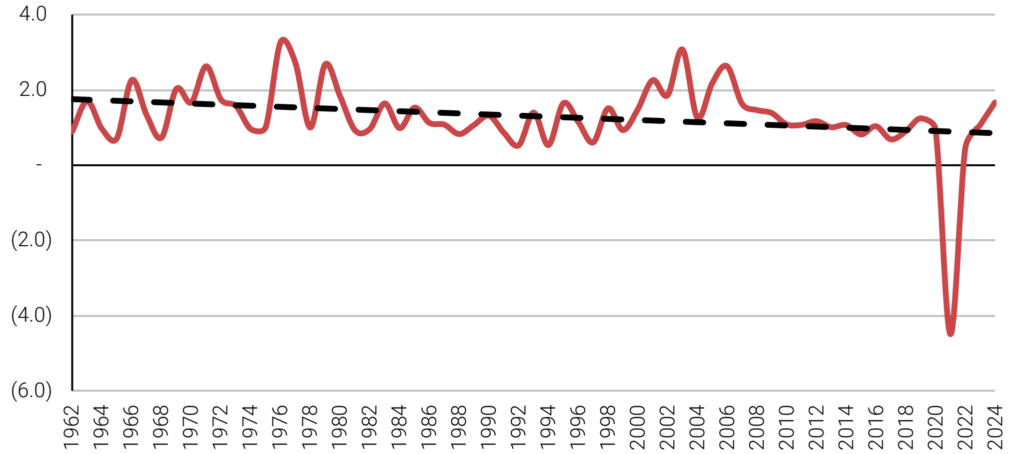
Exhibit 15: Loan growth for banks, March fiscal year-ends,1962-2024 (%)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

A pause in credit penetration compared to GDP growth in recent years

Exhibit 16: Loans to GDP ratio for banks, March fiscal year-ends,1962-2024 (%)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

The probability of credit growth lagging deposit and economic growth is high

We look at the two initial scenarios: (1) credit growth remains healthy or probably accelerates and (2) credit growth slows and remains sluggish till the uncertainties are behind. We would want to believe that both the outcomes have a similar probability as these actions tend to be self-fulling.

For example, higher credit growth essentially implies that lenders are comfortable with their borrowers. As much of this credit consumption translates into an economic activity, this would result in corporate profits or household savings to remain at comfortable or at better levels than where it is today. As the ability to repay is comfortable, lenders are likely to have a fairly stable asset quality metrics. Note that the above scenario could also be played through the government sector as well. Here, the government is taking most of the credit and releasing it back to the economy, creating a similar outcome as mentioned above. The challenge is usually similar to what we saw in the corporate NPL cycle. As credit is mostly driving the demand for economic activity, a reversal can be severe. Depending on where the excess credit was building up, we usually witness the reversal of the same. The time taken for recovery is a function of the collateral, clearing price of the collateral and the acceptable loss for various stakeholders. We witnessed this in the corporate NPL cycle where highly leveraged balance sheets eventually had to default to lenders. The only exception tends to be when the credit created is higher through government channel as the could always resort to higher taxation or create inflation to ride themselves out of their higher debt levels, though we note that they have several implications depending on the choices that are taken.

The other side of the same narrative is when lenders and borrowers are cautious. An example of the same is what we are witnessing post the corporate NPL cycle playing through where credit consumption tends to be weak. There is a combination of reluctance to lend and intent to borrow, which results in weak credit demand. The main challenge is that the vulnerable segments are likely to slip till the confidence comes back from lenders and borrowers to consume credit. Timing of recovery is usually a function of the intensity of the slowdown. We note that lenders could channel credit creation to other sectors where leverage is relatively low. For example, we saw post the corporate NPL cycle and importantly post Covid, credit shifted toward the retail segment. Demand for housing loans and personal loans dominated credit growth to the extent that the regulator had to signal their discomfort, especially in unsecured loans as it tends to have a high proportion of loans for consumption purposes.

In summary, we are looking two possible outcomes ahead of us and we have seen both these outcomes in the past two decades. For example, post Global Financial Crisis, we saw concerted attempts to channelize credit to the corporate sector, especially in the infrastructure sector. In recent times, we have seen lenders shifting credit supply to the MSME sector from the retail sector.

Loans in the ticket size range of Rs10-250 mn have seen faster growth over the past few years

Exhibit 17: Advances market share across bank groups, March fiscal year-ends (%)

Source: RBI, Kotak Institutional Equities

On the other hand, the lenders had largely stepped back from growing their loan portfolio aggressively post 2014-15. We saw that loan growth had generally been slower than deposit growth as balance sheet of lenders and borrowers were undergoing a normalization post a period of excess growth. Note that period post Covid, the lenders have not grown their credit books aggressively.

A slower credit growth channelized through the right incentives

From our perspective, we would be comfortable if lenders are slow, rather than offset an economic slowdown through credit growth. It becomes quite painful when the reversal is underway as the pain can continue for a prolonged period of time. Recovery is a function of confidence and rebuilding that confidence once it reverses is usually never easy. The simple metric that looks at credit growth and economic growth has usually been a good barometer. We are entering into this slowdown, if any, with a reasonably strong balance sheet of lenders and borrowers.

There could be several incentives that restart the cycle if there is a slowdown.

- **Regulatory incentives**. We look at the following from a regulatory perspective though much of it takes time to have an impact on the ground: (1) changes to risk weights for various sectors, (2) loosening of interest rates and reducing reserve requirements, (3) remove bottlenecks, if any, such as providing higher liquidity requirements in multiple ways, and/or (4) changes to capital requirements.

- **Government incentives**. There could be several fiscal measures, which include increased spending which shifts the level of savings to corporate and households from the government sector. However, persistent higher spending brings its own challenges on the quality of spending along with the familiar crowding out effect. There could be other methods such as giving higher tax incentives in specific segments, such as housing or corporate capital expenditure, which could bring back latent demand that could have otherwise taken longer time to materialize.

  On the other hand, the other measures that pique our interest are credit guarantee schemes. These schemes are not new and several countries, including India, have their own schemes targeting specific sector. In India, we have (1) Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), (2) Credit Guarantee Fund for Micro Units (CGFMU), (3) Credit Guarantee Fund for Education Loans, (4) Credit Guarantee for Stand-Up India, (5) Credit Guarantee for Skill Development, (6) Emergency Credit Line Guarantee Scheme (ECLGS), (7) Loan Guarantee Scheme for Covid Affected Areas, (8) Credit Guarantee Scheme for MFI, (9) Loan Guarantee Scheme for the Covid affected Tourism Service Sector, (10) Credit Guarantee Scheme for Startups, (11) Guarantee Scheme for Corporate Debt, (12) Credit Guarantee Scheme for Factoring.

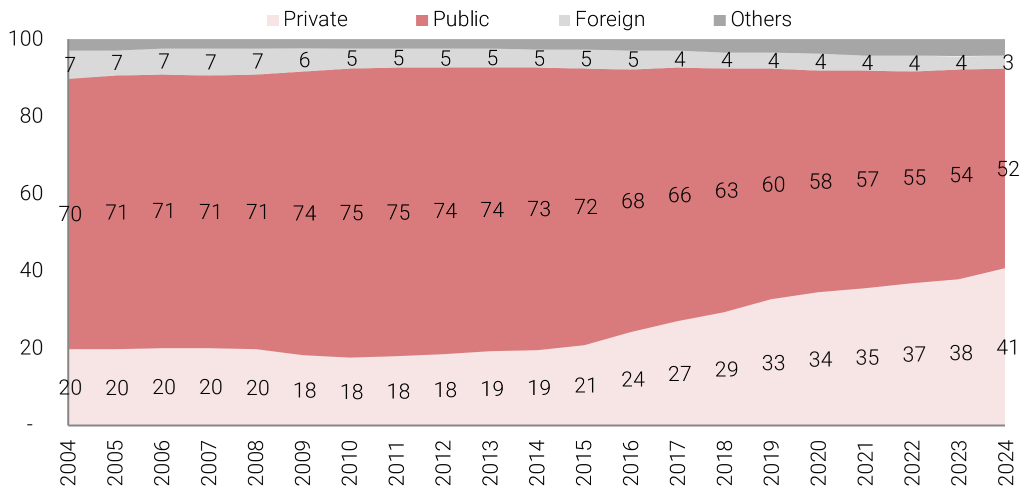
  Note that many of these schemes were launched post Covid and hence, targeted to address a specific concern on flow of credit. Within this the CGTSME, CGFMU and ECLGS can be considered as reasonably successful schemes. We would want to keep a close watch on such schemes hereon. A good guarantee scheme is a function of higher participation. Like any insurance product, it requires a combination of good and potentially riskier loans that were given under the framework that was acceptable for the underwriter and its users. When the scales of the scheme tilt unfavorably between each other, most schemes end up being unsuccessful.

Interpreting pace of growth between private banks and public banks

Exhibit 18 shows the market share between public banks and private banks. The long-term trend is consistent to the thesis that private banks are likely to gain share largely from public banks. Within this, it is likely that SBI would probably be the least impacted public bank.

PSU banks have steadily ceded market share to private banks over the past decade

Exhibit 18: Advances market share across bank groups, March fiscal year-ends (%)



Source: RBI, Kotak Institutional Equities

In the event of a credit slowdown, we are likely to face with the following options. Loan growth is weak for PSU and private banks. Within this, a relatively comfortable environment is when private banks, specifically led by the large private banks, are ahead of industry average. However, it would be uncomfortable if PSU banks are ahead of private banks. The larger the divergence of growth, the more it raises concerns on the causes of this divergence.

The general observation based on the corporate NPL cycle is that public banks are comfortable to take more risk than private banks. While we note that this conclusion has not played through in the post-Covid slowdown, it nevertheless remains an area of concern. Hence, a balance in growth between private banks and public banks is generally a preferred option.

Understanding the flow of credit across the various sectors

Looking at the various subsectors, we see the flow of credit as given below. Note that we are currently leaning toward a possible slowdown in our forecasts. Hence, much of the outlook for the various sectors is designed with this in mind.

Corporate sector is still the weakest link to loan growth revival

Exhibit 19: Loan growth across various segments, March fiscal year-ends, 2011-25E (%)

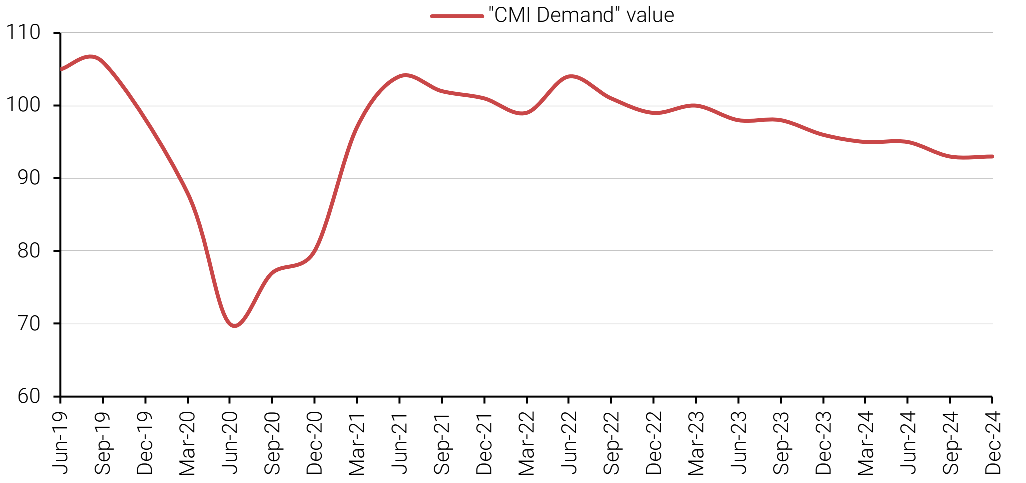
Source: RBI, Kotak Institutional Equities

- **Retail credit likely to slow down**. We have seen slowdown in retail credit in recent quarters. This has happened despite no noticeable trend in weakness in asset quality. The RBI had increased risk weights on unsecured loans, which resulted in lenders slowing down their growth. On the other hand, two of the largest private banks (Axis Bank and HDFC Bank) have been relatively slow on disbursements as they have looked to correct their liability side of the balance sheet rather than growth. Overall, it is quite likely that private banks have been growing slower than earlier with a possible rate cut cycle in mind. On the other hand, PSU banks have been able to maintain their growth. Disbursements have not accelerated given the slowdown seen at private banks. There is a greater preference for secured loans in comparison to unsecured loans. There is a greater preference toward better-rated customers in recent quarters.

  We don't see this approach changing given the uncertainty on the ground. Retail credit growth is likely to remain sluggish or trend similar to system credit. Auto loans are likely to be subdued as the volume growth is likely to be weak. Unsecured loans could potentially grow at a marginally faster pace from the current level. However, lenders are likely to keep growth slower within the overall retail loan portfolio.

Retail credit demand seems to have weakened steadily over the past couple of years

Exhibit 20: 'CMI Demand' value for retail credit as published by TransUnion CIBIL (X)



Notes:

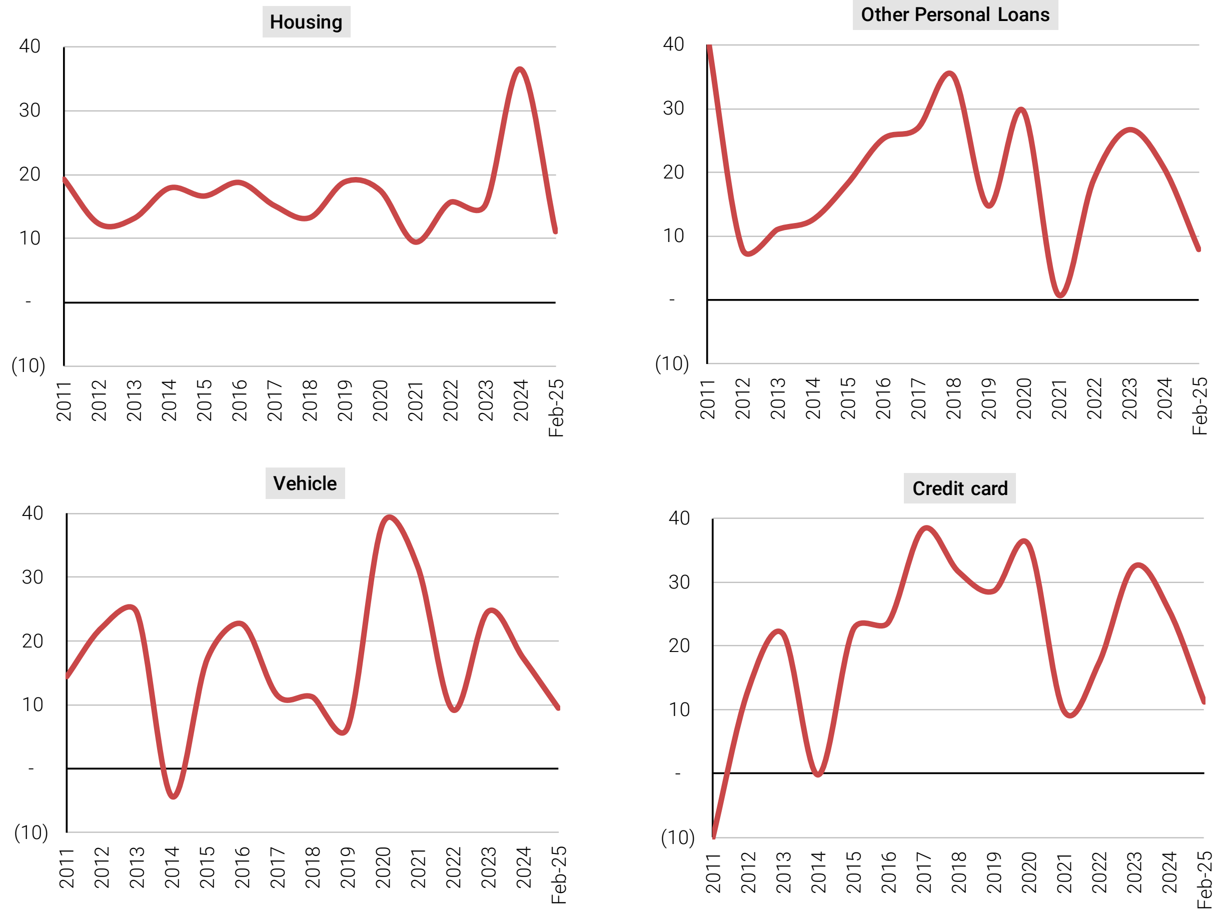
(1) "CMI" is a relative metric and needs to be looked at in relation to the previous period(s) and not in isolation. Higher value of CMI indicates better performance.

(2) "CMI Demand" is a function of credit inquiry volume and its distribution by loan type, consumer age, geography and risk band.

Source: TransUnion CIBIL, Kotak Institutional Equities

Retail loans across categories experiencing low growth

Exhibit 21: Break-up of retail loans for the banking system, March fiscal year-ends, 2011-24 (%)



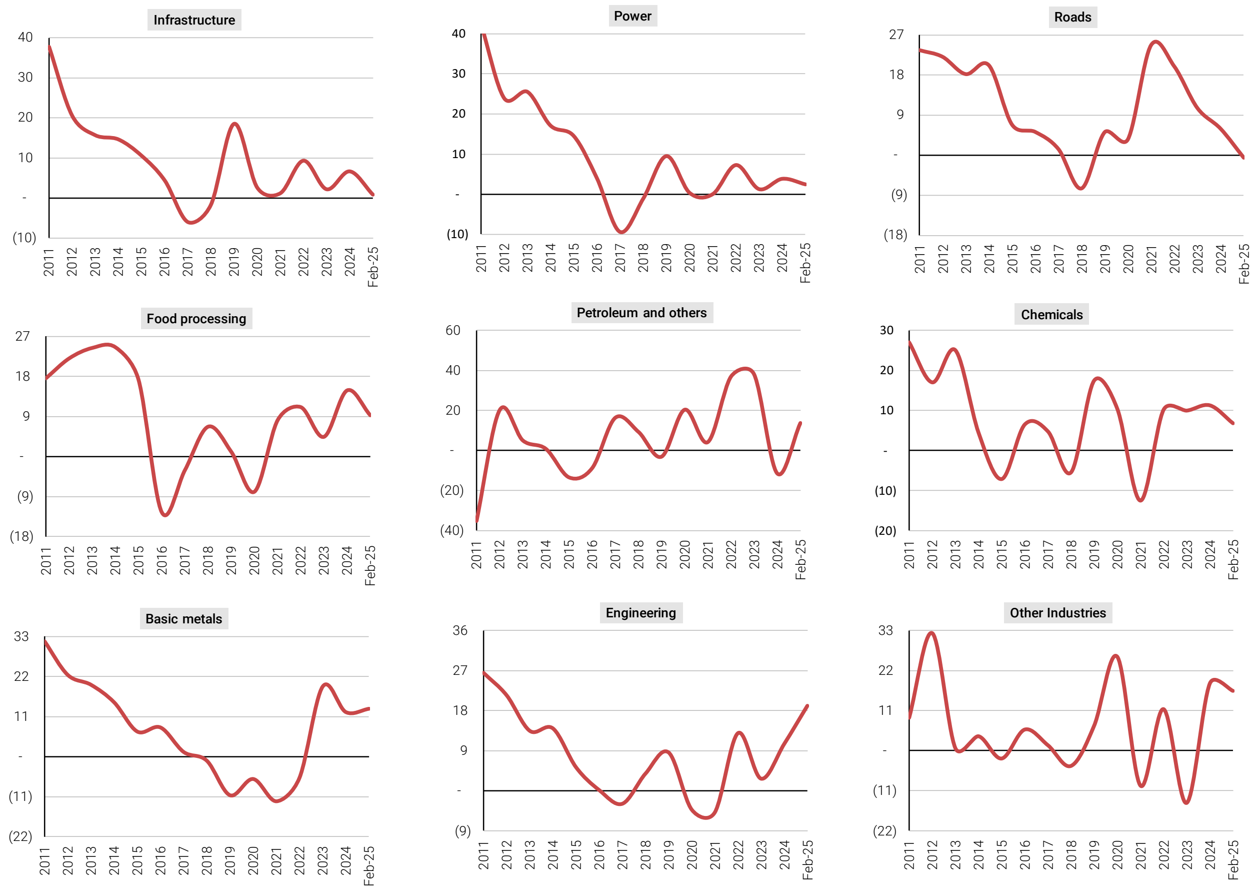
Source: RBI, Kotak Institutional Equities

- **SME credit is also likely to slow down**. We have seen a reasonably good growth in SME credit in recent years. Private banks have grown this portfolio faster than PSU banks, although we have noticed that PSU banks are gradually stepping up lending in this space. There has been a marked improvement in information flow, especially through various sources that provide much more granular and real time financial performance, thereby providing adequate comfort to lenders. However, with the slowdown likely to affect businesses, we can expect private banks to grow slower till there is clarity on the ground. It is quite likely that PSU banks may keep up their credit growth in this space.

- **Corporate credit could potentially see some signs of recovery**. We look at corporate credit demand through the lens of (1) demand for credit coming back for the balance of unfinished capital expenditure where credit sanctions were already in place, but drawdown was slower in comparison to the pace of execution and (2) cashflow mismatches start to be a lot more unfavorable, resulting in higher utilization of credit lines. We do not view this credit growth negatively despite a broad weakness in the economy. The starting point of this cycle for corporate credit is different to what we saw in the previous decade. Deleveraged balance sheet, significant consolidation in many sectors, strong cash flows from existing assets differentiates the current situation of these companies from what it was in the previous decade. We can expect lenders (public and private) to be fairly comfortable in disbursing loans.

Lack of capex-led loan demand implies that growth is still quite sluggish

Exhibit 22: Breakup of corporate loans for the banking system, March fiscal year-ends, 2011-25E (%)



Source: RBI, Kotak Institutional Equities

Asset quality to hold up reasonably well in the initial years, despite fears

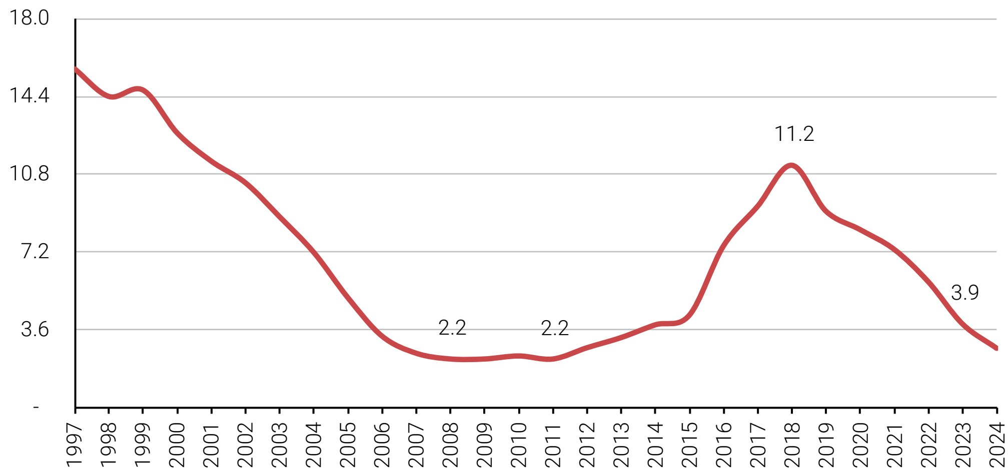
We would be rushing to make a conclusion on asset quality if we don't have a visibility on growth. We would want to believe that growth has two parts: (1) economic growth and (2) growth in credit. In a simplistic way to present this, we would want to believe that credit growth is usually a multiplier of economic growth. This assumption implies that during periods of strong economic activity, credit growth is usually higher than economic growth and vice versa.

With history behind us, we are most likely to ignore this event while we focus mostly on the corporate NPL cycle. The forecasts and its eventual outcome have two parts when there have been periods of uncertainty: (1) periods where the stress eventually got realized and (2) periods where the stress levels did not materialize.

We would look back at few specific events to iterate this view. (1) Global Financial Crisis, (2) Covid and (3) demonetization. We could also look at some of the shorter periods of uncertainty as well when regulatory actions resulted in higher fear. For example, the recent period with unsecured loans and its eventual outcome as we see today. In all these periods, the concerns on asset quality prevailed in the initial period, while it had failed to materialize either in the way it was initially forecasted or from an intensity/timing perspective.

Gross NPL peaked at ~11% in this cycle while it was at 15% in the previous one

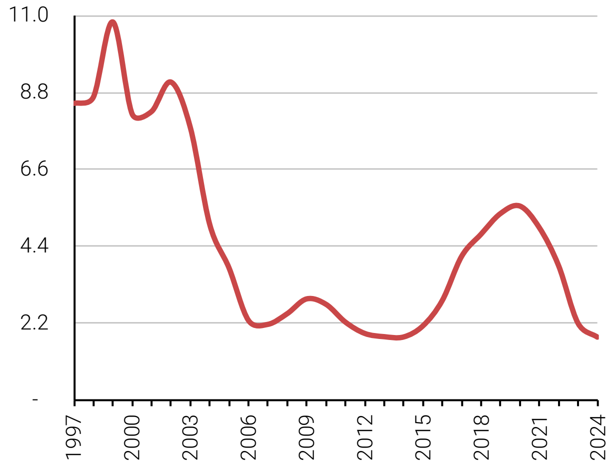
Exhibit 23: Gross NPL ratio of banks, March fiscal year-ends, 1997-2024 (%)



Source: RBI, Kotak Institutional Equities

Gross NPL peaked at 15% in this cycle while it was 18% in the previous one

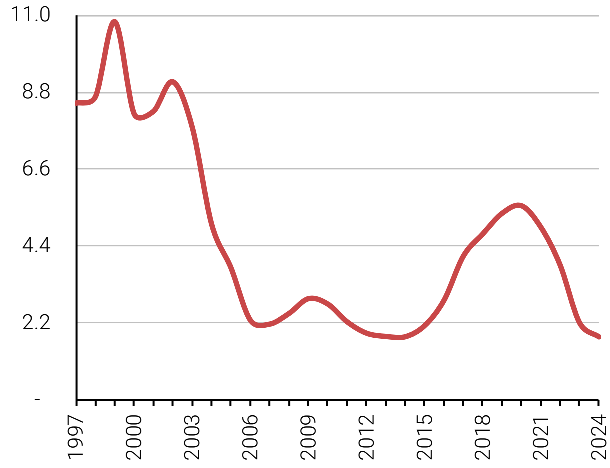
Exhibit 24: Gross NPL ratio of public banks, March fiscal year-ends, 1997-2024 (%)



Source: RBI, Kotak Institutional Equities

Gross NPL peaked at 11% in this cycle while it was 5% in the previous one

Exhibit 25: Gross NPL ratio of private banks, March fiscal year-ends, 1997-2024 (%)



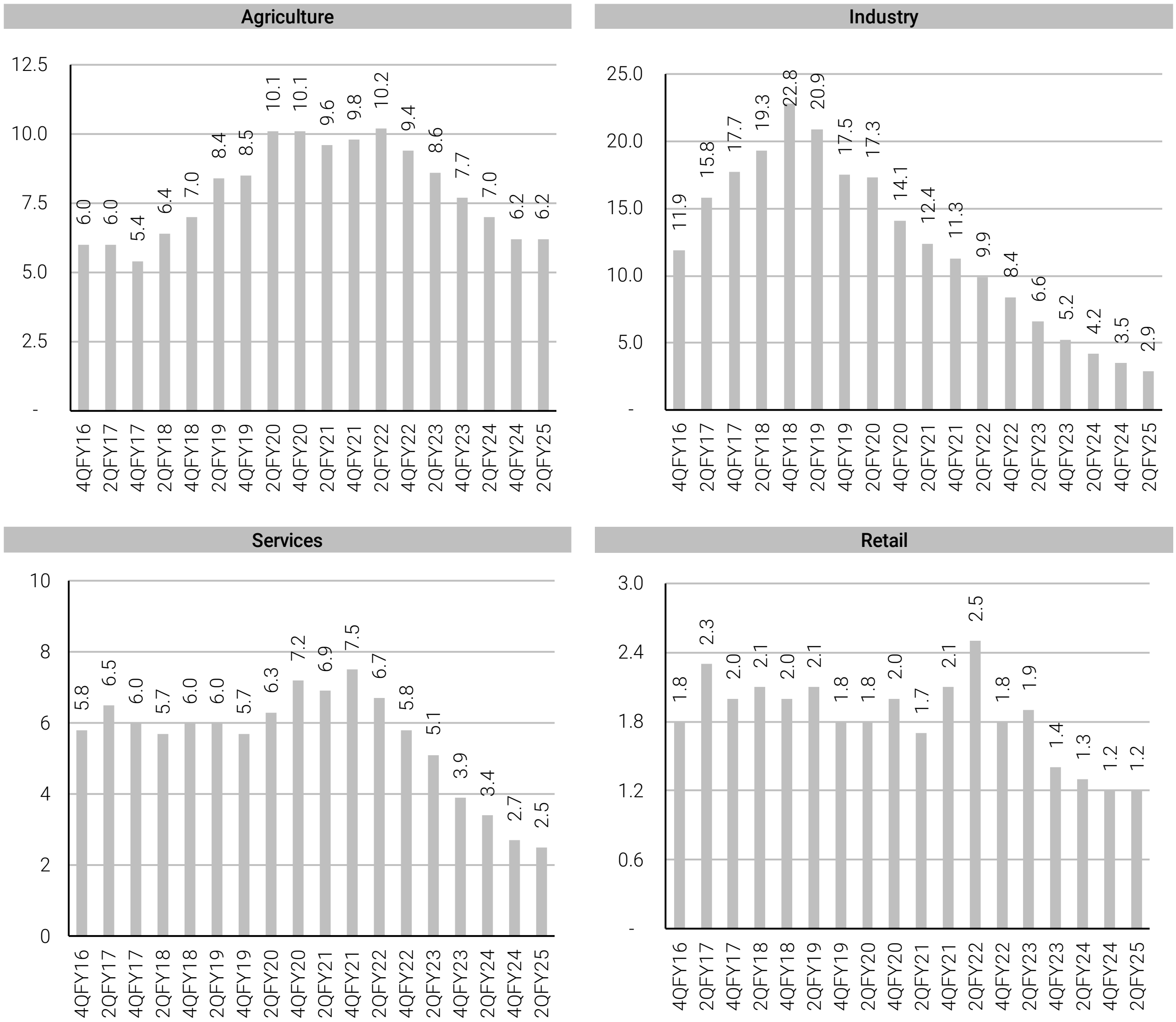
Source: RBI, Kotak Institutional Equities

The easiest way to look at the situation on asset quality is to understand the areas of growth and the growth levels seen in these segments across players. There is some strength to the thesis that higher growth has usually resulted in higher stress. However, the positive news is that credit growth has not been too high as we enter this period of macroeconomic uncertainty. We started to see decelerating trends on credit growth for the past year, especially led by private banks either due to (1) concerns on unsecured loans, (2) induced slowdown as focus shifted toward mobilizing deposits or (3) concerns on rising stress in microfinance. The slowdown should act as a key rationale to keep a positive outlook on asset quality.

We note that regulatory intervention tends to be high when there is a slowdown caused by extraneous factors. For example, (1) RBI had allowed restructuring of loans without classifying them as NPLs in 2008 Global Financial Crisis, and (2) loan moratorium was an option that was introduced during Covid. We could also look at the fears that was caused during demonetization, though the fears did not last for a long time. The reasons to mention these schemes is to broadly give a perspective that the forecasted outcome on NPL ratios does not always materialize because of these extraneous relaxations. These measures have consequences on credit flow, which in turn has implications on the intensity of NPL cycles.

NPL ratios have declined across all categories

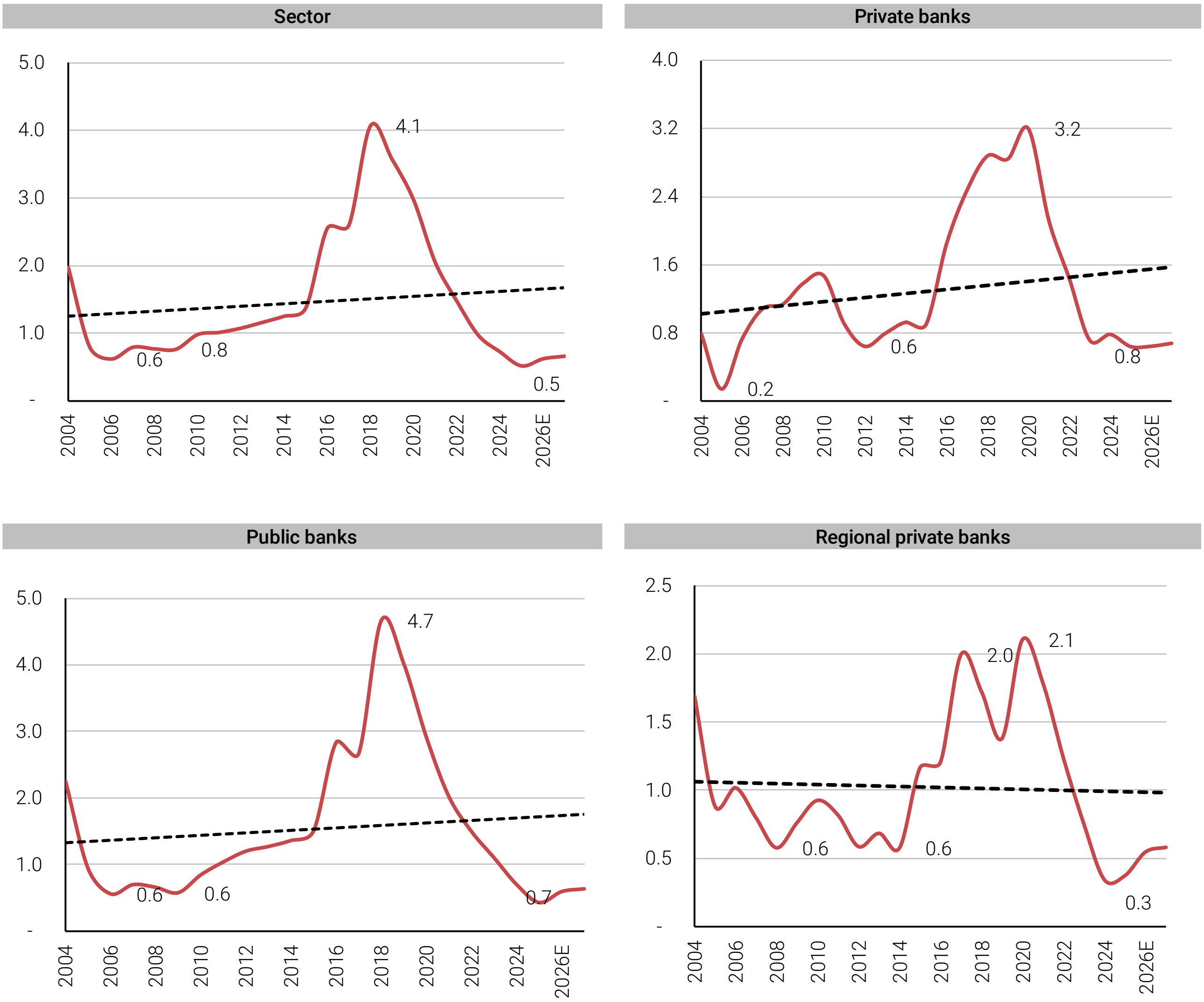
Exhibit 26: Gross NPL ratios for different categories, March fiscal year-ends, 4QFY16-2QFY25 (%)



Source: RBI

Loan-loss provision is likely to remain lower for longer

Exhibit 27: Loan-loss provisions for the sector, March fiscal year-ends, 2004-26E (%)



Source: Company, Kotak Institutional Equities

Margins: near-term pressure is inevitable, but any other argument is likely to be oversimplistic

In this section, we look at both the near-term impact on margins and the factors that can shape the outlook over the medium to longer term. At the outset, we acknowledge that forecasting NIM is a challenging task because (1) the sheer number of variables involved is very high, (2) these variables are sensitive to several external factors, and (3) the inter-dependence of the decisions by different lenders on some of the drivers is difficult to predict.

NIM for any bank is a function of several variables, which include:

- **Asset-related variables**:
  - Asset mix: share of loans, investments and cash on the balance sheet
  - loan mix across segments: retail, MSME, corporate or secured versus unsecured
  - pricing across segments (on incremental disbursements): which would be a function of competitive intensity and target borrower profile (salaried versus self-employed or lower-rated versus higher-rated, etc.), among other things.
  - benchmark-wise linkage of loans: share of EBLR, MCLR, fixed rate, etc.
- **Liability-related variables**:
  - liability mix: share of CA, SA, term deposits, borrowings and equity
  - pricing of each source of funds
  - re-pricing frequency of these liabilities
- **Miscellaneous variables**:
  - interest reversals from slippages
  - interest on income tax refund
- **External factors** which drive some of the variables listed above are:
  - changes to repo rate (its intensity and timeline) or requirement of CRR/ SLR, etc.
  - broader credit demand scenario
  - broader supply of deposits (especially retail deposits)

The list above is not intended to be comprehensive, but is presented only to give a sense of the number of variables, which drive NIM, thereby making projection a difficult task.

Near-term impact on NIM is inevitable; depth and speed of repo rate cuts will be key

As we pass through the next few quarters, we are likely to see a lot of conversation around contraction of NIM driven by re-pricing of EBLR-linked loans. The recent repo rate cuts (and further cuts over the next few quarters as anticipated by many) will inevitably put a significant pressure on loan yields over the near term given the large share of EBLR-linked loans for most large private banks as well as PSU banks (exhibit below). Some of the mid-tier private banks and small finance banks might be placed relatively better with a higher share of fixed rate loans.

The share of repo-linked loans is ~50% for the large private banks

Exhibit 28: Break-up of loan book by interest rate regime for banks (%)

	Repo linked	Other external benchmarks	MCLR and other older benchmarks	Fixed rate	Others	Comments
PSU banks						
SBI	28	14	35	20	3	As on December 2024
Bank of Baroda	33		47	20		As on September 2024
Canara Bank	41	NA	48	NA	11	As on September 2024
PNB	41	11	34	10	5	As on December 2024
Union Bank	31	12	46	10	NA	As on December 2024
Indian Bank	36		56	8		As on December 2022
Bank of India	48	NA	29	4	18	As on December 2024
Large private banks						
HDFC Bank	45			30		As on December 2024
ICICI Bank	52	16	1	31	-	As on December 2024
Axis Bank	54	4	12	29	1	As on December 2024
Mid-tier private banks						
IndusInd Bank	NA	NA	NA	52	NA	As on June 2023.
Federal Bank	51	NA	10	30	9	As on December 2024
City Union Bank	68		25		7	As on December 2022
RBL Bank	41		15	44		As on June 2023
IDFC First Bank	24		16	60		As on December 2022
KVB	37		47	16		As on March 2023
Bandhan Bank				70		As on March 2023
Small finance banks						
AU SFB				63		As on September 2023
Equitas SFB				80		As on December 2024

Source: Companies, Kotak Institutional Equities

The magnitude of repo rate cuts in this cycle along with the speed of it will be key to understand the near-term impact on NIM. The recent repo rate hike cycle between May 2022 and February 2023 was fairly steep (hike of 250 bps over a matter of just 10 months). Further, the magnitude of each individual step was in the range of 25-50 bps. The transmission of this repo rate hike into loan yield for banks was quite swift. For example, ICICI Bank saw its yield on loans increase to its peak level within ~5-6 quarters of the beginning of the cycle (see exhibit below). The magnitude of the transmission was also fairly high with the loan yield increasing by ~78% of the magnitude of the repo rate hike from bottom to peak for ICICI Bank. Note that the magnitude of the transmission was much higher (~78%) than the share of repo-linked loans (43-46% over the rate hike cycle) because of: (1) gradual upward re-pricing of other floating-rate benchmarks like MCLR (20-22% over the rate hike cycle) and (2) shift in loan mix toward higher-yielding loans, especially personal loans and credit cards.

At its peak, ICICI Bank saw its yield on loans increase by ~78% of the repo rate hike

Exhibit 29: Transmission of repo rate hike to loan yield across banks over the last repo rate hike cycle, March fiscal year-ends (% of repo rate hike)

	1QFY23	2QFY23	3QFY23	4QFY23	1QFY24	2QFY24	3QFY24	4QFY24	1QFY25	2QFY25	3QFY25
Public banks											
Bank of Baroda	-	12	39	56	55	62	66	71	65	62	58
Bank of India	-	22	36	48	51	70	66	71	71	62	70
Bank of Maharashtra	5	20	45	49	59	69	70	71	68	74	75
Canara Bank	-	5	23	40	43	54	51	60	54	60	57
Central Bank of India	-	36	47	74	61	60	77	71	71	71	74
Indian Bank	-	4	37	34	50	57	57	51	46	48	51
PNB	-	1	17	42	50	52	62	63	56	53	56
SBI	-	17	40	53	62	70	71	71	67	72	69
Union Bank	-	21	30	36	54	62	59	65	60	55	58
UCO Bank	-	4	26	33	47	46	49	60	52	57	54
Large private banks											
Axis Bank	6	31	56		68	77	81	84	80	82	81
HDFC Bank	-	19	41	47	59	62	61	58	60	64	63
ICICI Bank	-	22	45	63	72	74	78	77	74	76	70
IDBI Bank	-	11	23	44	122	33	51	67	18	74	27
Mid tier private banks											
Bandhan Bank	5	-	-	-	14	16	10	41	48	35	17
IndusInd Bank	-	6	23	28	34	42	39	43	35	28	20
RBL Bank	-	29	30	26	72	86	97	88	81	84	76
Yes Bank	1	14	32	40	44	50	51	55	50	52	43
Regional banks											
City Union Bank	-	9	6	2	18	26	22	26	18	28	31
DCB Bank	-	3	14	31	28	37	34	36	29	33	39
Federal Bank	-	16	35	42	47	56	58	53	59	59	64
Karur Vysya Bank	-	13	28	38	57	60	75	70	71	74	77
South Indian Bank	6	31	56	54	68	77	81	84	80	82	81
Small Finance banks											
AU SFB	-	11	14	14	15	6	4	-	50	54	52
Equitas SFB	-	-	-	-	-	-	-	-	-	-	-
Ujjivan SFB	12	25	29	37	49	61	71	64	52	97	51
Utkarsh SFB	35	33	20	16	10	19	41	64	66	35	11

Source: Companies, Kotak Institutional Equities

Thus, banks have no choice here but to pass on the lower repo rate to all repo-linked loans (with a lag of anywhere between 1 day to a few weeks) during the rate cut cycle. We have already seen several banks cut their repo-linked benchmarks over the past month (exhibit below).

Ability to cut deposit rates will be key to NIM over the medium term

Nevertheless, we argue that taking a negative view on NIM over the medium-to-long term makes for an incomplete argument given the number of variables involved and levers available with lenders. If we return to the recent rate hike cycle, we note that in spite of the magnitude and swiftness of rate cuts, banks were unable to preserve much of the benefit beyond a few quarters. For example, in the case of ICICI Bank, loan yield increased from 3.9% to 4.8% at its peak, but gave up a large part of these gains and returned to 4.3% soon thereafter (exhibit below). This was mainly driven by a steady commensurate increase in cost of deposits/funds, while the residual gains were largely due to a shift in loan mix toward higher-yielding products.

In spite of the sharp hike in repo rate and loan yields, banks gave up most of the NIM gains with a lag of a few quarters

Exhibit 30: Trend in NIM across banks over the last rate hike cycle, March fiscal year-ends (% of repo rate hike)

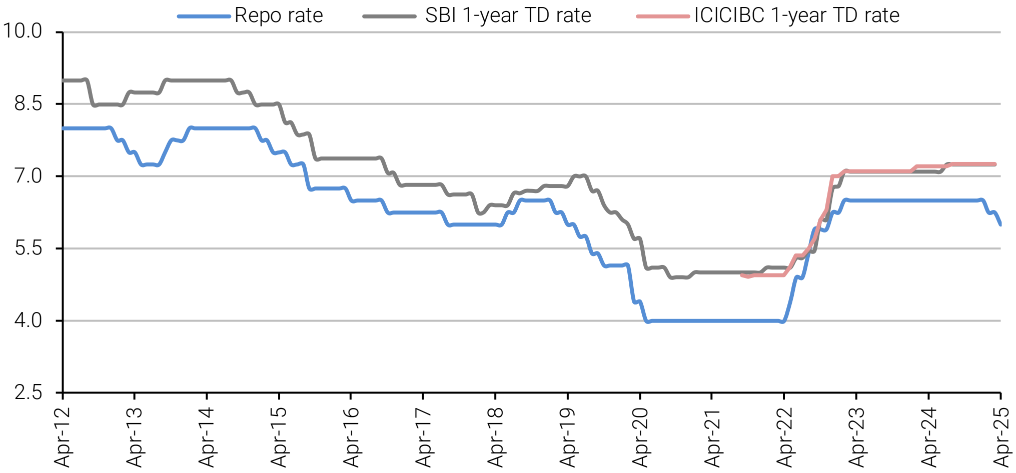
	Quarterly												
	4QFY22	1QFY23	2QFY23	3QFY23	4QFY23	1QFY24	2QFY24	3QFY24	4QFY24	1QFY25	2QFY25	3QFY25	Start of the cycle
Public banks													
Bank of Baroda	2.9	2.9	3.3	3.3	3.4	3.1	3.0	3.0	3.1	3.0	3.0	2.8	(0.1)
Bank of India	2.3	2.3	2.8	3.0	2.9	3.0	2.9	2.7	2.8	2.8	2.6	2.5	0.2
Bank of Maharashtra	3.0	3.0	3.3	3.4	3.5	3.6	3.7	3.7	3.6	3.8	3.7	3.7	0.7
Canara Bank	2.4	2.3	2.4	2.8	2.7	2.6	2.6	2.7	2.7	2.5	2.5	2.4	(0.0)
Central Bank of India	2.5	2.2	2.9	3.5	3.6	3.2	3.0	3.0	3.3	3.3	3.1	3.2	0.6
Indian Bank	2.7	2.8	2.9	3.4	3.3	3.3	3.3	3.3	3.3	3.2	3.2	3.2	0.6
PNB	2.4	2.4	2.6	2.8	2.8	2.7	2.8	2.9	2.8	2.8	2.7	2.7	0.3
SBI	3.0	2.9	3.2	3.3	3.4	3.2	3.2	3.1	3.1	3.1	2.9	2.8	(0.2)
Union Bank	2.8	3.0	3.2	3.2	3.0	3.2	3.2	3.1	3.1	3.1	2.7	2.7	(0.0)
UCO Bank	2.7	2.7	2.8	2.9	2.8	2.9	2.7	2.7	2.9	2.9	2.9	3.0	0.2
Large private banks													
Axis Bank	3.3	3.5	3.8	4.1	3.9	3.9	4.0	3.9	3.8	3.8	3.8	3.8	0.5
HDFC Bank	3.9	3.9	4.1	4.3	4.2	4.1	3.5	3.5	3.5	3.5	3.5	3.5	(0.5)
ICICI Bank	3.9	4.0	4.3	4.7	4.8	4.8	4.6	4.5	4.4	4.4	4.3	4.3	0.4
IDBI Bank	3.9	3.9	4.2	4.4	4.7	5.4	4.1	5.6	4.6	3.9	4.6	4.9	1.1
Mid tier private banks													
Bandhan Bank	7.7	7.3	6.4	6.1	6.9	6.7	6.6	6.7	7.1	7.2	7.0	6.5	(1.2)
IndusInd Bank	4.0	4.1	4.1	4.1	4.1	4.2	4.3	4.4	4.3	4.1	4.0	3.8	(0.2)
RBL Bank	4.6	4.1	4.7	4.6	4.6	5.2	5.2	5.3	5.2	5.4	5.0	4.8	0.2
Yes Bank	3.1	3.1	3.2	3.1	3.1	2.9	2.8	2.8	2.8	2.8	2.8	2.7	(0.4)
Regional banks													
City Union Bank	3.5	3.5	3.7	3.5	3.2	3.3	3.4	3.2	3.3	3.2	3.3	3.2	(0.3)
DCB Bank	3.5	3.3	3.6	3.7	3.8	3.5	3.4	3.2	3.3	3.1	3.1	3.1	(0.4)
Federal Bank	3.1	3.1	3.3	3.5	3.2	3.1	3.1	3.1	3.1	3.1	3.0	3.0	(0.0)
Karur Vysya Bank	3.5	3.5	3.8	3.9	3.9	3.8	3.7	3.9	3.8	3.8	3.8	3.7	0.2
South Indian Bank	3.3	3.5	3.8	4.1	3.9	3.9	4.0	3.9	3.8	3.8	3.8	3.8	0.5
Small Finance banks													
AU SFB	6.0	5.7	6.0	6.0	5.8	5.6	5.5	5.5	5.2	6.2	6.1	5.9	(0.1)
Equitas SFB	9.4	9.4	9.2	9.1	9.1	8.8	8.5	8.4	8.1	7.9	7.5	7.4	(2.0)
Ujjivan SFB	10.2	10.5	10.8	10.1	9.6	9.6	9.3	9.1	9.6	9.4	9.1	8.2	(1.9)
Utkarsh SFB	9.7	9.6	9.9	9.5	9.1	9.1	9.4	9.9	10.0	9.7	9.0	8.5	(1.2)

Source: Companies, Kotak Institutional Equities

The exhibit below shows the pricing of fresh term deposits (1-2 year bucket) by SBI and ICICI Bank in comparison with the repo rate. We observe that both banks hiked pricing on fresh term deposit rates swiftly and simultaneously as the repo rate was hiked. In our view, the choice of bank management to hike deposit pricing as swiftly was likely led by: (1) comfort on higher spreads due to yield expansion on the other side led by repricing of repo-linked loans and (2) the fact that this was also a period when system loan growth began running higher than system deposit growth, thereby making deposit mobilization more critical than usual (especially for the private banks most of whom were not left with a lot of headroom on the CD ratio front either). We know that the stock of term deposits gets repriced with a lag as existing term deposits come for renewal at the prevailing rates (higher or lower than that on the maturity deposit). As a result, NIM for most banks reverted closer to the pre-hike levels over a period of few quarters.

During the rate hike cycle, SBI and ICICI Bank hiked the pricing of term deposits swiftly and simultaneously

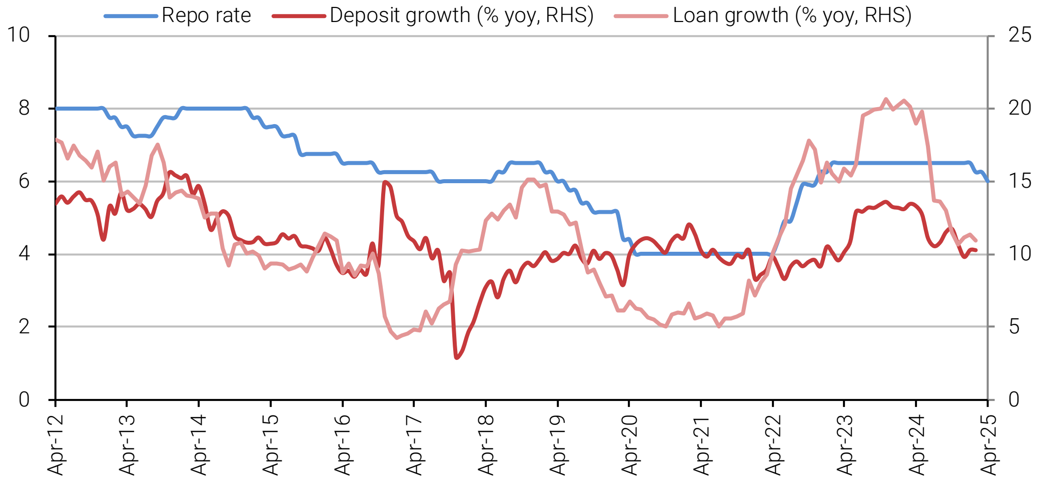
Exhibit 31: Trend in repo rate and rate offered by SBI on fresh term deposits for 1-2 year tenor (%)



Source: RBI, Companies, Kotak Institutional Equities

System loan growth overtook deposit growth coincidentally when the rate hike cycle began

Exhibit 32: Trend in loan growth and deposit growth for banking system (% yoy)



Source: RBI, Kotak Institutional Equities

As we go into the ongoing rate cut cycle, it will be crucial to watch the actions of banks on their term deposit pricing. Swift cuts to term deposit pricing should allow banks to offset the NIM pressure from declining loan yields over a period of time. However, we need to see the larger banks (both private and PSU banks) initiate these cuts because they are the ones, which tend to anchor pricing for the system. Thus far, a few banks have tweaked their term deposit pricing (exhibit below) over the past couple of months, but we have not seen a coordinated material action on pricing in the key bucket of 1-3 years by the large banks.

Several banks have tweaked their pricing of fresh term deposits recently, but not materially

Exhibit 33: Recent actions by banks on deposit pricing over the past few weeks

	Deposit type	Recent changes in fresh deposit pricing in key buckets	Maturity	Ticket size	Effective date	Effective amount of cut	Implication (KIE view)
Private banks							
HDFC Bank	Savings	Pricing cut by 25 bps	Not applicable	Across ticket sizes	12-Apr-25	25 bps	Expect immediate decline in cost of SA deposits by ~25 bps.
	Term	Discontinued the Special Edition FD schemes (launched in Jul-24) offering 7.35% (35 months) and 7.40% (55 months)	35 months and 55 months	<Rs30 mn	31-Mar-25	35-40 bps	Cut of ~35 bps and ~40 bps in 2-3 year bucket and >3 year bucket resp. Expect only a marginal decline in fresh TD cost because peak rate in 1-2 year bucket stays at 7.25%.
ICICI Bank	Savings	No changes. SA rate stays at 3.0% for <Rs5 mn ticket.	Not applicable			0 bps	No material change expected in SA deposit cost.
	Term	No material changes. Peak rate in 1-3 year bucket stays at 7.25%.	Not applicable			0 bps	No material change expected in TD cost.
Axis Bank	Savings	Pricing cut by ~25 bps	Not applicable	Across ticket sizes	15-Apr-25	25 bps	Expect immediate decline in cost of SA deposits by ~25 bps.
	Term	No material changes. Peak rate in 1-3 year bucket stays at 7.25%.	Not applicable			0 bps	No material change expected in TD cost.
IndusInd Bank	Savings	No material changes after March 2025	Not applicable			0 bps	No material change expected in SA deposit cost.
	Term	No material changes. Peak rate in 1-3 year bucket stays at 7.75%.	Not applicable			0 bps	No material change expected in TD cost.
Federal Bank	Savings	No material changes. SA rate stays at 3.0% for <Rs5 mn ticket.	Not applicable			0 bps	No material change expected in SA deposit cost.
	Term	No material changes. Peak rate in 1-3 year bucket stays at 7.50%.	Not applicable			0 bps	No material change expected in TD cost.
PSU banks							
SBI	Savings	No changes. SA rate stays at 2.7% for <Rs100 mn ticket.	Not applicable			0 bps	Not applicable
	Term	Pricing of Amrit Vrishti scheme (launched in Jul-24) cut from 7.25% to 7.05%	444 days	<Rs30 mn	1-Apr-25	20 bps	Expect a modest decline in fresh TD cost due to 10-20 bps pricing cut in 1-3 year bucket
		Discontinued the Amrit Kalash scheme (launched in Feb-23) offering 7.10%	400 days	<Rs20 mn	15-Apr-25		
		Pricing in 1-2 year FD cut from 6.80% to 6.70%.	1-2 years	<Rs30 mn	15-Apr-25		
		Pricing in 2-3 year FD cut from 7.00% to 6.90%.	2-3 years	<Rs30 mn	15-Apr-25		
Bank of Baroda	Savings	No changes. SA rate stays at 2.75% for <Rs500 mn ticket.	Not applicable			0 bps	Not applicable
	Term	Discontinued bob Utsav scheme (launched in Oct-24) offering 7.30%	400 days		6-Apr-25	15 bps	Expect a modest decline in fresh TD cost due to ~15 bps cut in peak rate in 1-2 year bucket
		Introduced bob Square Drive scheme offering 7.15%	444 days		7-Apr-25		
Canara Bank	Savings	No changes. SA rate stays at 2.9% for <Rs50 mn ticket.	Not applicable			0 bps	Not applicable
	Term	No change to Canara-444 scheme (launched in Apr-23) offering 7.25%	444 days	<Rs30 mn	10-Apr-25	5 bps	Peak rate in key bucket of 1-3 years is down effectively from 7.30% to 7.25%. Hence, expect only a marginal decline in fresh TD cost.
		Pricing in 2-3 year FD cut from 7.30% to 7.15%.	2-3 years	<Rs30 mn	10-Apr-25		
		Peak pricing in >3 year FD cut from 7.40% to 7.20%.	>3 years	<Rs30 mn	10-Apr-25		
Punjab National Bank	Savings	No changes to retail SA pricing. SA rate stays at 2.7% for <Rs1 mn ticket.	Not applicable			0 bps	Expect a marginal decline in cost of SA deposits because contribution of this bulk ticket size bucket is likely to be low
		Bulk SA pricing cut from 3.00% to 2.75%	Not applicable	>Rs1 bn	4-Apr-25	25 bps	
	Term	Peak pricing in 9-12 month FD cut from 7.05% to 6.80%.	9-12 months	<Rs30 mn	10-Apr-25	15 bps	Expect a modest decline in fresh TD cost due to ~15-25 bps cut in peak rate in key buckets
		Peak pricing in 1-2 year FD cut from 7.25% to 7.10%.	1-2 years	<Rs30 mn	10-Apr-25		
		Pricing in 2-3 year FD cut from 7.00% to 6.75%.	2-3 years	<Rs30 mn	10-Apr-25		
		Peak pricing in >3 year FD cut from 6.50% to 6.25%.	>3 years	<Rs30 mn	10-Apr-25		
Union Bank of India	Savings	No changes. SA rate stays at 2.75% for <Rs5 mn ticket.	Not applicable			0 bps	Not applicable
	Term	Pricing in 4-12 month bulk TD cut from 5.0% to 2.9%	4-12 months	>Rs30 mn	11-Apr-25	210 bps	Expect a modest decline in fresh TD cost because bulk TD constitutes ~26% of overall deposits for the bank
		Peak pricing in 1-2 year bulk TD cut from 7.25% to 6.75%	1-2 years	>Rs30 mn	11-Apr-25	50 bps	

Notes:
(1) For term deposits, "effective amount of cut" column shows the magnitude of cut in peak pricing offered in 1-3 year bucket.
(2) While all attempts have been made to make this list as comprehensive as possible, it is possible that it is not exhaustive.

Source: Companies, Kotak Institutional Equities

Note that in an environment where only term deposit rates are declining (not SA rates), NIM improvement will be sharper for banks with a lower CASA ratio (exhibit below). However, we are unsure what will encourage the large banks to undertake material cuts in pricing of deposits. The banking system is currently in a situation where: (1) loan growth is still running at a level similar or marginally higher than deposit growth, and (2) most banks (including private and PSU banks) are running at elevated CD ratio levels with little headroom. That is probably driving banks to not deviate from competitive pricing of deposits lest they risk losing their existing deposits to others in case peer banks do not follow through. Further, select large banks are currently in a situation where deposit growth is probably running below desired level. For example, Axis Bank has recently seen deposit growth running below peers. HDFC Bank is also in the process of replacing higher cost borrowings on its balance sheet with deposits. This might discourage them from aggressive cuts in pricing of deposits. Nevertheless, the trend in the deposit rate cuts will be a key variable to monitor to understand how banks attempt to protect NIM.

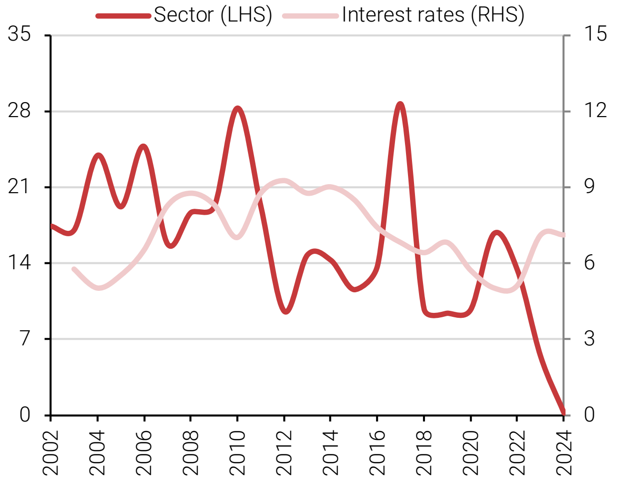
Recent deposit rate cuts not being led by design but more by lack of choices.

We note that Axis Bank and HDFC Bank have chosen to cut savings interest rates by 25 bps. We see several banks have started to cut interest rates on term deposits though the cuts are still not sufficient. We would not want to be positive on the recent rate cuts by banks as a sign that lenders are comfortable on deposit growth. We would want to attribute this as means to reduce the pressure on NIM compression and being comfortable to let go growth. As highlighted earlier, the sensitivity to interest rates on savings deposits is not a strong one, as assumed. Hence, we don't see a risk to market share arguments as is typically assumed.

Lowering the impact of NIM compression is the best explanation. We look at the cut in savings rates as follows: (1) the historical relationship between savings interest rates and term deposit rates are not that strong. The correlation is stronger in urban markets but negligible in urban, rural and metro regions. (2) the situation on NIM compression is a common theme across banks even if the intensity varies. We could see similar response from other players with leading banks taking the decision to cut rates making it easier for others to respond. (3) NII growth is a function of business growth and rates. With business growth likely to be weak, lenders are probably looking through offset this by reducing NIM pressure. (4) Lenders are probably comfortable to let go growth. The situation today is not extremely comfortable with uncertainties on the global front. As we have highlighted in the previous section on growth, the payoffs, if incorrect, could result in higher stress in the next few years.

Relationship between SA growth and term deposit rates has been weak

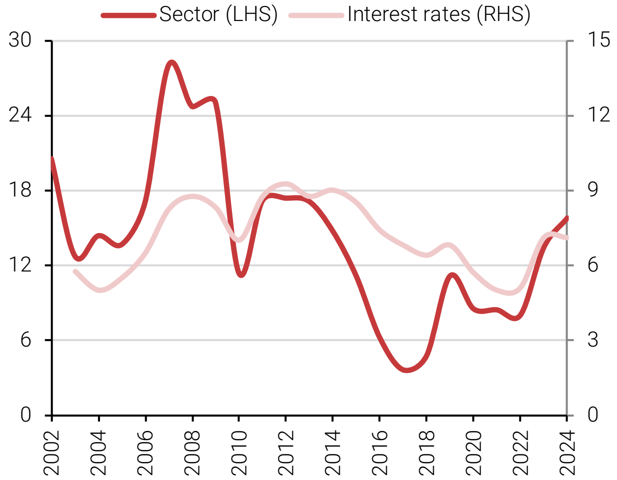
Exhibit 34: Relationship between growth in savings deposits and interest rates for sector, March fiscal year-ends (%)



Source: RBI, Kotak Institutional Equities

There seems a modest positive relationship between term deposit growth and term deposit rates

Exhibit 35: Relationship between growth in term deposits and interest rates for sector, March fiscal year-ends (%)



Source: RBI, Kotak Institutional Equities

The path of interest rates suggests that lenders have to take more cuts. Lenders are faced with limited choices with each path only resulting in lower NIM but with various degrees of intensity. As highlighted earlier, changes to NIM have many variables and forecasting the impact of each variable in isolation serves limited purpose. It would be useful to understand with possible actions to cut in policy rates and reactions to how other lenders approach the situation. The bear case earnings impact is most likely to be an extremely pessimistic outcome, which usually is less acceptable. However, ruling out bear cases and bringing in modifications to other variables (interest rate on loans, loan mix, CASA deposits or others) brings a certain degree of biases, which implies that we are mostly likely to accept the scenario that is most convenient. Hence, the best approach would be take the view that rate cycle would have a negative outcome on NIM.

Banks with a lower CASA ratio stand to benefit more in an environment where only term deposit rates are cut, while SA rates stay broadly intact

Exhibit 36: CASA ratio across banks, March fiscal year-ends (% of overall deposits)

	2018	2019	2020	2021	2022	2023	2024	2025E	2026E	2027E
HDFCB	43	42	42	46	48	44	38	39	40	41
ICICIBC	52	50	45	46	49	46	42	43	41	40
AXSB	54	44	41	45	45	47	43	41	41	40
IIB	44	43	40	42	43	40	38	39	40	41
YES	36	33	27	26	31	31	31	31	32	32
FB	34	32	31	34	37	33	30	29	29	29
KVB	29	30	31	34	35	33	30	31	32	32
CUBK	24	25	25	29	33	30	31	29	29	30
BANDHAN	34	41	37	43	42	39	37	35	33	31
DCBB	24	24	21	23	27	26	26	27	27	28
SBIN	44	45	44	45	45	43	40	40	40	40
BOB	36	35	35	40	41	39	39	39	40	40
CBK	32	29	31	33	34	31	30	31	32	32
PNB	41	42	43	45	47	42	40	39	39	38
UNBK	34	36	36	36	37	35	34	33	33	34
AUBANK	27	18	14	23	37	38	33	30	35	36
EQUITASB	29	25	20	34	52	42	32	32	35	38
UJJIVANS	4	11	14	21	27	26	27	28	30	31
UTKARSHB	5	10	13	18	22	21	21	23	26	29

Source: Companies, Kotak Institutional Equities

Levers available on the yield front might be less useful for NIM protection as of now

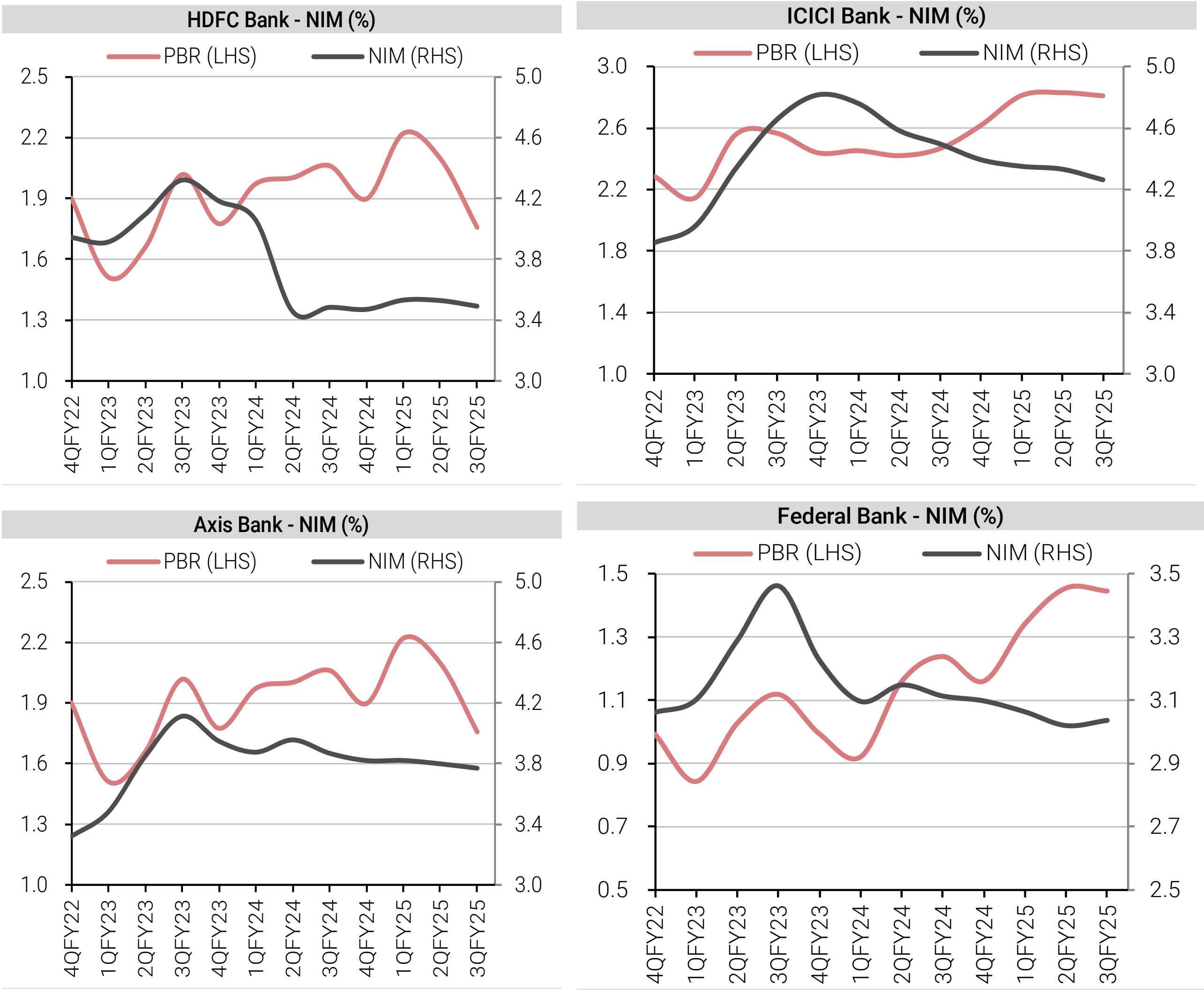
Banks can attempt to protect NIM through actions on the yield front as well. This can include (1) a hike in the pricing on incremental disbursements, (2) shift in borrower mix toward higher-risk borrowers, and (3) shift in product mix toward higher-yielding loans. A hike in pricing on incremental disbursements will be a function of broader credit demand as well as lenders' appetite to grow. The credit demand environment seems to have steadily weakened over the past couple of years (see Exhibit 20 above on CMI Demand). Further, as highlighted in an earlier section, we believe the second and third alternatives (shift in loan mix towards higher-risk borrowers or higher-yielding segments) have a low probability of playing out given the uncertainty in the environment.

Valuation multiples do not have to necessarily correct if NIM decline is transient

We also argue that valuation multiples for banks might not necessarily correct on the back of near-term NIM pressure in case investors acknowledge the ability to restore NIM closer to through-the-cycle average. For instance, valuation multiples for banks did not react to sharp NIM expansion during the rate hike cycle because investors chose to look through this transient period of inflated NIM and acknowledged that it had to revert lower with the hikes in deposit pricing on the other side.

ICICI Bank and Axis Bank saw sharp NIM expansion during the rate hike cycle, but valuation multiples did not react

Exhibit 37: Relationship between NIM and valuation multiple, March fiscal year-ends (X)



Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Operating leverage is probably not high but operating expenses growth could slow down

We don't see a massive operating leverage that is negative for banks during this period of NIM compression. When we look back at the period from strong NII growth (4QFY22-1QFY24), we did see operating expenses growing at a faster pace as well. As the re-pricing of deposits began from this period, we note that the operating expenses have slowed as well.

Note that the operating expenses growth has been different for public, private and regional banks. On an overall basis, we note that the operating expenses growth has a few primary variables. We saw a significant growth in disbursements in retail and MSME products, which would have entailed higher investments some of which pertains to building the long-term business (set-up costs) and some of it pertaining to growing the business. Much of the long-term business is behind us today, which implies that the incremental costs pertain only to scaling and maintaining the businesses. On the other hand, the liability side investments have generally been quite high in recent years but largely from private banks. We do expect a slowdown in these investments as focus is more to improve productivity as compared to increasing distribution. On the other hand, PSU banks and regional private banks had made wage cycle-related provisions in FY2023 and given that it is negotiated every five years, we should expect the next cycle only from FY2027 onwards.

We should expect cost growth to be closer to single digits till we see a NII growth bottoming out. As highlighted in the previous section, the path for interest rate is not well defined at this stage, which implies that there is greater uncertainty on depth, duration and intensity of the rate softening cycle.

Growth in operating costs has decelerated recently

Exhibit 38: NII growth and cost growth across bank groups, March fiscal year-ends (% yoy)

Source: Companies, Kotak Institutional Equities

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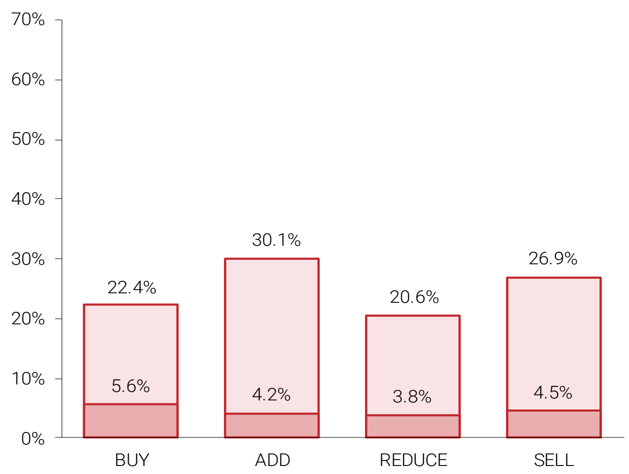

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Source: Kotak Institutional Equities

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