BANKING SECTOR ANALYSIS

Indian banking sector – Dragging down or driving up India's growth story?

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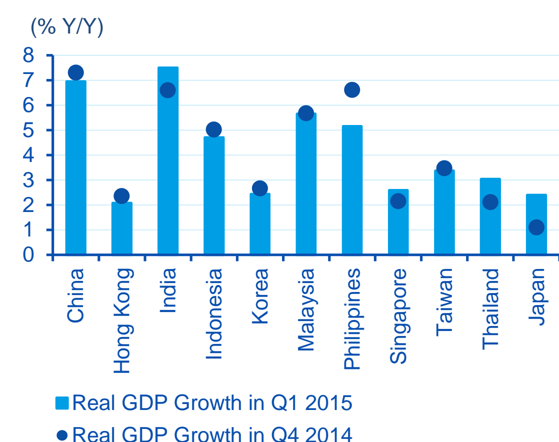
India outpaced China to become Asia's fastest growing economy in Q1 2015 (See Figure – 1). Concerted policy actions from a reform-minded government and the Reserve Bank of India have substantially improved the country's macro stability and activity momentum (See Figure – 2). Yet, the South Asian giant is still far from firing on all engines; with consumption and investment demand still noticeably weak under the hood. Ongoing policy efforts to fuel a more robust and balanced economic recovery have brought to fore daunting challenges facing India's banking sector and raised concerns that the sector may prove to be a drag rather than drive India's promising growth prospects. In this watch, we examine key issues facing India's banking sector, their impact on banks' ability to support India's growth up-cycle, the effectiveness of recent policy measures to tackle banks' inherent problems; and put forth policy recommendations.

India's banking sector performance – A study in contrasts

India's banking sector performance over the past five years since the 2008-2009 Global Financial Crisis (GFC) reflects a contrasting picture depending upon bank ownership. On the one hand, private sector Indian banks and foreign banks have exhibited profitability improvements, better asset quality trends, lower credit costs and healthy capital levels. On the other hand, state owned public banks (PSU Banks) have been facing declining earnings growth, narrowing profit margins, significant deterioration in asset quality and elevated credit costs (See Figures – 3 & 4). Weakness in India's banking sector is highly skewed, with bulk of the restructured loans (nearly 80%) sitting with small state owned banks, which have just 50% of the Indian banking system's Tier -1 capital.

Notwithstanding the differences, in general for India's banking system as a whole, profitability remains constrained due to rising credit costs given high level of impaired assets - which leads to the creation of higher loan loss reserves - , a sharp slowdown in incremental loan to deposits ratio and on-going cuts in lending rates by banks in response to RBI's recent monetary policy easing. Return of Assets (ROA) – a measure of bank profitability – of PSU banks is low, in the range of 0.7% to 1.0% and below 2% for private sector banks.

Figure 1
Indian economy is performing relatively better than most other economies in Asia today



Source: BBVA Research, Haver Analytics

Figure 2
India's external vulnerability indicators have improved over the past two years

	Fiscal Sustainability Central Govt Debt (% of GDP)		External Sustainability Current Account Balance (% of GDP)		Liquidity Management Short Term External Debt as share of FX Reserves (%)	
	May 2013	Current	May 2013	Current	May 2013	Current
India	46.8	45.0	-4.6	-0.2	34.3	26.7
Indonesia	22.7	25.8	-4.2	-2.8	61.2	55.0
Philippines	47.8	40.0	4.4	5.9	23.2	23.1
Thailand	30.9	32.0	-7.2	9.2	38.6	38.1
Malaysia	54.7	52.1	0.8	2.2	81.4	103.8

Source: BBVA Research, Haver Analytics

Loan advances by banks have hit multi year lows amid high credit costs and slowing credit demand

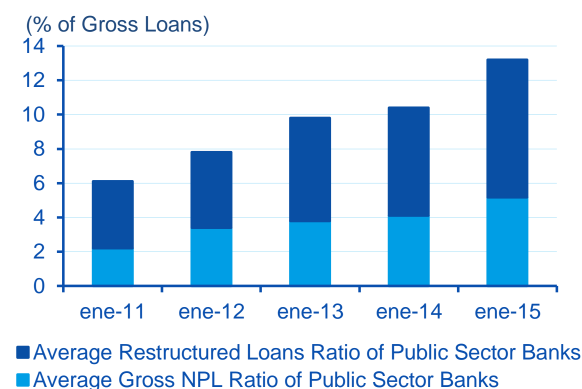
Credit costs of public sector banks have been in the elevated range of 1.1% to 1.2% while for the private banks they are lower, between 0.5% to 0.8%. However, credit costs are expected to remain under pressure for the entire banking system this year given weak asset quality trends. While an increasing share of retail loans, particularly housing and personal loans, has supported Net Interest Income growth of Indian banks in Q1 2015, yields from the corporate loan book remain low and the recent policy rate cuts have depressed banks' Net Interest Margins (NIMs) given the pressure to lower bank lending rates. A pick-up in government business on the back of on-going policy reform momentum has supported fee income growth of banks in Q1 2015, although weaker external demand dampened growth in fees on L/C guarantees.

Even as weak profitability has impinged upon banks willingness from taking up new loans, trends in advances are not too encouraging from the demand side either. Bank deposit and credit growth rates have slowed sharply to their lowest level in the past two decades. Deposits grew just 11.4% y/y in March 2015, dragged by wholesale deposit growth amid narrowing profit margins of Indian corporates and falling real interest rates. Meanwhile, credit growth slowed to 9.5% y/y in March 2015 as higher demand for individual and agriculture credit was offset by significant weakness in industrial and services loans, driven by a protracted slack in investment activity, strained corporate balance sheets, and less borrowing by oil marketing companies. Banks incremental credit to deposit ratio[1] has fallen sharply to 64.8% in March 2015 compared to 74% a year ago led by expectations of lower credit growth.

Elevated levels of stressed assets and weak capital positions – A toxic combination

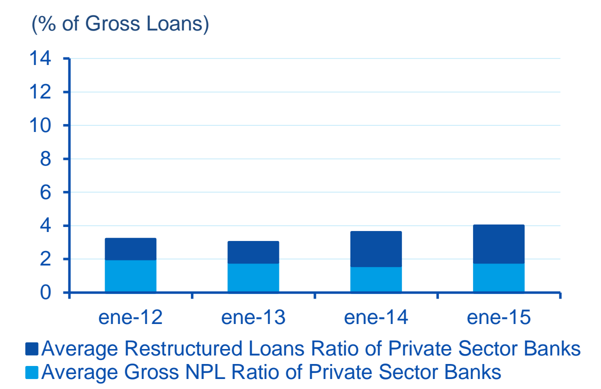
High level of impaired loans and weak capital positions of India's public sector banks undermines the overall credit profile of India's banking system. Net new NPL formation rate (as % of total loans) for India's public sector banks has jumped two fold from 1.0% in FY10 (Fiscal year ending March 2010) to 2.0% in FY15, reflecting acute asset quality weakness in the Indian banking system. Adequate capital is a pre-requisite for banks to clean up their balance sheets and support lending to productive sectors as investment cycle revives in the Indian economy.

Figure 3
Asset quality of India's public sector banks has weakened significantly over past several years



Source: BBVA Research, RBI, Haver Analytics

Figure 4
In contrast, Private Sector Indian banks have asset quality concerns under control



Source: BBVA Research, RBI, Haver Analytics

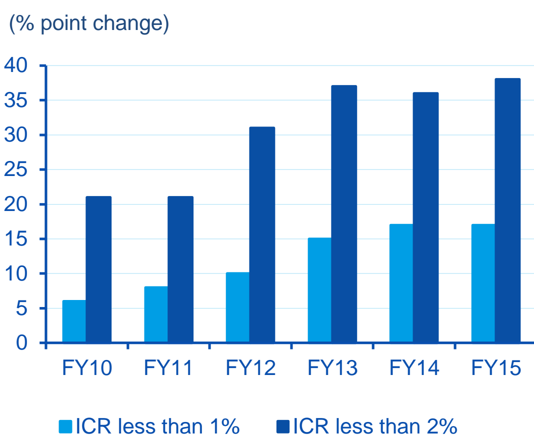
1: Incremental Credit to Deposit Ratio (ICDR) = Incremental Advances/Incremental Deposits;
Incremental Advances = Total Advances Current Year – Total Advances Previous Year ;
Incremental Deposits = Total Deposits Current Year – Total Deposits Previous Year; ICDR reflects the portion of new deposits used to extend loans.

Asset quality of most public sector banks in India remains exceptionally weak

As of March 2015, Gross Non-Performing Assets (GNPAs) and Net Non-Performing Assets (NNPAs) for the Indian banking system as a whole stood at 4.45% and 2.36% of total advances respectively as per RBI data. On a standalone basis, the impaired asset ratios do not appear as alarming but when one considers the total Stressed Assets Ratio (Gross NPA + Restructured Loans to Gross Advances)[2] for the Indian banking system, which stands at 10.9%; the situation is distressing. Q1 2015 saw a pick-up in migration from restructured loans to NPLs for Indian banks. State owned public sector banks account for the bulk of impaired assets in Indian banking system with GNPAs and stressed assets ratios significantly higher than system average at 5.17% and 13.2% respectively as on March 2015. Nevertheless, over the past year, India's banking system in general has seen a higher level of migration from restructured loans to Non-Performing Loans. According to industry estimates, gross NPAs for Indian banks are expected to rise to 5.9% of total advances for FY16 compared to 4.4% in the previous fiscal year.

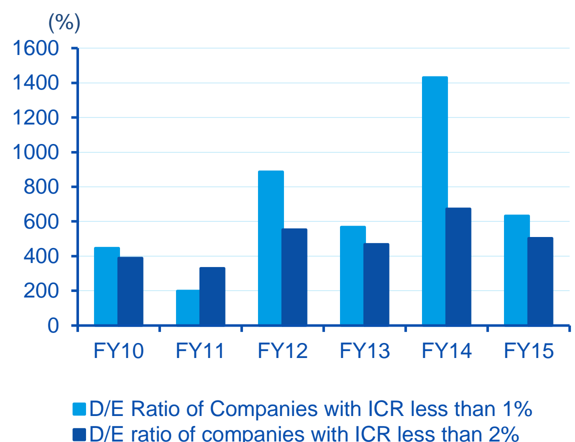
Asset quality stress is chiefly found in energy and metals sector such as Power, Iron and Steel, Engineering Procurement and Construction (EPC), Textiles and agriculture sector. Issues such as shortage of energy resources, in particular, coal availability; delayed payments by EPC companies have stressed road projects and the impact of unseasonal rains on agriculture output. Local corporates are saddled with high levels of external debt, which remains a concern amid prospects of Fed rate normalization. High corporate leverage represents a credit challenge for domestic banks, especially in the public sector domain. Such distressed corporates have exhibited low interest coverage ratios (ICR) over the past last two years. 17% of India's non-financial companies listed in the Indian stock market exhibited interest coverage ratio (ICR) of less than 1% in FY15 while 38% have ICR less than 2% (See Figure – 5). These stressed corporates have very high leverage with a Net Debt to Equity ratio in the range of 500% to 600% (See Figure - 6). The New Net NPL formation rate for public sector banks has therefore risen rapidly over the past five years (See Figure – 7).

Figure 5
Rising number of Indian corporates have poor interest coverage ratio of less than 2%



Listed Indian Non-Financial Companies Interest Coverage Ratio (ICR) of less than 2%
Source: BBVA Research, RBI, Haver Analytics

Figure 6
Stressed Indian corporates have very high debt to equity ratios



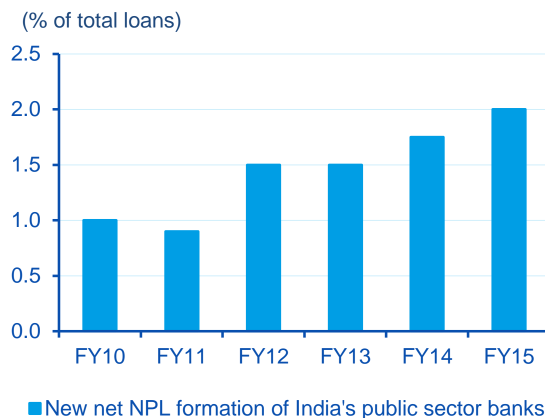
Debt to Equity Ratio of Listed Indian Non-Financial Companies
Source: BBVA Research, RBI, Haver Analytics

2: Restructured loan involves modification of terms of the advances/securities, which includes alteration of repayment period/repayable amount/ the amount of installments and rate of interest. Restructuring is a mechanism to nurture an otherwise viable unit, which has been impacted, back to health, by granting special concession from the bank. Unlike a restructured loan, a Gross Non Performing Asset does not generate income for the bank. The related term loan is overdue for a period of more than 90 days to be called an NPA. (RBI).

Capital raising requirements for Indian banking sector are significant

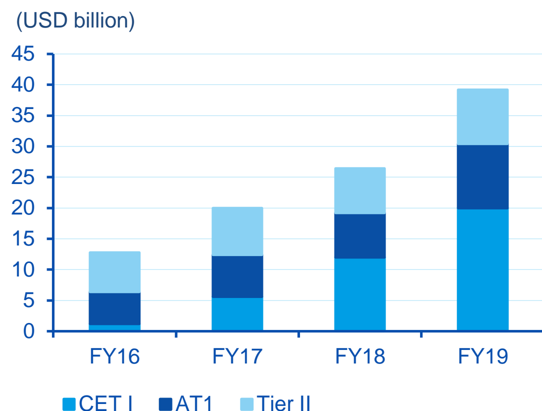
While the extent of asset quality deterioration differs for private and public sector banks, so does their ability to withstand elevated bad loans. The overall liquidity profile of Indian banking system benefits from 1) RBI's on-going accommodative monetary policy stance, 2) recent tightening in regulatory requirements to mitigate wholesale funding risks, 3) proactive liquidity management by the RBI, 4) substantial bank investments in highly liquid instruments, 5) India's high savings rate of about 30%, and 5) the fact that Indian banks are mostly deposit funded. 70% (of total banking assets) of India's bank balance sheets are funded by deposits. However, India's banking system needs to raise significant amount of fresh capital over the next few years to meet Basel 3 standards. While the average Tier 1 ratio of Indian private banks is 12.6% and 8.8% for Indian public sector banks, which is satisfactory, and above Basel III norms, there are several pockets of weakness, especially within the public sector banking space. Capital requirements for Indian PSU banks are high given a weak internal capital generation capacity and the challenges in raising capital in domestic equity markets. In contrast to the last fiscal year (ending March 2015), global portfolio allocations to India have fallen significantly since March 2015 with net portfolio capital outflows so far. As per industry estimates, total capital requirement of Indian Banks shoots up from about USD 12.8 billion for FY16 (fiscal year ending March 2016) to USD 38 billion in FY19.

Figure 7
Net new NPL formation rate has picked up for Public sector banks over the past year



Source: BBVA Research, RBI, Haver Analytics

Figure 8
Capital raising requirements in the Tier1 segment are significant for Indian banks going ahead



Indian Banking Sector Estimated Capital Requirements by Type
Source: BBVA Research, RBI, Haver Analytics

Pressing concerns over achieving capital adequacy goals emanate chiefly from challenges in raising Tier 1 capital. Nearly 80% of the total required capital needs to be raised by public sector banks; with the bulk (nearly 65%) of it comprising Common Equity Tier 1 (CET1)[3] and Additional Tier 1 (AT1) capital while the rest comprises Tier 2[4] capital (see Figure – 8). The daunting capital requirements are expected to drive significant issuances of AT1 debt by PSU banks going forward even as private Indian banks would be able to raise funds in the capital market. Q1 2015 saw roughly USD 1 bn of AT1 bond issuances from seven Indian banks. AT1 bonds, as per Basel III norms qualify as core or equity capital and come with loss absorbing features. They can thus be written off or converted into common equity by banks during times of stress, subject to approval by the Reserve Bank of India. Furthermore, the RBI has facilitated AT1 bond issuances by amending related norms last year, to allow 1) shorter maturity of up to five years, 2) temporary write-

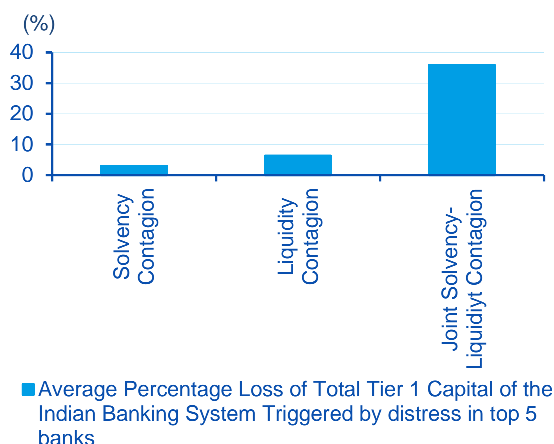
3: It consists mainly of share capital and disclosed reserves (minus goodwill, if any). Tier I items are deemed to be of the highest quality because they are fully available to cover losses.
4: Also known as supplementary capital, it consists of certain reserves and certain types of subordinated debt. Tier II items qualify as regulatory capital to the extent that they can be used to absorb losses arising from a bank's activities. Tier II's capital loss absorption capacity is lower than that of Tier I capital.

downs at pre-specified trigger points, 3) allowing retail participation, and 3) permitting payment of dues from past reserves. The appetite for AT1 issuances will be tested in the coming months. Particularly so given that the AT1 market still underdeveloped in India and there are concerns amongst investors related to risks associated with AT1 securities. Long term investors are likely to prefer infrastructure bonds as compared to AT1 instruments. Against this backdrop PSU banks will have to find alternate ways to mobilize Tier 1 capital for themselves although Tier 2 should not be a problem. In this regard, it would be interesting to look for potential RBI measures to allow banks to raise external commercial borrowings from abroad. This window for India banks to raise capital abroad is shut currently.

Could the banking sector become a major drag for India's growth cycle?

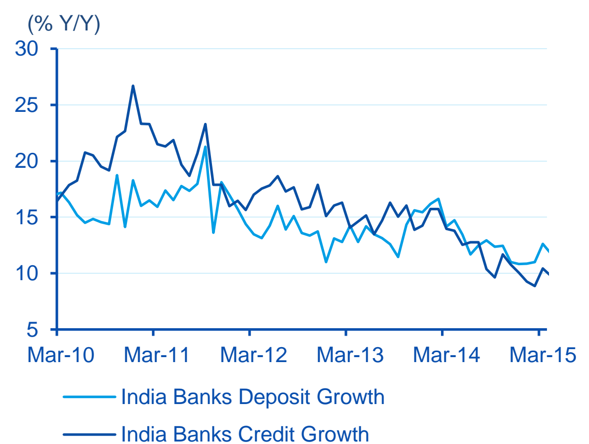
Even as prospects for India's economic growth have improved materially over the past year on the back of structural reforms, the two key pillars of Indian banking system – 1) asset quality and 2) capital adequacy – have weakened over the corresponding period. Challenges faced by India's public sector banks have raised concerns over the sector's ability to support India's growth up-cycle. The Reserve Bank of India, last December, conducted a contagion analysis[5] to estimate potential loss to the Indian banking system triggered by the failure of one or more of the top five connected banks. The study revealed that the Indian banking system could potentially lose close to 50 per cent of its total Tier-I capital under the joint solvency-liquidity condition in the event of a particular bank triggering a contagion. The analysis suggests that although a particular bank may not cause substantial solvency or liquidity contagion on a standalone basis, it could have a magnifying impact under the joint scenario i.e. Solvency and Liquidity impact (See Figure – 9). In this context, several large Indian banks, particularly those in the public sector, can be termed as 'Too Connected to Fail (TCFT)' and are associated with high risk of a contagion. Not just their interconnectedness, but also the counterparties and quantum of exposure involved in the connection can lead to potential macro stability issues in the Indian economic landscape. In India's context, the risk of a liquidity contagion is higher than a solvency contagion given that most public sector banks are net lenders; and thus a distress situation would most likely impact the economy through the bank lending channel.

Figure 9
RBI's banking contagion analysis raises concerns



Source: BBVA Research, RBI, Haver Analytics

Figure 10
Credit and Deposit growth has slowed



Source: BBVA Research, RBI, Haver Analytics

5: See RBI's Financial Stability Report, December 2014.

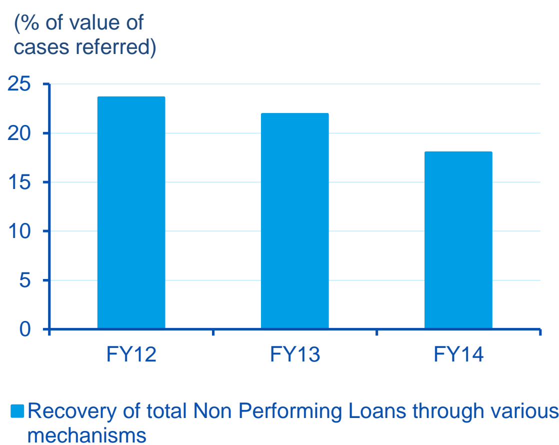
The initial impact of a banking sector distress on India’s economic environment is already visible

In particular for India's 23 state owned banks (PSU Banks) , which account for about 73 percent of domestic banking sector assets, credit costs have risen, led by high levels of impaired assets, weakening, albeit still overall adequate, capital buffers and subdued rate of credit and deposit growth (See Figure – 10). This stress has hurt bank profitability, hit bank stock prices, impeded transmission of RBI's policy rate cuts, and, in turn, undermined government's planned overhaul of India's infrastructure, which needs a staggering USD 1 trillion in aggregate funding. Currently, the capital to risk weighted assets ratio (CRAR) of the scheduled commercial banks is satisfactory, averaging at around 12.8 per cent and therefore isn’t proving to be a drag on India’s economic growth. However, going forward, the Indian banking sector is less capable of funding India’s growth up-cycle. Public sector banks would require substantial capital to meet regulatory requirements with respect to additional capital buffers and even more if it has to become a key driver of India’s growth story. On the flipside, an improvement in India’s macroeconomic conditions, led by structural reforms and complemented by effective regulatory oversight, would have a salubrious effect on bank asset quality and aid bank recapitalization efforts.

An uncertain global environment has exacerbated risks to domestic financial stability

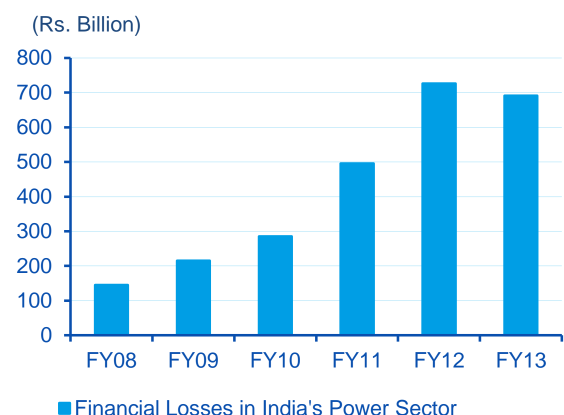
Despite India’s improving macro outlook, ongoing illiquidity spillovers have amplified gyrations in India’s equity, bond and foreign exchange market. India VIX, the measure of local stock market volatility, has surged, bond yields have jumped to multi-month highs while the rupee has weakened to a near 20 month low against the US dollar over the past quarter. The sharp nominal dollar appreciation has raised indebtedness of Indian corporates, given their high levels of unhedged foreign currency liabilities. The IMF, in its April 2015 Global Financial Stability Report (GFSR) warned that 36.9 percent of India’s total debt is at risk[6], amongst the highest in emerging economies. This compares with 24.5% for China, 17.5% for Indonesia and 3.2% for the Philippines. Vulnerabilities to India’s banking sector thus emanate from two key issues, 1) Rising levels of impaired loans related to leveraged corporates with high debt levels particularly in the form of foreign exchange liabilities and 2) Weak capital positions of Indian banks, particularly the state owned ones. With the loss absorbing buffer[7] of Indian banks having weakened significantly to 7.9% – lowest amongst

Figure 11
Debt recovery has yielded limited success so far



Source: BBVA Research, RBI, Haver Analytics

Figure 12
Bulk of bad debts related to power sector



Source: BBVA Research, RBI, Haver Analytics

6: Percent of firms with interest coverage ratio below 2. Interest Coverage Ratio = (EBITDA/Interest Expense).
7: (Tier 1 capital + loans loss reserves – NPL)/(risk-weighted assets).

emerging economies as per IMF estimates –, risks to India's banking sector from a deterioration in private non-financial sector balance sheet remains high.

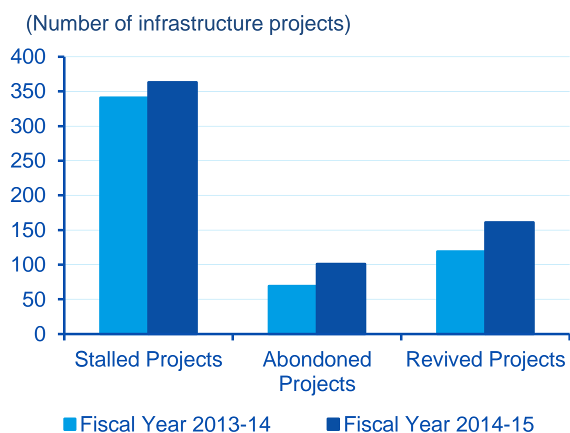
Policymakers efforts to reinvigorate India's banking sector

In an effort to mitigate risks to the Indian banking sector, arising mainly from asset quality deterioration and capital adequacy issues, the Reserve Bank of India has introduced several micro as well as macro prudential measures; and also enhanced supervision of distressed sectors in the economy (See Table – 1). Over the past three years, banks track record of recovering NPL through various mechanisms has deteriorated from 23.6% recovery of value of cases referred to various recovery tribunals in FY12 to 18% in FY14 (See Figure – 11). Reassuringly, more recent actions at the policy level aimed at improving the recovery mechanism have been impressive, although their effective implementation will be vital.

Government's efforts to revive stalled infrastructure projects would enable project developers to clear long pending dues to banks

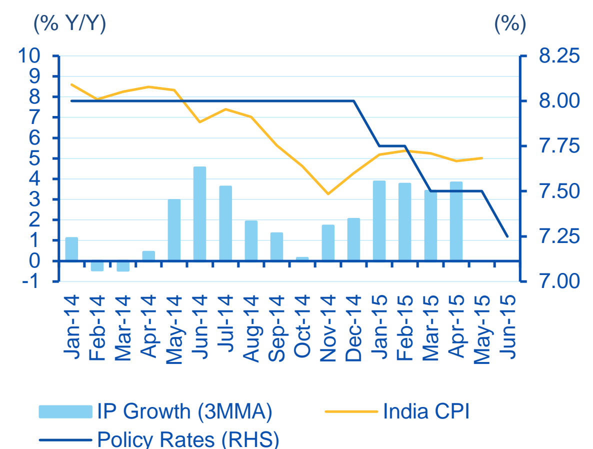
Besides focusing on sector specific measures, the Indian government has also, importantly, focused on productive spending across infrastructure, reviving stalled infrastructure projects, particularly in the power sector (See Figure – 12), and unclogging bottlenecks in supply of energy resources by expediting environmental clearances and addressing land acquisition issues. Ongoing structural reforms are expected to revive a sluggish investment cycle while providing room for resolving stretched balance sheet of Indian corporates. A bulk of these corporates have borrowed heavily from PSU banks in the past, but are unable to repay their dues as several infrastructure projects are stalled due to delays in environmental and land acquisition clearances and other bureaucratic hurdles. Policy efforts to revive such projects would ease balance sheet strains for corporates, in turn enhancing their ability to repay pending dues (See Figures 13 & 14). Meanwhile, India's FY16 union budget allocated Rs. 79.4 bn (USD 1.25 bn) for public sector bank recapitalization, which was lower than the Rs. 112 bn allocated in the previous budget but more targeted at efficiently managed banks. The budget also proposed introduction of a new bankruptcy law and announced steps to improve corporate governance standards at public sector banks. Separately, the RBI has pushed for quicker monetary policy transmission to support credit growth to productive sectors: Benign inflation, lower interest rates and RBI's thrust on quicker transmission of recent policy rate cuts should support loan growth, which has remained sluggish.

Figure 13
Reviving stalled infrastructure projects is key…



Source: BBVA Research, RBI, Haver Analytics, CMIE

Figure 14
…to boost growth and ease banking sector stress



Source: BBVA Research, RBI, Haver Analytics

Table 1
Measures by RBI and Government to address Indian banking sector issues

	Measure	Details	Impact
1	Higher provisioning on bad loans	• Increased loan loss provisions for Indian banks for restructured assets to 15% of outstanding loans from the 5% currently required • Banks don't have the incentive to restructure as they have to set aside the same provision as they would for the NPLs	• Higher provisioning will augment banking stability • Make banks more selective in restructuring activity • Clean bank balance sheets Enhance operational transparency • On the flipside, can have near term adverse impact on margins
2	Improve operating framework for Securitization and asset reconstruction companies (ARCs)	• ARCs to allocate higher capital when buying bad loans, amounting to 15% of security receipts from 5% previously	• Making ARCs more selective and careful in the restructuring process.
3	Tighter rules on reporting of bad loans	• Banks to report their impaired loan accounts and their total investment exposure to the borrower on a more frequent, weekly, basis to the RBI	• Increase banks accountability
4	Strategic Debt Conversion	• New Norm that automatically gives lenders an option to convert loans to equity and even a controlling stake in the stressed corporate	• Empowers lenders with unprecedented negotiating power in recovering impaired loans
5	Quicker discloser of Non-Performing Loans	• Banks are required to disclose information on loans overdue above 60 days on its website.	• Enhance transparency in disclosure
6	Greater autonomy for banks to recover dues	• Supreme Court upheld law that allowed banks to follow differential guidelines for declaring NPLs	• Empowers lenders to enable quicker recovery of bad loans
7	Targeted recapitalization approach	• Government to infuse capital only into profitable banks while completely excluding weaker banks which did not meet the set efficiency criteria for capital infusions	• Will compel poorly managed banks to rev up their efficiency levels • Near term, it is likely to put additional pressure on public sector bank balance sheets
8	Effectively manage short term volatility in bank liquidity and set high capital requirement standards	• Back to back cuts in Statutory Liquidity Ratio and effective use of OMOs • Implementation of the Liquidity Coverage Ratio (LCR) as per Basel guidelines from January 2015 • RBI committed to the scheduled implementation of Net Stable Funding Ratio (NSFR) from January 1, 2018 • Capital requirement guidelines set by RBI are stricter than those set under Basel III norms	• Smoothens fluctuations in short term liquidity which can deter lending to productive sectors • Minimum Common Equity Tier 1 (CET1) plus Capital Conversion Buffer (CCB) has been set higher at 8.0% compared to 7.0% requirement of Basel III. • Enhances RBI credibility in ensuring banks are well capitalized compared to international benchmarks.
9	Hiring top talent to run state owned public sector banks and improve corporate governance standards	• Government is hiring top professionals to run state owned public sector banks and has separated the posts of Chairman and Managing Director	• Aimed to enhance operational efficiency and control • Longer term impact
10	Permit banks to flexibly structure existing loans to infrastructure	• Infrastructure loans to be refinanced by existing lenders and/or new financers and retain their status as 'standard loans'	• Drive economic growth through infrastructure development and in turn alleviate banking sector strains

Source: BBVA Research, RBI, Government of India Official Websites

What more can be done to alleviate Indian banking sector stress?

India's banking reforms agenda is mainly centred around 1) empowering banks with greater autonomy to deal with non-performing loans burden, 2) reviving the investment cycle through structural reforms and kick starting stalled infrastructure projects, 4) prudent monetary policy practices for ensuring adequate liquidity in the banking system and 5) hiring top talent to revive public sector bank prospects. Although broad-based, the pace of banking sector reforms in India needs to be expedited. Also, greater clarity in the strategy to tackle mounting non-performing loans and meet the sizable capital requirements of public sector banks is

warranted. Track record of Indian banking sector as far as bad debt recovery is concerned is poor. Given India's legislative bottlenecks, for bank recovery to be effective, the mechanism should have limited legislative intervention. Below, we present our view on India's on-going banking sector reform process and list our potential policy expectations for the sector:

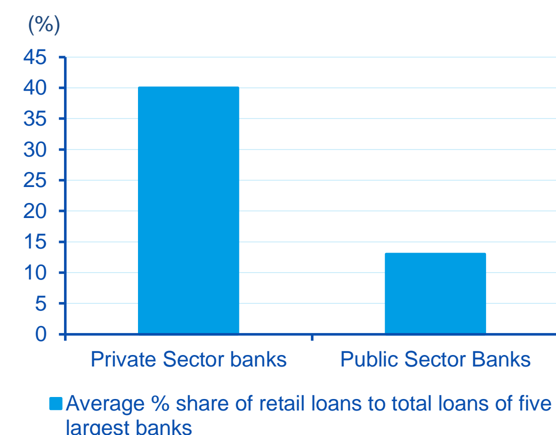
Need for greater transparency and appropriate disclosure on stress loan formation at the banks. Reported asset quality of Indian banks does not reflect an accurate picture of the actual stress levels in their books. For public sector banks in India, loan loss coverage ratio on an aggregate impaired asset basis is very low (14% to 26%) compared to private sector banks (20% to 126%); and hence requires higher provisioning even on their existing stressed assets.

Debt restructuring is inevitable in some cases but must be complemented by effective deleveraging and internal reforms by troubled corporates: Debt restructuring is essential to help corporates overcome temporary financial troubles, but it must be complemented by effective deleveraging and internal reforms by corporates to alleviate their stressed balance sheet. The extent of asset sales and equity-raising by PSU banks to address asset quality issues has been inadequate so far.

Power sector reforms are crucial to ease asset quality burden of PSU banks: The government needs to expedite structural reforms in India's power sector, which has acute asset quality weakness, which is still not fully recognized by banks. Finances of State Electricity Boards are weak and expediting ongoing debt restructuring process of power distribution companies is crucial.

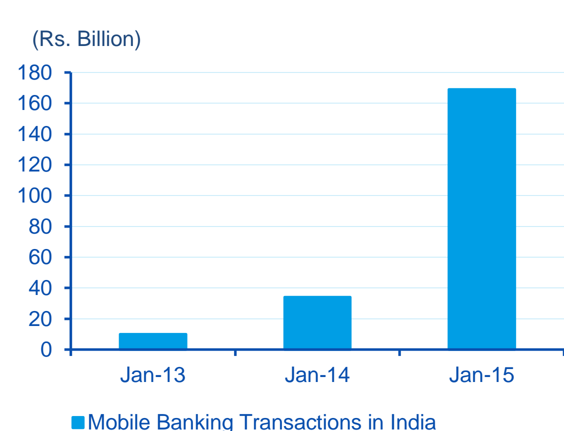
Strategy of targeted infusion of bank capital is fraught with risks: The government's strategy of targeted funding can restrict access to capital for poorly managed banks and in turn keep credit growth subdued at least in the near term. Only 9 out of 23 public sector banks were eligible for capital infusion in FY2015 with the rest likely to face severe capital constraints. The implicit belief amongst investors that the government is backing India's PSU banks, i.e. as PSU banks as a homogeneous unit needs to be preserved.

Figure 15
Private sector banks have benefitted from a higher portfolio of retail loans



Source: BBVA Research, RBI, Haver Analytics

Figure 16
Mobile banking transactions have picked up sharply over the past two years



Source: BBVA Research, RBI, Haver Analytics

Slow progress on creation of bad bank

India's progress on creation of a bad bank, on lines of the Chinese experience has been slow so far. For China, a clear strategy to tackle the NPL issue through close coordination between its central bank (PBoC), the China Ministry of Finance (MoF), the Chinese commercial banks and the Asset Management Companies

(AMCs), which act as Bad Banks, has paid dividends. China's NPL clean up and re-capitalization drive since 2003 was supported by the Government's massive foreign exchange reserves and strong economic growth over the past decade.

Public sector banks can draw important lessons from their private sector counterparts

The key drivers of variance in performance trends between the private and public sector banks in India presents important lessons for India's public sector banks to get their house in order. These include:

1. **PSU banks need to focus on assets with lower risk weights, such as collateralized products in retail segment, SME or agriculture loans:** Retain loans constitute roughly 30% to 60% of the loan books of private sector Indian banks as compared to 10% to 20% for their public sector counterparts (See Figure – 15). The bulk of incremental loan growth in the retail segment constitutes collateralized products such as home loans and auto loans, which have seen lower default rates since 2010. In addition, asset quality in the personal loans segment has also been supported by a meaningful consumer income growth, especially across rural India over recent years.
2. **Better credit portfolio selection:** Notwithstanding a lower share of retail loans, Indian PSU banks also suffered from poor credit portfolio selection within the corporate lending book. Distressed assets in the Indian banking system are concentrated in a few sectors, mainly infrastructure – Roads, Power, and Iron & Steel – besides Construction, Sugar and Textiles, which form the bulk of PSU banks' lending portfolio.
3. **Tighter underwriting standards:** Asset quality deterioration was more pronounced for India's private sector banks between 2008 and 2010 compared to public sector banks. Since then, a step up in underwriting standards in the ensuing years has greatly benefitted private sector banks, in turn keeping impaired assets in check and pushing down credit costs.
4. **Focus on margins to offset sluggish loan growth:** Against the backdrop of sluggish loan growth, India's private sector banks have focused on improving profitability and improvements in Current Account Savings Account Ratio (CASA), which resulted in better margins, higher ROA's and higher earnings performance. In contrast, public sector banks focused more on growing their loan book through greater reliance on bulk funding which led to margin erosion and hampered profitability.
5. **Leveraging on technology and innovation in retail digital banking space:** India's private sector banks are way ahead of their public sector counterparts in leveraging technology in the retail banking space. An aggressive customer acquisition strategy, superior customer service and a focus on converting customers to the digital platform has helped private banks enhance market share. Large private sector banks such as ICICI Bank, HDFC Bank, IndusInd Bank and Kotak Mahindra Bank have introduced a plethora of innovative digital banking products such as mobile banking, e-wallets, contactless debit and credit cards, banking on social media, among others. Mobile banking transactions have surged manifold over the past three years in India (See Figure – 16). Industry estimates suggest that HDFC Bank alone accounts for roughly 32% market share in India's mobile banking and 40% share in e-commerce transactions. Among public sector banks, only State Bank of India, India's largest bank, is trying to match its private sector counterparts in using technology to enhance efficiency and customer service.

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