ICRA

PRESS RELEASE
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Uptick in delinquencies to dampen growth and profitability of small finance banks in the near term: ICRA

- ***ICRA estimates growth to moderate to 18-20% in FY2025***
- ***GNPAs shall increase to 2.6-2.8% by end of March 2025***
- ***Return on assets (RoA) projected to decline to 1.4-1.6% in FY2025 and marginally improve to 1.6-1.8% in FY2026***

The small finance banks (SFBs) had witnessed a strong growth momentum in FY2023 and FY2024, with expansion being driven by buoyant credit demand and improved product offerings by them. However, given the industry-wide headwinds, specifically in the microfinance segment, ICRA expects the SFB growth to moderate in FY2025 to 18-20% from 24% in FY2024 and subsequently pick up in FY2026 to 20-23%.

Manushree Saggar, Senior Vice President & Sector Head - Financial Sector Ratings, ICRA said*: "The SFBs have been diversifying their product offerings over the years to include other retail asset classes such as vehicle loans, business loans, LAP, gold loans and housing finance, which has led to reduction in the share of unsecured loans in their overall pie. Considering the stress seen in the microfinance sector, a larger share of incremental business shall come from secured asset classes, which would be the likely growth drivers in FY2026".*

After registering an improvement in the asset quality indicators in FY2024, the trend reversed in H1 FY2025, with the SFBs reporting a 50-bps increase in GNPA% to 2.8% as of September 2024, driven by slippages, primarily in the microfinance loans. ICRA believes that the stress in the microfinance loans and seasoning will weigh upon asset quality indicators of the SFBs in FY2025. Elevated risk of the stress spillover to other asset classes would keep asset quality volatile.

From a funding perspective, the SFBs have been gradually increasing the share of current account and savings accounts (CASA) deposits over the years and the same stood at around 28% as of the end of September 2024, albeit significantly lower than universal banks. The CD ratio stood at ~89% as of September 2024 (reduced from 97% in March 2023), which at present is comparable to the private sector bank average; it, however, is expected to reduce further. In line with the trend seen in universal banks, there has been a move towards term deposits offering higher interests, thus leading to a drop in the share of CASA deposits across most SFBs in H1 FY2025. Increasing the share of these deposits will be a challenge for the SFBs. The trend is likely to continue over the near term.

ICRA projects the SFBs' margins to witness compression as the cost of funds remains elevated and the share of secured loans goes up. Operating expenses, in relation to average assets, rose in FY2024 because of the branch expansion, higher employee expenses and increasing efforts towards recoveries from delinquent customers. With a more calibrated expansion in the current fiscal, the operating ratios shall benefit from higher efficiency. Higher credit costs, however, shall lead to a moderation in the overall profitability in FY2025.

"ICRA expects profitability for the SFBs to remain under pressure in H2 FY2025 as these entities would need to provide/write off delinquent loans to keep the reported GNPA/NNPA under the threshold levels required for universal bank licence application. Accordingly, ICRA estimates the RoA of the industry to decline to 1.4-1.6% in FY2025 and improve marginally in FY2026 to 1.6-1.8% vis-a-vis 2.1% reported in FY2024," **Saggar** reiterated.

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