

## Banking

BSE Sensex: 7,992

S&P CNX: 2,418

25 October 2005

### Highlights of credit policy

The RBI announced the busy season credit policy today with a positive stance on the key macro parameters for the economy. While the key monetary measures like Bank Rate and CRR were unchanged, RBI has hiked the reverse repo rate by 25 basis points, which is a pre-emptive measure to control inflation.

The key highlights of the policy are

**Bank rate, CRR kept unchanged:** In line with the overall market expectations, the RBI has kept the bank rate unchanged at 6% and CRR at 5%. However, it has reiterated its stance of lowering the CRR to 3% in the medium term. Keeping the bank rate intact signals that interest rates will remain benign in the near term.

**Reverse Repo Rate hiked by 25bp:** The RBI has taken a pre-emptive measure to control inflation increasing the reverse repo rate by 25bp to 5.25%. It has also increased the repo rate by 25bp to 6.25% (maintaining the spread at 100bp). This was also widely expected taking cues from higher US interest rates, higher inflation and also the recent pressure on rupee. A 25bp rate hike was already factored in the bond market and we do not expect any adverse reaction on account of this. The bond yields, infact, dropped post the policy announcement.

**Positive stance on the economy, but concerns on the global front:** The RBI governor has reiterated its positive stance on the Indian economy:

- ✍ GDP forecast for FY06 has been raised to 7.0-7.5% as compared to 7% earlier.
- ✍ Inflation range still maintained at 5-5.5%. However, if the entire impact of higher oil prices are passed in the economy, inflation levels might over shoot the target.
- ✍ The Non-food credit which recorded a growth of 27.8% in 1HFY06 (as compared to 21.4% growth in 1HFY05),

should increase significantly higher than 19% projected earlier.

- ✍ Money supply may turn out to be higher than 14.5%. Even deposit growth is expected to be higher than the earlier projections of 15%.

### Other key highlights

**Capital market exposure restricted to 40% of networth:** RBI has changed capital market norms linking it to networth, as against its previous cap of 5% of loans. This might benefit banks having a higher capital market exposure coupled with a higher Tier-I ratio. We believe that HDFC Bank will be the clear winner in this respect as its exposure was restricted on account of the 5% limit. Most of the other banks' exposure to capital markets is still much lower than the norms permit. Hence, the current move is unlikely to affect other banks.

**Provisioning for standard assets increased from 0.25% to 0.4%:** The total impact of this one-time provisions would be Rs8.7b on the banking sector. However, almost all the banks under our coverage have sufficient amount of floating provisions on their books, which can be used to offset the impact of this hike. Thus, bank profits are unlikely to be affected for FY06 and FY07.

### Strong credit demand could result in higher rates:

As a strong economic growth leads to a higher credit demand, we expect banks start demanding higher rates for credit, especially on the corporate front, which has been excluded from any rate increases so far. Also, retail loan rates especially on the mortgage and auto front could increase (by 25-50bp). However, we do not foresee any slowdown given the robust economic growth (even the couple of interest rate increases of 50bp on auto and mortgages have failed to have any effect on loan demand).

**Cushion against yield increases**

While the overall outlook for the Indian economy and subsequently the credit offtake continues to remain robust, any rise interest rates might put pressure on bank's treasuries. However over the last 4 quarters, almost all the banks have insulated themselves to a great extent and built up cushion of upwards of 7.4% (10-year G-Sec Yield) by transferring bonds to HTM (in the process they have already taken a hit on their profits as well). Also incrementally, over the last 6 quarters, the investments book has risen very slowly for the banks and SLR investments as a proportion of assets have declined and so has the risk on investment book. Thus, we believe that a 20-25bp increase in bond yields from current levels is unlikely to affect bank profits.

**Current fall presents buying opportunities**

We expect core income to be driven by a strong loan growth (from both corporate as well as retail) aided by steady margins. Fee income is also set to emerge as a strong growth driver for private and the aggressive state owned banks. Further as asset quality has improved significantly for the Indian banks, further provisioning requirement is likely to be moderate for the banks, as incremental delinquencies have been low.

We believe that the core fundamentals for the banking sector are intact (we expect loan growth in excess of 23% in FY06), valuations (at 1-1.2x FY07E Book Value and a near 20% RoE) continue to be attractive. We maintain our positive view on Indian banking sector.

## **N O T E S**

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