

Review of annual monetary policy statement

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The Reserve Bank of India (RBI) has increased the cash reserve ratio (CRR) further by 25bps to 8.25% in its annual monetary policy statement for the year 2008-09. It has kept the other policy rates unchanged. The hike will come into effect from May 24, 2008.

We see this as a move more to do with management of liquidity and inflationary expectations in near future and do not see any threat to the interest rate scenario in the economy. Our stance on the interest rates stems from the ambitious targets set by the RBI in terms of credit growth (20%) and incremental CD ratio of 86%!!!

We find RBI's language not too hawkish as, alongside the demand side pressures it has also acknowledged the improvement in the domestic supply.

Taking cognizance of the much debated issue of the Forex derivatives, the RBI is likely to issue guidelines regarding appropriate risk weights and provisioning requirements for off-balance sheet exposures of banks by next month.

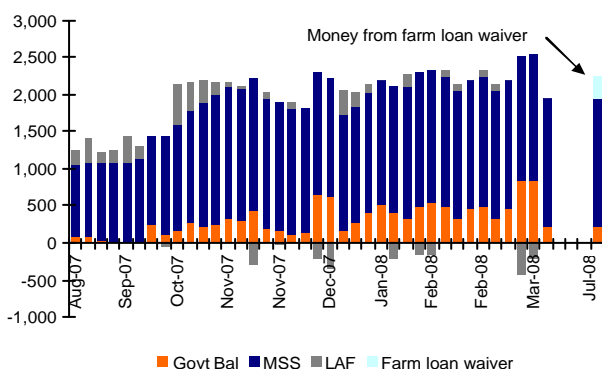
We see the G-Sec yields moving up in near future as the supply of paper is likely to exceed demand. We also maintain our view that the policy moves are unlikely to impact the NIMs for the banking system as the cost of funds is unlikely to move up due to liquidity overhang.

Increase in CRR – a preemptive action

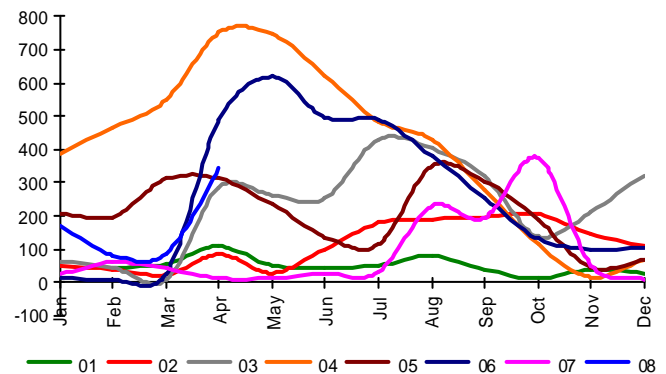
In its annual monetary policy statement for the year 2008-09, the RBI has increased by CRR to 8.25% with effect from May 24, 2008. Earlier the RBI had increased the CRR to 8.0% in two phases of 25bps each on April 28, 2008 and May 10, 2008. The first hike has already sucked out Rs90bn from the system and two more hikes are likely to take out similar amounts on respective dates. We see this as pre-emptive action by the RBI to drain the excess liquidity (that can have potential to spiral up the inflationary expectations) as

- Current liquidity overhang in the system is about Rs2.0tn which may see further rise with Rs250bn coming from the farm loan waiver by July 2008
- As and when the sixth pay commission recommendations are accepted, one time payment of Rs180bn will further add to the liquidity
- As the banks move into lean season of credit pick up (April-July 2008), the liquidity in system will rise as has been the case in five out of last seven years

Liquidity overhang (Rs bn)



Reverse repo outstanding (Rs bn)



Source: RBI, Emkay Research

Inflation target raised to 5.5% - greater flexibility for policy

The RBI has upped its inflation target from 5% in 2007-08 to 5.5% for 2008-09, *with a preference for bringing it as close to 5.0% as soon as possible*. The increase in the tolerance level of inflation is likely to bring more flexibility to the monetary policy and hence be positive for the interest rates. The medium term target for inflation has been kept unchanged at 4.0-4.5% with a view to bring down the same to 3.0%.

Policy also takes into account growth perspective

We see the policy statement as also taking the growth perspective into account. Our stance emanates from the following positive things outlined by the RBI in the policy statement

- Increase in the limit of home loans qualifying for lower risk weights of 50% from Rs2mn to Rs3mn – thereby making loans more affordable in tier I and tier II towns
- The target for the non-food credit has been kept at an aggressive 20%, which means incremental loans of Rs4.6tn in FY09 compared with Rs4.1tn for FY08 or a growth of 10% in overall disbursements
- Ensuring that the growth momentum continues and interest rate environment remains conducive for the same, has been outlined as one of the goals for the monetary policy

Targets on deposit growth and M3 look may be overshoot

Looking at the target credit growth of 20%, we believe that the banks may overshoot the target set for deposit mobilisation of 17% as it implies an incremental CD ratio of whopping 86%. Consistent with the same we believe that the RBI will also overshoot its targets for M3 of 16.5%-17.0%

Incremental CD ratio of 86%!!!

Rs bn	FY07 (1)	FY08 (2)	Incremental (3)= (2) - (1)	FY09 (4)	Incremental (5)= (4) - (2)	Growth in disbursement /mobilisation (%) (6)= (5)/(3)
Credit	18,847	23,041	4,194	27,649	4,608	9.9
Deposits	26,119	31,966	5,847	37,400	5,434	-7.1
CD Ratio (%)	72.2	72.1	71.7	73.9	84.8	

Source: Annual monetary policy statement for the year 2008-09, Emkay Research

Inclusion of loans to RRBs in the priority sector lending – marginally positive

With a view to augmenting the resource base for the regional rural banks (RRBs), the RBI has allowed the sponsor banks to classify loans granted to RRBs for on-lending to agriculture and allied activities as indirect finance to agriculture. We believe it to be marginally positive for the banks.

Measures taken to moderate the Forex flows

The RBI has also taken couple of measures to moderate the Forex flows into the system. It has permitted:

- The domestic crude oil refining companies to hedge their price risk on domestic purchase of crude oil and sale of petroleum products fully while permitting upto 50% on crude oil imports based on the volume of actual imports during the previous year or of the average volume of imports during the previous three financial years, whichever is higher.
- The exporters to enhance the present period for realisation and repatriation to India of the full export value of goods or software exported from six months to twelve months from the date of export

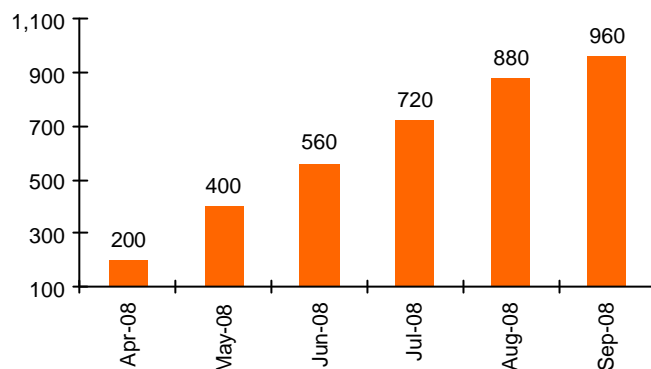
Taking cognizance of turmoil caused by Forex derivatives

In the view of huge MTM losses faced by the corporates on the exotic Forex derivatives contract and likelihood of the problems of NPAs cropping up for the banks from such products, the RBI has proposed to review current guidelines regarding conversion factors, risk weights and provisioning requirements for specific off-balance sheet exposures of banks. The guidelines in this regard are likely to be released by May 15, 2008.

G-Sec yields may continue to move up

We expect the G-Sec yields to continue to move up in as the supply of papers is likely to exceed the demand. Over next six months the government will try to conclude most of its borrowing program, about Rs960bn out of total of Rs990bn envisaged over FY09. The demand however, is likely to be low as the CRR hike is likely to take out Rs270bn on cumulative (75bps) over next one month.

Cumulative government borrowing (Rs bn)

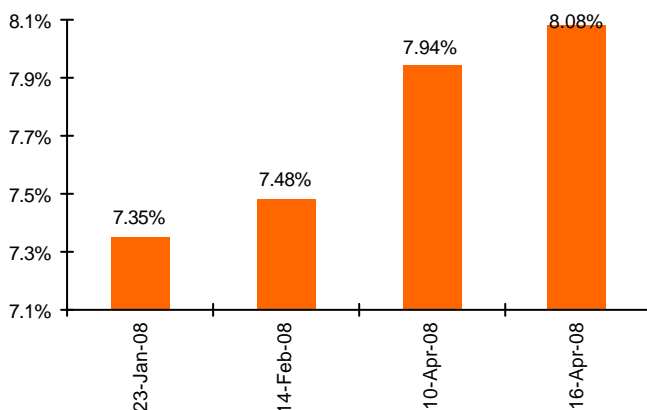


Source: RBI, Emkay Research

Little impact on the NIMs for banks

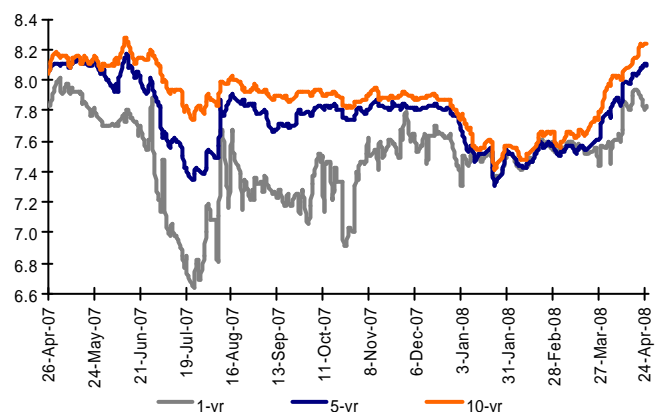
We expect the cumulative impact of 75bps increase in the CRR on the NIMs to the extent of 6bps. As we have been mentioning the impact the same could be partially compensated by rising yield on investments as the auction yields on dated securities have been moving up and are likely to continue the trend.

6.75%/2011 bond MSS auction yield



Source: RBI, Emkay Research

Bond yields (%)



Valuations quite cheap

We find the valuations of PSU banks at 0.6x-1.8x and that of the private banks at 1.8-3.1x on standalone adjusted value are quite reasonable and way below their fair book value multiple and in many cases near their 52-week low multiple. We remain positive on the sector.

Valuation Table

	CMP (Rs)	Reco	TP (Rs)	PER (x)		P/ABV (x)		P/PPP (x)		RoE (%)	
				FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
Allahabad Bank	84	BUY	170	3.8	3.0	0.7	0.6	2.4	2.0	17.5	18.9
Andhra Bank	82	BUY	110	5.3	4.3	1.0	0.8	3.0	2.5	19.3	20.1
Axis Bank	944	BUY	1,200	25.4	21.3	3.4	2.9	11.8	9.8	14.6	15.4
Bank of Baroda	315	BUY	440	7.8	6.5	1.1	0.9	3.9	3.3	14.0	15.0
Bank of India	333	BUY	425	8.0	6.4	1.8	1.4	4.2	3.6	24.8	23.7
Canara Bank	238	REDUCE	228	5.6	4.6	1.0	0.8	3.0	2.5	17.5	18.3
Corp Bank	343	BUY	470	6.4	5.2	1.0	0.8	3.3	2.7	16.8	18.0
DCB	106	BUY	134	28.4	16.6	2.2	2.0	14.8	9.6	8.9	12.2
HDFC Bank	1,548	BUY	1,700	26.0	20.2	4.1	3.4	11.2	9.2	16.8	18.3
ICICI Bank	901	BUY	1,600	18.3	14.0	2.1	1.9	9.7	7.5	11.3	13.5
PNB	565	BUY	594	8.2	6.9	1.4	1.2	3.8	3.3	17.4	17.8
SBI	1,794	BUY	2,200	16.7	13.4	2.1	1.9	8.1	6.6	14.4	13.8
UBI	163	BUY	240	5.8	4.8	1.2	1.0	3.2	2.7	21.4	21.2
Yes Bank	171	BUY	260	17.4	10.7	2.5	2.1	9.2	6.1	17.9	21.0

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