BFSI

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Liquidity blues = deposit rates set to move = Positive for margins

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Liquidity is likely to continue to remain stretched until August 2010, given:

(1) scheduled issuances; (2) gradual inflow via government spending; and (3) slow deposit accretion. We believe rising wholesale rates are a precursor to the imminent increase in retail deposit rates (earlier than expectations). Banks highly dependent on wholesale funds (Yes Bank, IndusInd Bank), and NBFCs, could witness pressure on cost of funds. However given the effective transmission via base rate and emergence of pricing power amidst tight liquidity and pick up in credit offtake will positively impact margins.

- **Liquidity to remain tight unless buoyed by strong deposit growth and increased government spending**

  Considering the government issuance (Gsec, T-Bills, SDL) calendar and scheduled maturity, and interest due for these instruments, we estimate incremental outflows of ~INR 230 bn over next eight weeks. This is over and above the current repo of INR 568 bn (though redemption of INR 305 bn of Gsecs on July 28 will provide comfort). Post August, advance tax outflow in September and uptick in credit offtake before festive season will keep liquidity under pressure.

- **Wholesale rates rising sharply; retail to follow suit**

  Tight liquidity has created pressure on short-term rates; 3-month CP/CD rates are up 150-200bps, to 6% plus levels, and yield curve has started flattening. We believe repo rate hike and current tight liquidity scenario (to prevail for few more weeks) will aggravate pressure on wholesale rates. The trend in deposit mobilisation has not been so encouraging YTD; tight liquidity and rise in wholesale funds will pressurise banks to increase the retail deposit rates sooner than later.

- **NIMs unlikely to come under pressure soon over the medium term**

  We believe banks having higher dependence on wholesale funds viz Yes Bank, IndusInd Bank or higher proportion of deposits maturing within six months (adjusting for core CASA) viz ING Vysya Bank, Oriental Bank of Commerce, Kotak Mahindra Bank, and Yes Bank could witness relatively higher pressure on cost of funds. Over the medium term, however, we expect trend in bank margins to be positive, considering effective transmission of rise in deposit cost via base rate and enhanced pricing power amidst tight liquidity and pick-up in credit offtake.

  As per our recent interactions with NBFCs, most of them have started witnessing increase in funding cost due to rise in wholesale cost (CPs). On analysing the asset-liability maturity profile, we understand that there is no significant mismatch for NBFCs in the near term that can impact their margins adversely. For HDFC and LIC Housing Finance, assets and liabilities maturing within one year are matched effectively; M&M Financial, Magma and Shriram City Union have more assets maturing within one year than liabilities. While in case of PFC and REC, proportion of liabilities maturing in one year is higher than assets, we believe the asset-liability structure (above 80% liabilities fixed and more than 70% assets floating), coupled with pricing power should support margins.

Liquidity has come under significant pressure (net repo position at INR 650 bn on an average in the past 15 days) and is likely to remain stretched until August 2010, in our view, given: (1) scheduled issuances; (2) gradual inflow via government spending; and (3) slower deposit accretion. Support from government spending is, however, likely to flow only gradually, and RBI's pre-emptive measures to ease liquidity will prevent the situation getting worse from here.

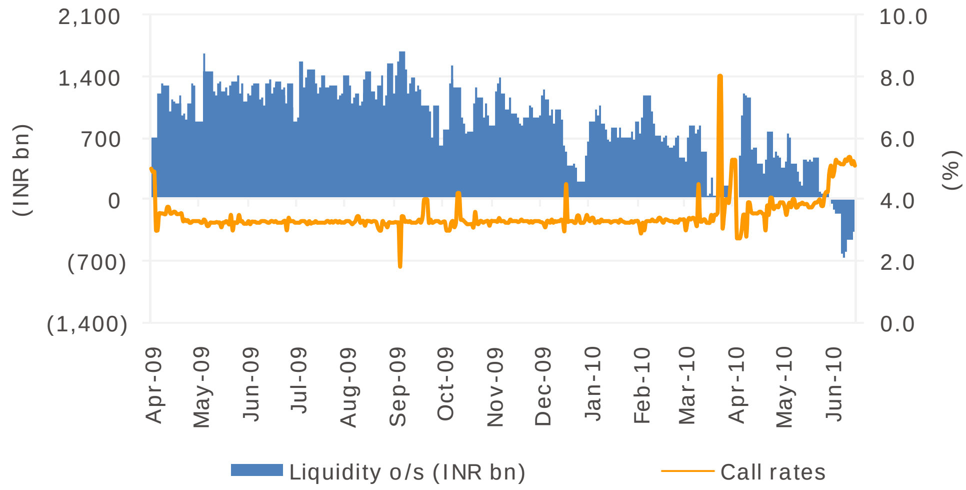
Tight liquidity, in return, has created pressure on wholesale rates (CPs/CD rates have gone up by 150-200bps, to 6% plus levels). We believe rising wholesale rates are a precursor to the imminent increase in retail deposit rates (earlier than expectations). Banks with higher dependence on wholesale funds (Yes Bank, IndusInd Bank), coupled with NBFCs, could witness pressure on cost of funds. Margins are, however, expected to be positively impacted, given the effective transmission via base rate and emergence of pricing power amidst tight liquidity and pick up in credit offtake.

- **Recent bout of liquidity tightening led by 3G/BWA auction…**

Liquidity situation, which was extremely comfortable (in fact excessive) until mid-May (reverse repo at INR 440 bn), has recently come under significant pressure - reflected in net repo position at INR 650 bn in the past 15 days. We believe the recent bout of liquidity tightening was on account of:

- Outflows of INR 674 bn for 3G auction and INR 385 bn for BWA auction
- Advance tax payment of INR 300-350 bn (estimated)

Chart 1: Tight liquidity due to 3G auction and advance tax outflow

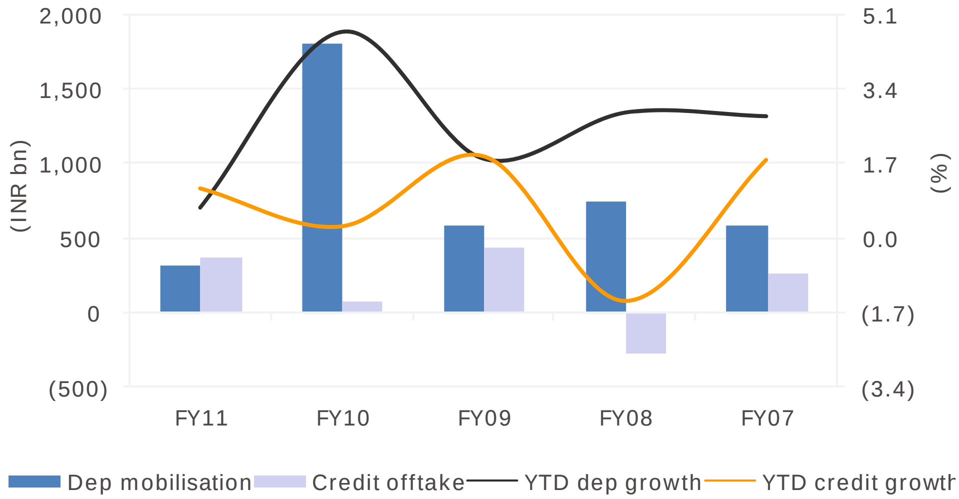


Source: Bloomberg

…and muted deposit mobilisation this fiscal

Deposit growth YTD in this fiscal was muted as the banking system was flushed with excessive liquidity at the start of this fiscal, and there was no serious thrust on deposit mobilisation. Net deposit mobilisation YTD was merely INR 310 bn (14% growth Y-o-Y) against INR 1.4 tn in FY10 (22%) and INR 576 bn (23%) in FY09. Comparatively, credit offtake (net) YTD was INR 368 bn in FY11 against meager INR 2 bn in FY10.

Chart 2: YTD deposit mobilisation slowest in past few years



Source: RBI

- Liquidity to remain tight unless buoyed by strong deposit growth and increased government spending

Today, the banking system is borrowing to the tune of INR 568 bn in the repo market. Even banks' investments in mutual funds (indicating excess liquidity parked in money market debt instruments) have come down from an average of INR 1 tn in April to INR 350 bn as of June. We have looked at government issuance (Gsec, T-Bills, SDL) calendar and scheduled maturity and interest payments due for these instruments to understand the liquidity position over the next few weeks. We estimate incremental net outflows of INR 230 bn over the next eight weeks, over and above the current repo of INR 568 bn. However, redemption of INR 305 bn of Gsecs on July 28, 2010 will provide some comfort to liquidity positions in the last week of July. In August, however, we again estimate incremental net outflows of ~INR 290 bn. Post August, advance tax payment in September and pick-up in credit offtake before festive seasons will keep liquidity under pressure. Hence, liquidity situation is likely to remain tight unless buoyed by strong deposit mobilisation and increased government spending.

Table 1: 3G/BWA auction and issuances to keep liquidity under pressure

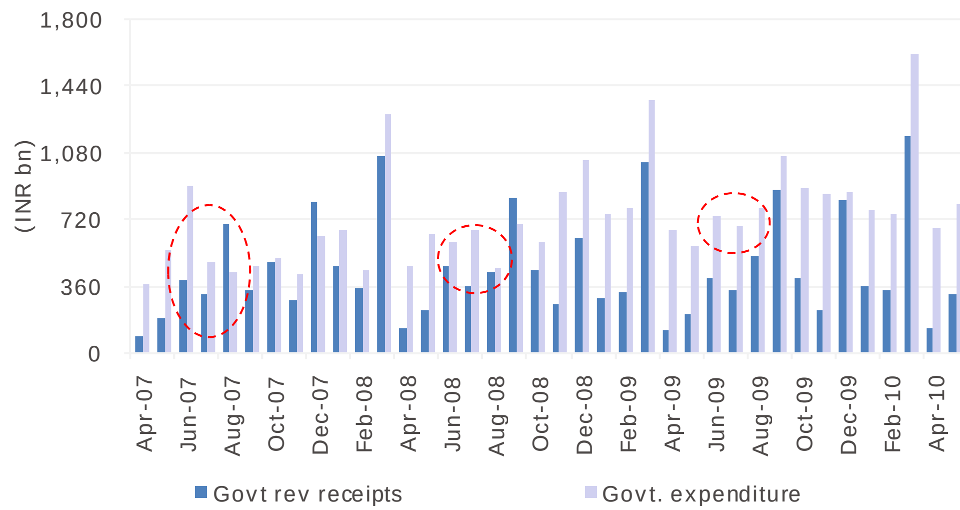
(INR bn)	Cash flow for the next ten weeks							
Week ending on	11-Jul	18-Jul	25-Jul	1-Aug	8-Aug	15-Aug	22-Aug	29-Aug
Outflow								
BWA auction								
Advance tax								
ISSUANCEs								
- Gsec	120	120	130	150	130	120	120	120
- T-Bill	35	30	35	30	85	80	85	80
- SDL	45		30		30		30	
Total outflows	200	150	195	180	245	200	235	200
Inflow								
G sec								
- redemptions	5			305				
- int payments	14	44	4	25	35	90	28	52
SDL								
- redemptions			24			12		
- int payments	9	4	13	8	8	1	12	18
T-Bill mat	85	82	85	80	85	80	85	80
Total inflows	113	130	126	418	128	183	126	149
Incremental inflows/(outflows)	(87)	(20)	(69)	238	(117)	(17)	(109)	(51)
Cumulative inflows/(outflows)	(87)	(108)	(176)	62	(55)	(72)	(181)	(232)

Source: RBI, Edelweiss research

…aid from government spending to flow gradually

Tax and other outflows from the system generally get pumped back into the system by way of government spending, easing the liquidity scenario. However, this time, we believe, liquidity of INR 1 tn absorbed at one go from the system (due to 3G and BWA auction) will flow only gradually over 2 months by way of government spending. Historical trend suggests that government spending (net of revenue receipts) ranges between ~INR 200-300 bn per month (on average) in the first half of a fiscal; in April and May 2010, government spending (net of revenue receipts) was at INR 500 bn (average per month). Generally, revenue receipts pick up sharply post May, bringing down the average government spending to INR 200-300 bn. We, therefore, believe that support to liquidity by way of government spending will flow only gradually.

Chart 3: Gross Government spending at INR 700 bn/month in June-August



Source: Business Beacon

…RBI / government may continue with liquidity easing measures

RBI has been taking pre-emptive measures to address liquidity pressures – additional LAF facility up to 0.5% of NDTL, second LAF and early buy back of Gsecs. RBI has extended additional LAF facility for commercial banks up to 0.5% of NDTL and continued second LAF (SLAF) auction till July 16, 2010. It also announced early buy back of Gsecs (in June for redemptions due in July and February) for its cash management operations up to INR 200 bn in multiple tranches; however, the response has been lukewarm and it was able to buy back only INR 96 bn. In June-July, it deferred auction of Gsecs of INR 80 bn. We believe RBI is committed to its stance of ensuring adequate liquidity and prevent the situation worsening from here; few options available with RBI/government include:

- Early redemption or repurchase of securities due for maturity before the end of this fiscal
- Accelerated government spending

On the CRR front, we do not expect RBI to reverse its tightening stance just to ease temporary liquidity pressure; it will be used as the last resort.

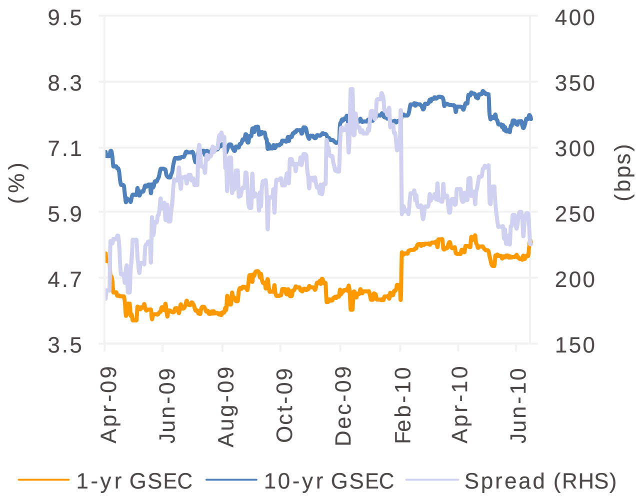
After effects of tight liquidity

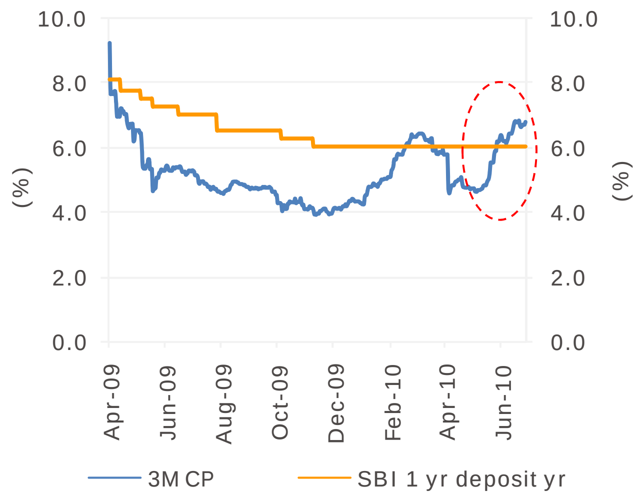
Gsec curve flattening; wholesale rates rising sharply

Tight liquidity in the past one month has created pressure on short-term rates:

- 3-month CP/CD rates have moved up 175-200bps since May, to 6% plus levels
- Yield curve is flattening; spreads between 1-year and 10-year Gsec came off to 225bps (had widened to as high as 350bps in December 2009 to January 2010)

Chart 4: Gsec spreads narrowing; wholesale rates moving up





Source: Bloomberg

We believe the increase in repo rates, coupled with current tight liquidity scenario (expected to prevail for few more weeks), will aggravate pressure on wholesale rates. The trend in deposit mobilisation has not been so encouraging YTD and tight liquidity and rising wholesale rates are a precursor to the imminent increase in retail deposit rates (earlier than expectations).

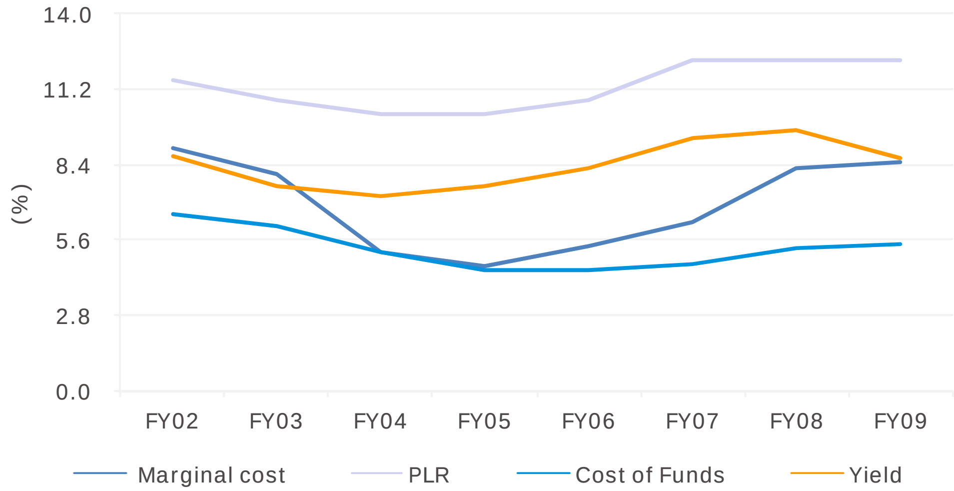
Bank NIMs to be positively impacted in medium term

Marginal cost of funds for banks is set to rise with the increase wholesale and subsequently retail deposit rates. However we believe bank's margins will be positively impacted in the medium term on following accounts:

- Transmission of rise in deposit cost will be more effective in base rate regime - We expect banks' in the first leg to withdraw teaser rates schemes and then subsequently up the base rate. A larger part of the book is linked to benchmark (Base Rate/PLR) hence facilitating faster repricing; while on the liability side, only the proportion of deposits/borrowings maturing in the near term (say 6 months) will be re-priced upwards. This will aid margin improvement over the medium term.

  As can be seen from the chart below, even though the marginal lending and marginal cost of deposits increased simultaneously, loan spreads expanded in the initial part of the monetary reversal due to stickiness in the cost of deposits.

Chart 5: Advances more flexible than deposits

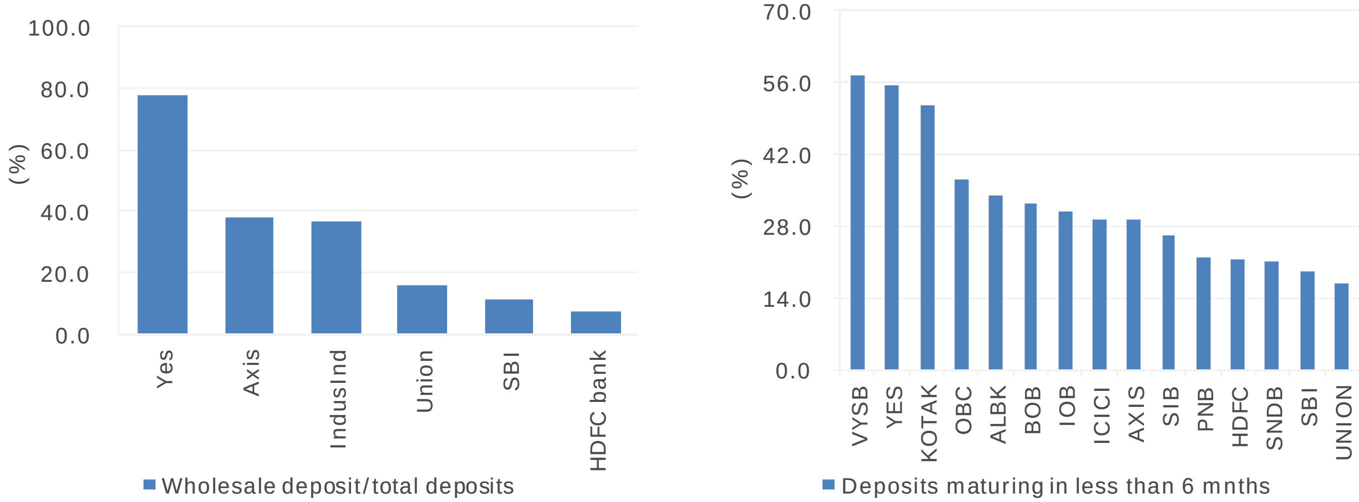


Source: RBI, Company, Edelweiss research

- Moreover, tight liquidity and pick up in credit offtake will enhance pricing power of banks, enabling them to effectively pass on the pressure of higher funding cost.
- With base rate coming into effect, there will be upward re-pricing of short-term working capital loans that were being provided below the base rate.

We believe banks having higher dependence on wholesale funds viz Yes Bank, IndusInd Bank, coupled with higher proportion of deposits maturing within six months (adjusting for core CASA) viz ING Vysya Bank, Oriental Bank of Commerce, Kotak Mahindra Bank, and Yes Bank could witness relatively higher pressure on cost of funds.

Chart 6: Banks dependant on wholesale funding to see funding cost pressure



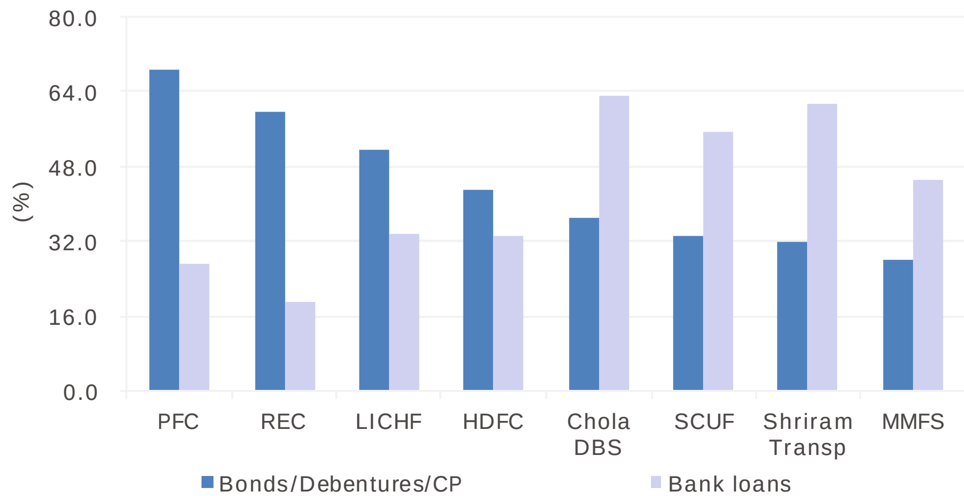
Source: Company, Edelweiss research

Note: We have adjusted 10% of savings deposits and 15% of current deposits from the first maturity bucket assuming it to be treated by banks as volatile CASA

NBFCs asset liability maturity profile to protect margins

NBFCs largely rely on wholesale bond market (40-50% of borrowings) and bank loans (20-30%) for their borrowing requirement. As per our recent interactions with NBFCs, most of them have started witnessing increase in funding cost due to rise in wholesale cost (CPs). Even with base rate coming into effect, borrowings from banks are expected to become costly as deposit rates start moving up.

Chart 7: Proportion of borrowings from wholesale market

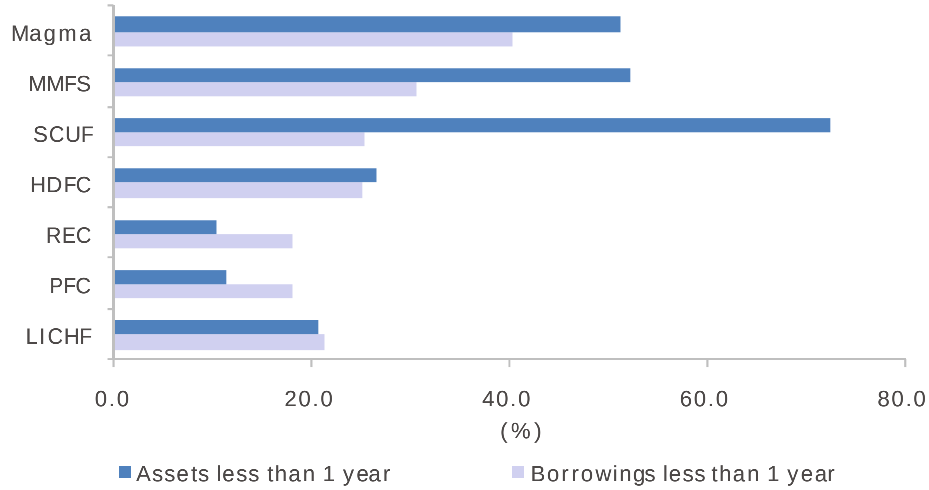


Source: Company Edelweiss research

Our recent interactions with managements of various NBFCs and broad analysis of their asset liability structure suggest that the proportion of borrowings maturing within a year is in the range of 20-40% (with an average at ~25%). Short-term borrowings are higher than the industry average for Mahindra Finance, Shriram City Union and SREI Infra; while this proportion is low for LIC Housing and PFC.

We also analysed asset and liability profile of various NBFCs across maturities to understand if there is any significant mismatch in the near term that can impact their margins adversely. In case of HDFC and LIC Housing Finance, assets and liabilities maturing within one year are matched effectively. M&M Financial, Magma and Shriram City Union have more assets maturing within one year than liabilities. While in case of PFC and REC, proportion of liabilities maturing in one year is higher than assets. However, their asset liability structure, with more than 80% of liabilities being fixed nature and more than 70% of assets being floating, coupled with pricing power, should support margins. We, therefore, believe that though cost of fund is expected to move up for NBFCs, the impact on margins will be limited based on the assumption that they have sufficient pricing power to pass on the increase in funding cost.

Chart 8: Short term asset liability maturity profile of NBFCs



Source: Company, Edelweiss research

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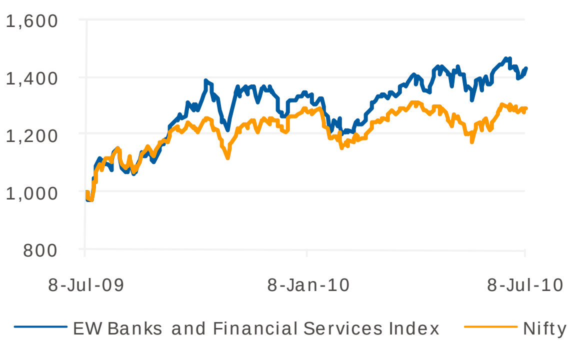
Coverage group(s) of stocks by primary analyst(s): Banking

Allahabad Bank, Axis Bank, Centurion Bank of Punjab, Federal Bank, HDFC Bank, ICICI Bank, IOB, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

EW Indices



Recent Research

Date	Company	Title	Price (INR)	Recos
30-Jun-10	United Bank of India	Moving in the right direction; *Visit Note*	91	Not Rated
29-Jun-10	Banking	Base rate set to roll; *Sector Update*		
28-Jun-10	Life Insurance	IRDA's final guidelines: Near-term pain, long-term gain; *Sector Update*		
24-Jun-10	Life Insurance	Private insurers' WNRP-individual growth at 14% in May; *Monthly Update*		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	101	56	9	169

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	103	53	13

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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