HSBC Global Research

Financial Institutions Group
Commercial Banks
Equity – India

India Banks

RBI policy: Savings rate deregulated; more than meets the eye

- **RBI hiked the repo rate by 25bps, but may pause now, giving respite to banks on rate increases; positive for wholesale-funded NBFCs and banks with low CASA deposits**
- **Savings deposit rate deregulated in a surprise move, but negative impact may not be much, we believe**
- **YES likely to be the biggest beneficiary, followed by IIB**

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Rate pause in sight: The Reserve Bank of India hiked the repo rate by 25bps to 8.5% and indicated risks to growth have increased, while it expects inflation to moderate from December to 1HFY13. The signal came as a relief for banks, which we believe now are likely to see stable margins in the near future. Wholesale-funded entities such as NBFCs and banks with lower CASA deposits appear likely to be better-placed from here on, as pressures on margins should diminish going forward.

Savings rate deregulation is theoretically negative: This came as a huge surprise. Theoretically, the impact is two-fold – higher savings deposit costs, and migration to banks offering higher rates. The deregulation appears negative for banks with high savings deposits in their liabilities, as increases in the savings rate would put some pressure on margins. For every 100bp increase in the savings rate, private banks may see 1-24bp compression in margins and a 0.8-13% impact on PBT, with HDFC Bank being the hardest hit and YES the least, we estimate. Accordingly, YES stands out most positively. For PSU Banks, the hike would imply 17-27bp compression in margins and a 14-30% impact on PBT, with SBI being the hardest hit and BoB the least.

Realistically, not a big negative: While most bankers from large banks do not expect any disruptive pricing, we believe that even if the savings rate does rise, the impact will be different for PSU and private banks. Private banks appear likely to be able to protect their top lines, as they expect to pass most of the hike through via higher transaction fees or higher lending rates or both. PSU Banks, on the other hand, may find it difficult to charge higher fees or pass through increases in funding costs. Also, migration is easier said than done, as savings deposits are usually a function of transaction products offered, inertia of retail depositors, and service levels offered by banks. A 50-100bp increase is not likely to prompt customer shifts from one bank to another, in our view. Accordingly, we do not see any material impact on profitability of HDFC Bank and Axis Bank.

YES and IIB the beneficiaries: YES appears likely to benefit significantly, followed by IIB, as both have lower proportions of savings deposits, and deregulation augurs well in terms of better savings deposit growth, thereby lowering funding costs.

Savings rate deregulation – Is it that bad?

The announcement

The Reserve Bank of India deregulated savings deposit rates. Banks now are free to determine their savings deposit interest rates, subject to the following two conditions:

- Each bank will have to offer a uniform interest rate on savings bank deposits up to INR0.1m, irrespective of the amount in the account within this limit.
- For deposits of more than INR0.1m, a bank may pay differential rates of interest. However, there should be no discrimination between customers with the same deposit amount on the same day.

Theoretically negative?

We don't believe so. Below is a table demonstrating a pure theoretical exercise of the impact of a 100bp increase in the savings rate on a bank's profits. All else being the same, private banks would see 1-24bp compression in margins and a 0.8-13% impact on PBT. At private banks, HDFC Bank would see the biggest compression in margins, at 24bps, and a 3.2% impact on PBT, while Yes would be the least affected. PSU Banks would see a 17-27bp impact on margins and a 14-30% impact on PBT. Of the PSUs, SBI would have the biggest impact on margins and PBT, and BoB the lowest.

Indian banks: Sensitivity of margins and profit to 100bp increase in savings rate

Private banks	Savings deposits % of total deposits	NII (INRm)	NIM (bp)	PBT (%)	Remarks
Axis Bank	24	4,679	18	11.7	Axis, HDFC Bank, and ICICI have high CASA ratios. While the theoretical impact is substantial, we expect the effect to be muted. Predatory pricing is not likely to make customers shift from them due to significant deepening of relationships already established with banks. Also, empirical evidence suggests that service levels matter much more than a 50-100bp differential as savings a/c are primarily transaction accounts.
HDFC Bank	30	6,902	24	13.2	
ICICI	29	6,686	16	11.3	
IIB	9	329	7	4.1	IIB and YES are likely to benefit from savings deregulation, as both have low savings deposit balances. Higher deposit rates, along with superior service levels on par with larger banks and savings deposit-driven products, will help them increase savings deposits at a healthy pace. Accordingly, they would be net beneficiaries from savings rate deregulation with positive effects on profits.
Yes	2	82	1	0.8	
PSU Banks					
BOB	21	6,565	17	14.0	PSU Banks also have high savings deposits on their balance sheets. However, given the gaps in their service levels vs private banks, coupled with less ability to increase transaction fees and lending rates, this implies that while they might not be subject to the full impact, partial effects on profits seem likely.
BOI	24	5,884	16	22.6	
Canara	20	6,091	17	16.6	
PNB	29	9,488	23	20.0	
SBI	36	34,439	27	30.4	
Union	23	4,541	18	24.3	

Source: Company, HSBC Research

Realistically, not a big negative

However, at this juncture, the situation is still evolving, with most bankers either expecting savings rates to remain largely the same or to increase to 45–60-day deposit rates, which are in the range of 5-6%. Also, most private banks are talking about increasing transaction fees for all savings a/c transactions and are looking to pass increases through to borrowers. Accordingly, when all is said and done, they might end up experiencing only a marginal impact or no impact on profit. However, PSU Banks may be slow to pass through cost increases in terms of fees and higher lending rates, and therefore they appear likely to see some impact on their profits.

Migration myths

Again, one may argue about the flight of deposits from a bank to another one offering better rates. We do not see that happening in the near term due to inertia of retail depositors, and we do not expect retail depositors would shift all their banking needs to another bank that is offering 50-100bp higher rates, especially when there is already significant deepening of relationships with customers. Empirical evidence of the past 10 years suggests that banks that have better service levels and that offer products that tie in CASA have far better prospects to attract incremental CASA deposits. A case in point is the success of HDFC Bank and Axis Bank in developing a sound CASA base in the past decade vs declining CASA ratios of PSU Banks. Therefore, over the longer term, we believe that private banks will largely be able to protect their CASA, while PSU Banks may see some erosion, especially if some private banks offer higher savings deposit rates.

YES and IIB likely to be gainers, but no threat to larger banks

We see YES and IndusInd Bank benefiting from this deregulation. YES has already increased its savings deposit rate by 200bps to 6%. We will monitor how this pans out over the next couple of months. YES has only 2% of deposits as savings deposits and IIB has 9%. But given these banks' market shares of just 0.7-0.8%, these higher rates do not appear likely to threaten the savings deposits base of any large bank.

Market reaction overdone; HDFC Bank and Axis Bank give entry opportunity

Following the RBI policy release, prices of HDFC Bank and Axis Bank shares fell steeply. HDFC Bank shares fell almost 7.5% during the day but recovered to close 3.4% below the previous day's close. Axis fell 4.5% during the day and remained at that level. We expect that as clarity emerges over the next few days, confidence will be restored and the stocks will bounce back. We see the stocks' declines as good entry points.

Other important measures announced

Branch opening in Tier-II centres made free

The RBI gave freedom to banks to open branches in Tier-II centres (populations of 50,000-100,000 as per Census 2001), as it observed that branch openings have not occurred at the desired pace. This is likely to be meaningfully positive for banks, as these are mainly CASA-rich centres, and this will make deposit mobilising easier than before. Again, this should a significant positive factor for smaller banks, as they can aggressively open branches in these centres, especially before the new census becomes applicable. We expect to see significant ramp-ups of branches by IIB and YES in coming quarters in these centres.

Forthcoming important measures

- The RBI is working on the Basel-III guidelines and is most likely to issue draft guidelines by December 2011.
- The RBI is proposing to issue a discussion paper by end-March 2012 on the proposed provisioning approach for comments.
- The RBI has set up a working group to look into principles governing proper, transparent, and non-discriminatory pricing of credit.

- The RBI has formed a working group to review prudential guidelines on restructuring of advances by banks and financial institutions and to suggest revisions, taking into account the best international practices and accounting standards.

Valuation and risks

We to value Indian banks using a weighted average combination of PE, PB, and economic profit model (EPM) methodologies. The three-stage EPM uses explicit forecasts until FY14, followed by 10 years of semi-explicit forecasts. The final stage of 12 years (fade period) assumes convergence of ROE and COE. EPM is based on the assumptions in the following table.

HSBC Indian banks coverage universe: EPM assumptions

	BOB	BoI	CNBK	PNBK	SBI	UNBK	AXSB	HDBK	ICBK	IIB	YES	HDFC	LICHF
Semi-explicit forecasts for 10 yrs													
Loan CAGR	8%	8%	8%	8%	8%	8%	13%	20%	14%	8%	13%	14%	10%
Dividend payout	18%	18%	15%	18%	20%	10%	23%	25%	30%	20%	13%	45%	20%
Fade period of 12 yrs													
Risk-free rate	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.7	1.0	1.0	1.0	1.0	1.0
Equity risk premium	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
Cost of equity	14%	14%	14%	14%	14%	14%	14%	12%	14%	14%	14%	14%	14%
EPM value	**902**	**487**	**601**	**1,229**	**1,937**	**299**	**1,030**	**475**	**720**	**157**	**340**	**647**	**233**

Source: HSBC

Under our research model, for stocks with or without a volatility indicator, the Neutral band is 10 or 5 ppts, respectively, above and below the hurdle rate for Indian stocks of 11%, or 1-21% or 6-16% around the current share prices. For a stock to be rated Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, must exceed the required return by at least 5 percentage points over the next 12 months or 10 percentage points for a stock classified as Volatile. For a stock to be rated Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months or 10 percentage points for a stock classified as volatile. Stocks between these bands are rated Neutral.

For our valuation and risks of stocks in our coverage universe, see the tables on pages 5 and 6.

HSBC Indian banks coverage universe: Valuation and risk factors

(INR)	PE multiple	PE-based TP (weight)	PB multiple	PB-based TP (weight)	DCF value (weight)	Weighted TP (INR)	Upside risks	Downside risks
Public sector banks								
BOB	7.0	1,080 (50%)	1.3	998 (20%)	902 (30%)	1,010	—	Management change in FY13, asset delinquencies.
BOI	6.0	388 (50%)	1.2	476 (20%)	487 (30%)	435	Significant improvement in macro-economic environment, sharp rebound in margins.	Worse asset quality, higher credit costs.
CNBK	5.0	515 (50%)	1.0	581 (20%)	601 (30%)	554	—	Higher slippages, lower margins, management change in 2HFY13.
PNBK	6.8	1,318 (50%)	1.4	1,330 (20%)	1,229 (30%)	1,294	—	Adverse asset quality and margins.
SBI	11.7	3,011 (50%)	1.8	2,556 (20%)	1,937 (30%)	2,600	—	Higher asset quality slippages, negative surprise on margins.
UNBK	5.0	246 (20%)	0.8	223 (50%)	299 (30%)	250	—	Weak asset quality trends, negative margins surprise, management change.
Private sector banks								
AXSB	13.0	1,750 (50%)	2.1	1,464 (20%)	1,030 (30%)	1,477	—	Margins surprising downwards again; asset quality risks.
HDBK	24.3	692 (50%)	3.6	551 (20%)	475 (30%)	603	—	Slower- than-expected loan growth, worsening asset quality.
ICBK	23.4	1,538 (50%)	2.2	1,231 (20%)	720 (30%)	1,230	—	Slowing loan growth momentum, spike in NPLs.
IIB	19.0	493 (50%)	2.7	340 (20%)	157 (30%)	362	—	Further policy tightening by RBI, higher-than-expected loan slippages and credit costs.
YES	10.0	402 (50%)	1.8	330 (20%)	340 (30%)	369	—	Longer than expected build up of retail liabilities; Asset quality risks.
HDFC	24.2	898 (50%)	5.0	827 (20%)	647 (30%)	808	—	Any sharp increase in rates could temporarily slow business momentum; asset quality risks.
LICHF	10.0	323 (50%)	2.0	276 (20%)	233 (30%)	287	—	Global financial shock would hurt buying sentiment, affecting our loan growth assumptions.

Source: HSBC

India banks: Coverage universe (closing prices as on 25 October 2011)

RIC code	Company	Market price (INR/sh)	Target price (INR/sh)	HSBC rating	Market cap (USDm)	HSBC PE Fy12e	HSBC PE Fy13e	HSBC PE Fy14e	HSBC P/B Fy12e	HSBC P/B Fy13e	HSBC P/B Fy14e	EPS CAGR Fy11-14e
Public sector banks												
BOB.BO	Bank of Baroda	719	1,010	OW	5,689	6.0	4.9	4.0	1.2	1.0	0.8	16.8%
BOI.BO	Bank of India	315	435	N	3,473	6.6	5.2	4.1	1.0	0.8	0.7	18.0%
CNBK.BO	Canara Bank	441	554	OW	3,948	5.3	4.5	3.8	0.9	0.8	0.7	7.3%
PNBK.BO	Punjab National	929	1,294	OW	5,947	6.2	5.1	4.1	1.2	1.0	0.9	17.0%
SBI.BO	SBI	1,840	2,600	OW	23,598	10.3	7.6	6.0	1.6	1.4	1.1	33.0%
UNBK.BO	Union Bank	210	250	OW	2,223	5.9	4.8	3.8	0.9	0.8	0.7	10.8%
PSU universe					**44,878**	**7.5**	**5.9**	**4.8**	**1.3**	**1.1**	**0.9**	**21.0%**
Private sector banks												
AXBK.BO	Axis Bank	1,118	1,477	OW	9,309	11.5	9.2	7.5	2.1	1.8	1.5	21.3%
HDBK.BO	HDFC Bank	468	603	OW	22,104	20.8	16.7	13.6	3.7	3.1	2.7	26.5%
ICBK.BO	ICICI Bank	878	1,230	OW	20,447	17.1	14.1	11.6	1.7	1.6	1.4	19.2%
INBK.BO	IndusInd Bank	273	362	OW	2,577	16.0	12.2	9.3	2.9	2.4	2.0	30.6%
YESB.BO	Yes Bank	306	369	OW	2,172	10.9	8.7	6.8	2.3	1.9	1.5	28.6%
Pvt universe					**56,610**	**16.8**	**13.3**	**10.5**	**2.3**	**2.0**	**1.8**	**23.1%**
NBFC												
HDFC.BO	HDFC	669	808	OW	19,895	23.6	19.6	16.6	5.0	4.3	3.8	18.6%
LICHF.BO	LIC Housing Finance	218	287	OW(V)	2,092	9.8	7.2	5.7	2.1	1.7	1.4	23.1%
NBFC universe					**21,987**	**21.1**	**17.4**	**14.9**	**4.5**	**3.9**	**3.4**	**20.7%**
Total coverage universe					**123,475**	**11.9**	**9.4**	**7.6**	**1.9**	**1.7**	**1.4**	**21.6%**

HSBC ratings: OW = Overweight, N = Neutral, V = Volatile.
Note: Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for Indian stocks of 11%, or 1-21% around the share price, and for stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate for Indian stocks of 11%, or 6-16% around the share price. At the time we set our target prices, they implied potential returns that were above, below, or within the Neutral band; therefore, we respectively rate the stocks OW(V), OW, UW(V), UW, N(V), or N, as indicated in the HSBC Rating column above. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.
Source: Company data, Bloomberg, HSBC

Disclosure appendix

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AXIS BANK LTD	AXBK.BO	1168.55	25-Oct-2011	2, 4, 5, 7, 11
BANK OF BARODA	BOB.NS	732.60	25-Oct-2011	1, 5, 6, 7, 11
BANK OF INDIA	BOI.NS	323.15	25-Oct-2011	1, 4, 5, 6, 7, 11
CANARA BANK	CNBK.BO	440.45	25-Oct-2011	1, 4, 5, 6, 7, 11
HDFC	HDFC.NS	640.50	25-Oct-2011	6, 7
HDFC BANK	HDBK.BO	484.35	25-Oct-2011	6, 7
ICICI BANK	ICBK.NS	868.45	25-Oct-2011	1, 2, 4, 5, 6, 7, 9, 11
INDUSIND BANK	INBK.BO	273.05	25-Oct-2011	4, 7
LIC HOUSING FINANCE LTD	LICH.BO	211.65	25-Oct-2011	4, 7
PUNJAB NATIONAL BANK	PNBK.BO	970.20	25-Oct-2011	6, 7
STATE BANK OF INDIA	SBI.NS	1908.75	25-Oct-2011	2, 4, 6, 7, 11
UNION BANK OF INDIA	UNBK.BO	212.15	25-Oct-2011	7, 11
YES BANK	YESB.BO	281.65	25-Oct-2011	4, 7

Source: HSBC

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