March 17, 2008

Banking Sector Update

Farm Loan Waiver Scheme - Banks to be reimbursed in cash over 3 years

Full cash reimbursement: Quelling uncertainties resulting from one of the most ambitious populist packages announced by the incumbent government, the Finance Minister has stated that the government would reimburse banks in cash the entire Rs60,000cr pursuant the Farm Loan Waiver Scheme announced in Budget 2008-09.

Disbursement schedule: By August 2008, Rs25,000cr (42%) would be disbursed, Rs15,000cr (25%) by August 2009, Rs12,000cr (20%) by August 2010 and Rs8,000cr (13%) by August 2011.

Farmers eligible for fresh loans: The Banks will have to waive off the entire amount by June 2008, and the farmers that stand to benefit will be eligible for fresh loans.

Recipient Banks: It is estimated that Rs33,000cr (55%) of the overdue loans covered in the Scheme are in the books of co-operative banks, Rs21,000cr (35%) with scheduled commercial banks (SCBs) and Rs6,000cr (10%) with the regional rural banks (RRBs). The FM said that out of the initial installments of Rs25,000cr and Rs15,000cr, a larger portion will go in favour of co-operative banks and RRBs, since they are in greater need of liquidity than the SCBs.

Funding: The FM said that the Scheme will be funded (in order of preference) through: (1) Tax revenues; (2) Non-tax revenues including dividend, interest, royalty and fee; (3) non-debt capital receipts including recovery of loans and advances, premium on sale of sequestered assets and initial listing of public sector enterprises; and finally (4) additional borrowing, if necessary.

Impact Analysis

Overall direct lending to agriculture by the SCBs is estimated at Rs2,50,000-3,00,000cr. Of this, Rs21,000cr is estimated to be overdue and is within the purview of the Scheme. Guidelines in respect of NPA classification of farm loans differ from other loans. As a result, only a part of the overdue loans would have been classified as NPAs. Assuming an average provisioning coverage of 75% on the NPA portion, roughly Rs4,000-6,000cr may already have been provided by the banks. It is not certain that the government estimates include this portion as well. However, if they do then the amount would go to the Bottom-line of the Banks as provision write-back. Either ways, to the extent that the banks are now ensured of recovery of these overdue loans (earlier, to an extent recovery appeared doubtful), the reimbursement plan outlined by the FM is a positive.

The moot question relates to the 'good' loans ie., Rs2,30,000-2,80,000cr of loans, which were regularly being repaid by the farmers, as well the fresh loans to be disbursed to the farmers covered by the scheme, who are known defaulters: Could the scheme provide a 'perverse incentive' to farmers to default willfully in the future in expectation of further loan waiver schemes?

Most bankers we spoke to pointed out that there is very little incentive for farmers to default willfully. Consider this:

- **Land/asset collateral makes repayment a foremost priority:** Direct loans to farmers fall under two categories viz., short-term crop loans (working capital for seeds, fertilisers, etc., and secured against agricultural produce, warehouse receipts, etc.) and medium-term investment credit (for farm mechanisation, poultry, horticulture, sericulture, etc., and secured against the asset financed). In most cases, the agricultural land is also mortgaged and the facility is provided by way of revolving Cash Credit. In such cases, recovery is difficult due to the small-ticket size and illiquid assets (Debt Recovery Tribunal route generally not available). However, from a farmer's point-of-view, a large portion of his assets are given as collateral and it seems unlikely that he would risk having them embroiled in civil court recovery processes by defaulting willfully based on speculation of future loan waiver schemes. One must appreciate the pressure that the charge on his assets creates to repay the loan as a foremost priority.
- **Default closes access to further institutional credit:** We believe farmers cannot afford to take the risk of willful defaults based on speculation about future loan waiver schemes. One must appreciate the importance of institutional credit to the economic well-being of Indian farmers. After interest subvention by the government, credit is available to them at a mere 7% (likely to be further reduced) as opposed to usurious interest rates charged by the private money-lenders.

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Once a loan is overdue, interest subvention is withdrawn and further credit is not provided, leaving the farmer with no option but to fall back on the money-lenders. On the other hand, regular repayment of institutional credit empowers farmers to invest regularly, improve productivity, etc., and is the sole route for farmers to improve their standard of living.

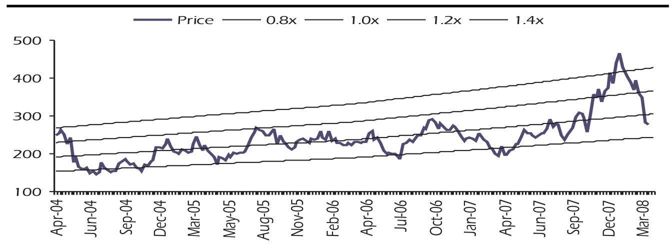
- **Farm credit by SCBs mainly to large farmers:** In general, 40% (or less) of farm loans are disbursed to the small farmers, while 60% are to large farmers (though they represent 30% of the accounts) who have superior credit risk profiles and an even lesser economic incentive to default wilfully.

- **Repayment culture:** There have been loan waivers in the past (for instance, in 1989 by Maharashtra Government, etc.) though smaller in quantum. Bankers indicated that these schemes did not result in marked deterioration in the repayment culture. They described numerous instances of 'honourable' behaviour by the Indian farmers with the general conclusion being that traditionally farmers treat repayment of debt as a foremost priority and do not default unless faced with genuine economic hardship that makes it impossible to repay. Anecdotal evidence apart, we are inclined to concur with this view. Global experience (especially of various microfinance institutions) tends to corroborate the view that borrowers from the weaker sections of the society are credit-worthy and have a strong repayment culture.

We acknowledge that the uncertainty about possible repercussions of the loan waiver represents an overhang on the PSU Bank stocks. However, based on the above

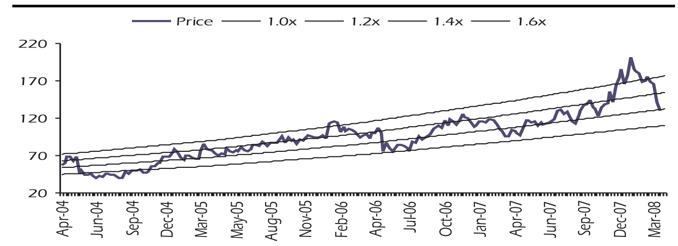
One-year forward Adjusted Book Value Price Bands

Bank of Baroda



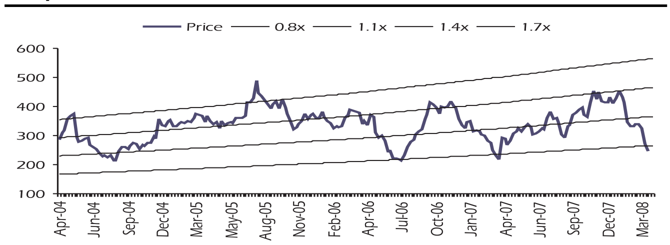
Source: Bloomberg, Angel Research; Note: Adjusted for UTI AMC Value

Indian Overseas Bank



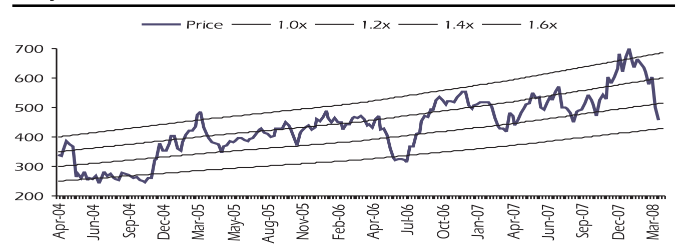
Source: Bloomberg, Angel Research

Corporation Bank



Source: Bloomberg, Angel Research

Punjab National Bank



Source: Bloomberg, Angel Research

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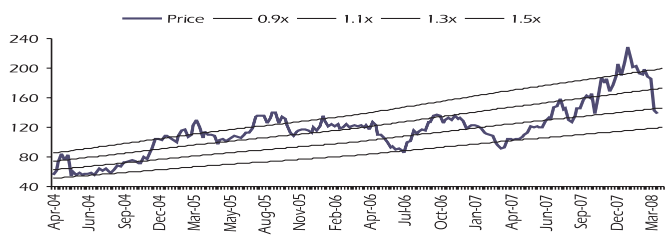
analysis (unless evidence emerges to show marked increase in default rates over the next few quarters), **we remain Overweight on Banking stocks, especially in light of the margin of safety created on account of the sharp correction in their prices.** While strong profit growth in 9M2008 for a number of PSU banks was driven by strong treasury profits and recoveries, and is not expected to be repeated in FY2009E, RoEs are expected to remain stable.

At current valuations (based on P/ABV and corresponding RoE estimates), **we believe a number of quality, large-cap PSU Bank stocks are attractively priced, trading near the lower end of their P/ABV range. Our Top Picks in the sector are HDFC Bank, Axis Bank and Corporation Bank. In the PSU Banks space we also like Bank of Baroda and Punjab National Bank.**

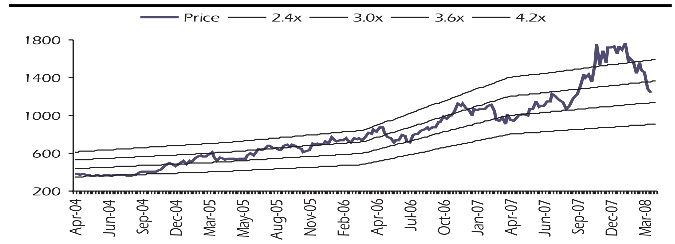
One-year forward Adjusted Book Value Price Bands

Union Bank of India



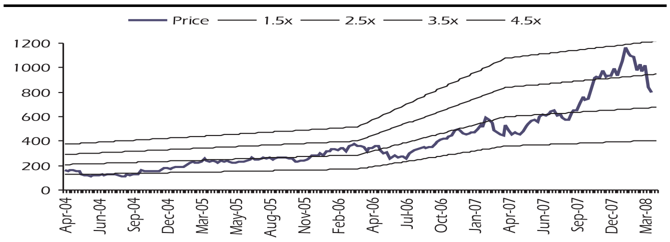
Source: Bloomberg, Angel Research

HDFC Bank



Source: Bloomberg, Angel Research

Axis Bank



Source: Bloomberg, Angel Research

Analyst **- Vaibhav Agrawal**