

# BANKING

*Base rate set to roll*

Today, State Bank of India (SBI) announced its base rate at 7.5%, in line with its guidance of below 8%. Banks in India will move to a new lending rate regime of base rate from July 1, 2010. The new regime will replace the common Benchmark Prime Lending Rate (BPLR) that largely proved ineffective, given wide disparities between banks and proliferation of sub-PLR lending. Following SBI's announcement, other PSU banks (BoB, PNB etc) have also announced base rate of 8%. Over the next few days, we believe other PSU banks will mirror SBI and fix base rate at ~7.5-8.5% depending on their cost of deposits and proportion of CASA. Private sector banks, on the other hand, are expected to announce rates closer to 6.5-7.0%, marginally higher than the earlier expectation of 6.0-6.5%, given the recent rise in short-term rates.

## ■ Our view

We see the following impact of a new base rate regime:

- **Marginal swing in market share in favour of private banks**

Having set a rate lower than PSU banks, we expect private banks to witness shift in business from top-rated corporates specifically for short-term needs. However, limits on borrower-wise exposure could restrict the swing in favour of private sector banks.

- **Partial increase in disintermediation**

Disintermediation is set to increase as the top rated corporates are likely to opt more for commercial papers (CP). However, we expect limited migration as CP rates over the past one month have picked up by 150-200bps gyrating to the liquidity tightness and are currently hovering at ~6.5-7.0% - paring down the differential significantly. Also, given that the CP market is not very deep (limited appetite below P1/P2+ rated corporate), we believe the mid-size corporates will continue to depend on the banking system.

- **Cost of funds may rise for large corporates**

Though there is no prudential limit set by RBI for banks' investment in CPs, banks are expected to set internal limit on exposure via CP. Hence, we believe large corporates will not be able to fully meet their short-term needs via the CP route. Therefore, there could be marginal rise in cost of funds.

## ■ Structurally, we see new base rate regime as positive for banking industry

- **Volatility in margins to reduce**

In the current cycle, we saw banks sharply increasing and reducing their lending rates. Impact of margins was strongly positive in the initial phase, while it was negative in the downcycle. Moral suasion was leading to strong volatility in NIMs, especially for PSU banks. This move could reduce artificial changes to yields. However, effective yields could still be managed given that other components like tenor premium and credit risk premium are within banks' control.

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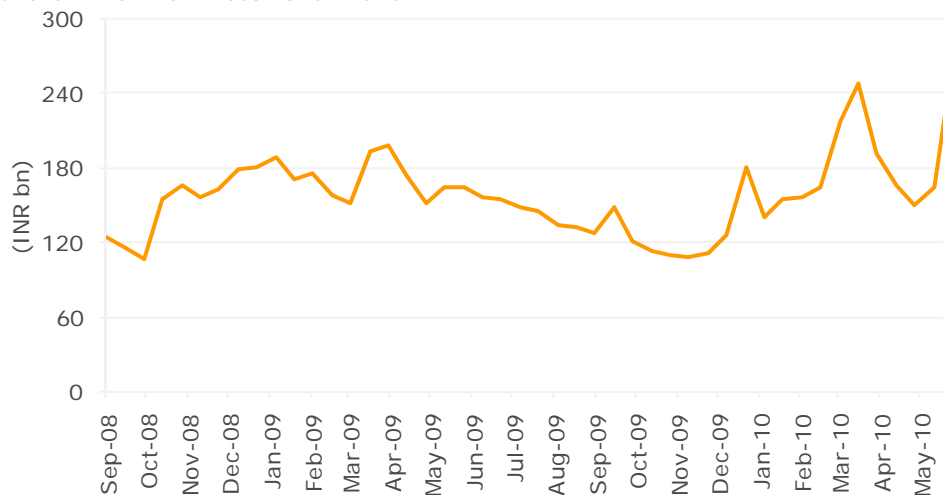
- **Better response to policy rates**

Lending rates for Indian banks are not currently linked to deposit rates, which RBI has been trying to do. With hike in CRR and deposit rates, the impact on lending rates will now be immediately visible. Transmission, henceforth, is likely to be easier.

- **Structural positive for PSU banks**

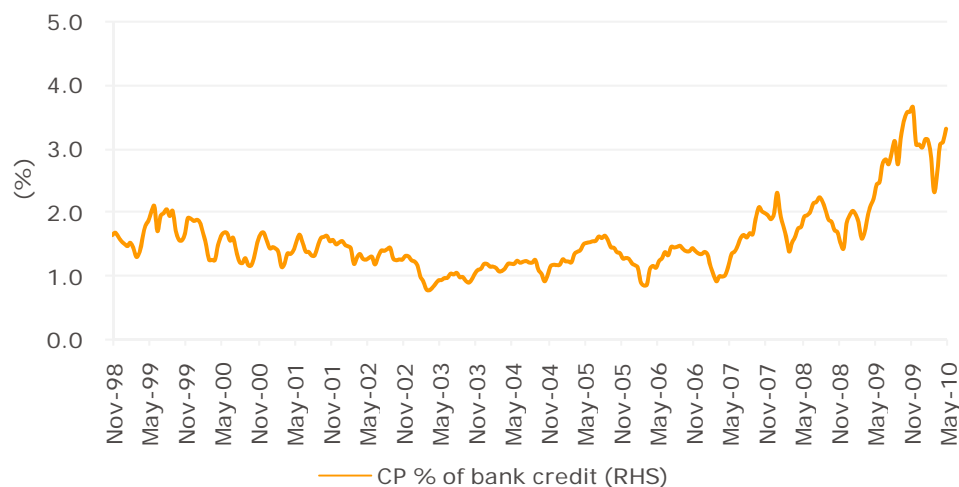
The new regime will reduce the wide dispersion in PLR of PSU and private banks - a positive for PSU banks as the base rate system will give them more flexibility to alter their rates (PSU banks, being more amenable to moral suasion from policymakers, reduce PLR more than private banks).

**Chart 1: Bank's investment in CPs**



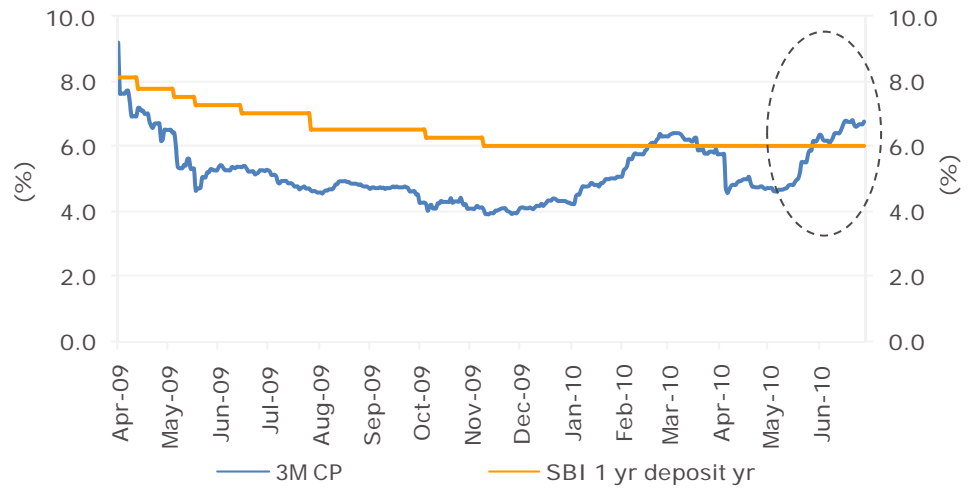
Source: RBI, Edelweiss research

**Chart 2: Disintermediation via CP**



Source: RBI, Edelweiss research

Chart 3: Whole sale rates inching up



Source: Bloomberg, Edelweiss research

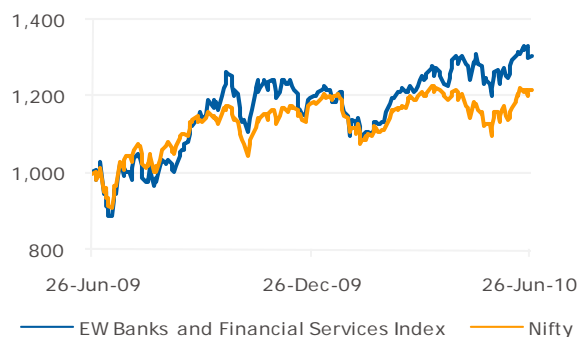
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### Coverage group(s) of stocks by primary analyst(s): Banking

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
28-Jun-10	<b>Life Insurance</b>	IRDA's final guidelines: Near-term pain, long-term gain; <i>Sector Update</i>		
24-Jun-10	<b>Life Insurance</b>	Private insurers' WNRP-individual growth at 14% in May; <i>Monthly Update</i>		
27-May-10	<b>Life Insurance</b>	IRDA plans to cap surrender charges; negative for margins, volumes; <i>Sector Update</i>		
17-May-10	<b>Federal Bank</b>	Healthy core to offset asset quality pressures; <i>Result Update</i>	293	Buy

#### 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
<b>Buy</b>	appreciate more than 15% over a 12-month period
<b>Hold</b>	appreciate up to 15% over a 12-month period
<b>Reduce</b>	depreciate more than 5% over a 12-month period

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