Financials

Regulatory dynamics: The strong to emerge stronger

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Financials

Summary

Regulatory dynamics: The strong to emerge stronger

Balance sheets will strengthen; P&L may hurt during transition

Over the last 12 months, the regulators (RBI and NHB) have tightened their grip on the Indian financial sector through a spate of regulations. We enumerate some of the key game changing regulations proposed/issued by the RBI/NHB:

1) Final guidelines on Basel III norms
2) Discussion paper on dynamic provisioning framework
3) De-regulation of savings deposit rate
4) Final guidelines on securitization
5) Multiple regulations for gold financiers
6) Removal of prepayment penalty and uniform rates for old and new customers for housing loans, and
7) Separate regulatory framework for microfinance institutions (MFIs).

Major impact on key segments

- **Banks: Earnings volatility to reduce but near-term return ratios may be impacted.** Profitability of mid-cap PSU banks is at higher risk; private banks would be better placed due to higher capital buffer and strong risk management practices.
- **Housing finance companies likely to remain largely unscathed** due to their niche focus, robust risk management practices, and cash flow based lending.
- **Gold financiers may have to reinvent business models**; growth and return ratios to decline
- **Micro finance Institutions will continue to grow at a slower pace** as they transit into the new regulatory environment.

Sector view and strategy: Expect medium-term RoEs to come under pressure due to (a) higher capital requirement, and (b) stringent provisioning and asset recognition norms. Prefer market leaders with strong management and liability franchise, and superior technology. **Top picks: SBIN**, **PNB**, **ICICIBC** (large cap banks), **YES**, **OBC** (mid cap banks), and **HDFC, IDFC** (NBFCs).

Comparative valuation

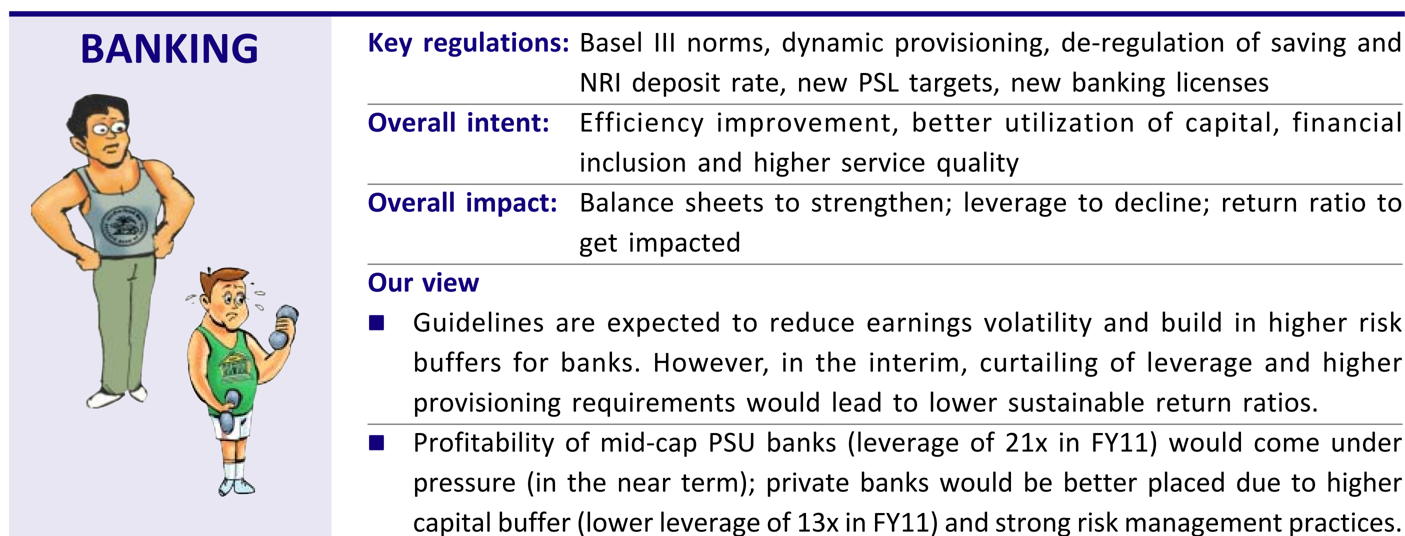
	Mcap	CMP	EPS CAGR	P/BV (x)		P/E (x)		RoE (%)		RoA (%)	
	(USD b)	(INR)	FY12-14E	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
SBIN*	23.7	1,939	25.4	1.0	0.9	6.7	5.7	17.2	17.9	1.1	1.1
ICICIBC#	16.8	801	18.3	1.3	1.1	8.9	7.9	14.2	14.9	1.5	1.5
PNB	4.4	721	15.4	0.8	0.7	4.5	3.8	18.9	19.3	1.1	1.1
YES	2.1	322	23.9	2.0	1.6	9.3	7.6	23.4	23.6	1.5	1.5
OBC	1.2	220	18.7	0.5	0.5	4.5	4.0	12.2	12.6	0.7	0.7
HDFC#	17.3	643	17.9	4.1	3.2	13.4	10.4	29.9	30.7	2.9	3.0
IDFC#	3.3	118	14.1	1.1	1.0	10.5	8.8	13.3	14.2	2.6	2.6

* consol P/E and P/BV. # Multiples adj. for value of key ventures/Investments

In this report, we examine the impact of the proposed/issued regulations on

- Banks
- Housing finance companies (HFCs)
- Non-banking finance companies (NBFCs) - (1) Gold Financiers; (2) Asset and Infrastructure Financing companies and (3) Micro Finance Institutions (MFIs)

Regulatory changes at a glance



BANKING

Key regulations: Basel III norms, dynamic provisioning, de-regulation of saving and NRI deposit rate, new PSL targets, new banking licenses

Overall intent: Efficiency improvement, better utilization of capital, financial inclusion and higher service quality

Overall impact: Balance sheets to strengthen; leverage to decline; return ratio to get impacted

Our view

- Guidelines are expected to reduce earnings volatility and build in higher risk buffers for banks. However, in the interim, curtailing of leverage and higher provisioning requirements would lead to lower sustainable return ratios.
- Profitability of mid-cap PSU banks (leverage of 21x in FY11) would come under pressure (in the near term); private banks would be better placed due to higher capital buffer (lower leverage of 13x in FY11) and strong risk management practices.

Snapshot of regulatory changes

	Proposed/Recommendations/ Guideline changes	Status	Intent	Impact
1	Final Guidelines on Basel III	To be implemented in phased manner till FY18	■ Increase core equity contribution ■ Keep a check on banking system leverage ■ Create buffer for down cycle	■ To strengthen balance sheet ■ Reduce impact of downturn on real economy ■ Improvement in core operating parameters a key
2	Discussion Paper on Dynamic Provisioning Framework	RBI has requested views from industry participants by 15 May 2012 post which draft guideline will be issued	■ To create countercyclical buffer and smoothen earnings	■ To strengthen balance sheet however, higher transitionary impact on P&L
3	Recommendation on changes in Priority Sector Lending	Detailed guidelines to be released soon based on M. V. Nair committee recommendations	■ To increase direct lending towards targeted segments ■ Better Financial Inclusion	■ Opex to rise; balancing of risk and growth will be a key. ■ Banks may find it difficult to achieve sub-segment targets
4	De-regulation of Saving and NRI Deposit rate	Implemented	■ To give higher autonomy to banks ■ End administered interest rate system	■ Superior liability franchise, services and technology will play an important part; Mid-cap PSU banks at risk
5	Liberalization of branch licenses / New banking licenses	Implemented / New Banking license under discussion	■ Financial inclusion ■ Improve customer service levels by promoting healthy competition	■ C/I ratio to rise; ■ Effective use of technology holds the key
6	Abolition of foreclosure charges/ prepayment penalty on home loans on a floating rate basis	Detailed guidelines to be released soon	■ To reduce the gap between new and old customers of home loans and create a level playing field	■ Competitive intensity to increase. ■ Prepayment charges as a proportion of overall fee income is negligible thus, unlikely to have financial impact
7	Variation in interest rates between bulk and retail deposits to be minimal	Detailed guidelines to be released soon	■ Reduce the variation between retail term and bulk deposits rates in the system	■ Re-alignment of deposit taking strategy ■ Bank with strong liability franchise to benefit

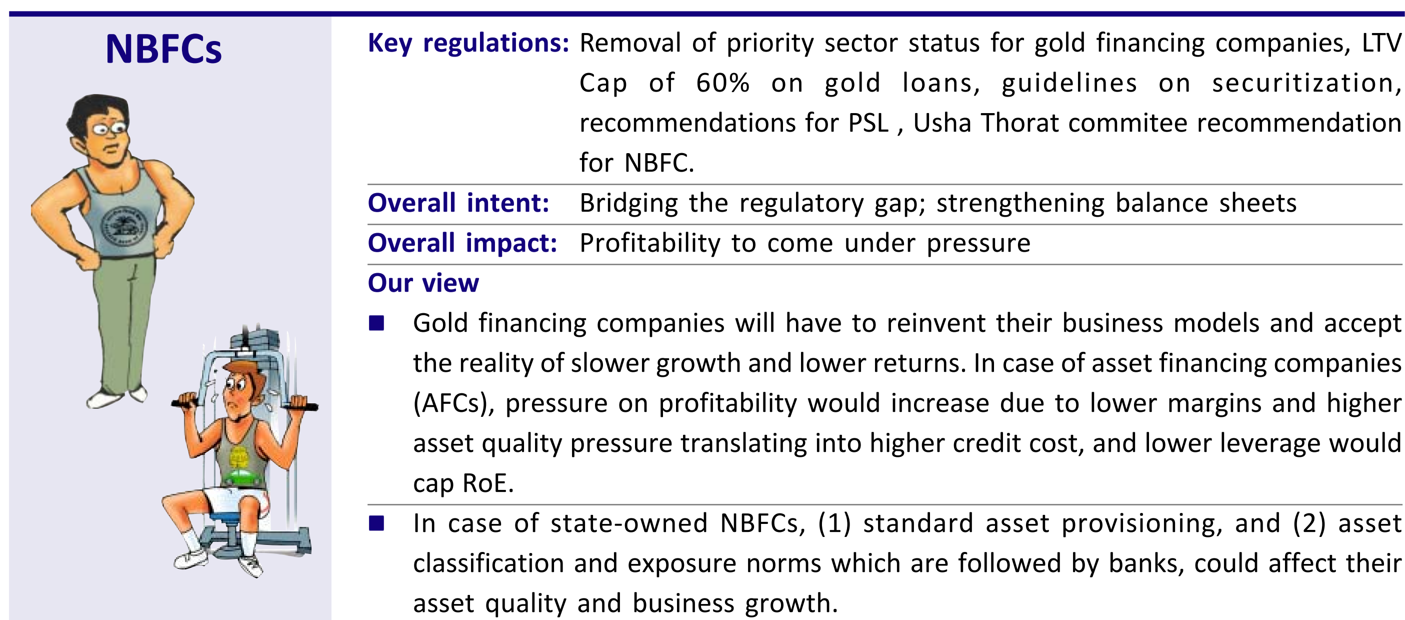
Chronological order of regulations (from May 2011)

Date	Regulations	Date	Regulations
May-11	Enhancement of provisioning norms on NPA and restructured Loans	Mar-12	Discussion Paper on Dynamic Provisioning Framework
Aug-11	New Banking Licenses	Apr-12	Abolition of foreclosure charges/ prepayment penalty on home loans on a floating rate basis
Oct-11	De-regulation of Saving and NRI Deposit rate	Apr-12	Variation in interest rates on deposits to be minimal (between bulk and retail deposits)
Nov-11	Liberalization of branch licenses	Apr-12	Final Guidelines on Basel III
Dec-11	De-regulation of NRI Deposit rate		
Feb-12	M V Nair recommendation on PSL targets		

Guidelines / Recommendation Expected

- Review of prudential guidelines on restructured loans based on international practices and accounting standards (July 2012)
- Final guideline on priority sector lending - RBI has invited comments/suggestions on the same
- Roadmap for provision of banking services with population less than 2,000
- Offer basic savings bank account deposits with certain common facilities and without requirement of minimum balance
- Working group set-up by RBI to assess the flexibility of introducing more long-term fixed rate products
- Working group set-up to examine pricing of credit, based on international experiences (July-2012)

Regulatory changes at a glance



NBFCs

Key regulations: Removal of priority sector status for gold financing companies, LTV Cap of 60% on gold loans, guidelines on securitization, recommendations for PSL , Usha Thorat commitee recommendation for NBFC.

Overall intent: Bridging the regulatory gap; strengthening balance sheets

Overall impact: Profitability to come under pressure

Our view

- Gold financing companies will have to reinvent their business models and accept the reality of slower growth and lower returns. In case of asset financing companies (AFCs), pressure on profitability would increase due to lower margins and higher asset quality pressure translating into higher credit cost, and lower leverage would cap RoE.
- In case of state-owned NBFCs, (1) standard asset provisioning, and (2) asset classification and exposure norms which are followed by banks, could affect their asset quality and business growth.

Snapshot of regulatory changes

	Proposed/Recommendations/ Guideline changes	Status	Intent	Impact
1	Removal of priority sector status for loans to gold financiers; LTV Cap of 60%; capping of the banks exposure to single gold financing NBFC	Implemented	■ To curb super-normal growth rate and to make business model more prudent and sustainable	■ Near term pressure on profitability ■ Entry barriers to increase
2	Final guidelines on securitization	Implemented	■ To curb risk associated with 'originate to distribute model'	■ Could hamper growth and margins
3	M V Nair committee recommendations on PSL	Recommendation	■ To push banks for direct lending and reduce intermediation	■ Negative for NBFC growth and spreads
4	Increase in Tier I Capital to 12% from currently 10%	Recommendation/guideline to be issued by June 2012	■ Strengthen balance sheet	■ Reducing leverage could bring down RoE
5	NPAs to be recognized based on 90days overdue	Recommendation/guideline to be issued by June 2012	■ To remove regulatory arbitrage and tighten risk management	■ Could result in higher NPAs and credit cost
6	Government owned NBFCs should comply with regulations applicable to other NBFCs	Recommendation/guideline to be issued by June 2012	■ To remove regulatory arbitrage and tighten risk management	■ Return Ratios of REC and POWF could be adversely impacted

Chronological order of regulations (from May 2011)

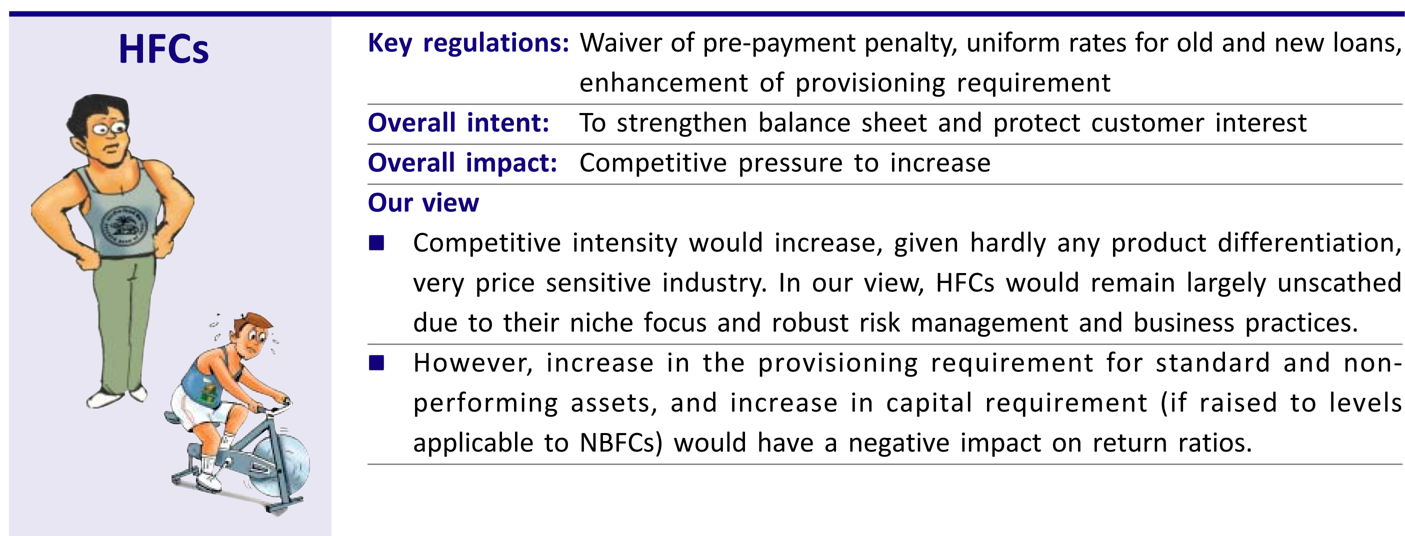
Gold financing

Date	Regulations
Jul-11	Removal of priority sector status for loans to gold financiers;
Mar-12	LTV Cap of 60% and enhancement of capital requirement
Apr-12	Capping of the banks exposure to single gold financing NBFC from 10% to 7.5% of the networth

Asset financing

Date	Regulations
Aug-11	Usha Thorat Committee Recommendations
Feb-12	M V Nair recommendation on PSL targets
Mar-12	Guidelines on fair practices code
May-12	Final guidelines on securitization

Regulatory changes at a glance



HFCs

Key regulations: Waiver of pre-payment penalty, uniform rates for old and new loans, enhancement of provisioning requirement

Overall intent: To strengthen balance sheet and protect customer interest

Overall impact: Competitive pressure to increase

Our view

- Competitive intensity would increase, given hardly any product differentiation, very price sensitive industry. In our view, HFCs would remain largely unscathed due to their niche focus and robust risk management and business practices.
- However, increase in the provisioning requirement for standard and non-performing assets, and increase in capital requirement (if raised to levels applicable to NBFCs) would have a negative impact on return ratios.

Snapshot of regulatory changes

	Proposed/Recommendations/ Guideline changes	Status	Intent	Impact
1	Waiver of Pre-payment penalty	Implemented	■ To remove arbitrage between different players	■ Competition to intensify, minor P&L impact
2	Uniform rates for old and new loans	Implemented	■ To offer same rates to customers with similar risk profile	■ Ample scope remains for subjective evaluation - has become dilutive (v/s proposed guidelines) as it is with prospective effect and not applicable to special rate loans
3	Enhancement of provisioning requirement	Implemented	■ Remove regulatory arbitrage ■ Strengthen risk management practices	■ To impact profitability but balance sheet to strengthen

Chronological order of regulations (from May 2011)

Date	Regulations
Aug-11	Enhancement of provisioning requirement
Oct-11	Waiver of Pre-payment penlaty
Oct-11	Uniform rates for old and new loans

Regulatory changes at a glance

Micro Finance Segment

Key regulations: Seperate MFI Act: (1) Capital requirement hiked to 15% (2) Asset classiication and provisioning norm tightened and (3) Margin capped

Overall intent: Assuaging the regulatory overhang on the sector

Overall impact: Growth and profitability impacted

Our view

- The cabinet has cleared the Microfinance Bill which proposes to make RBI as the sole regulator for microfinance companies. This would end the uncertainty for microfinance companies from the regulatory standpoint and also help them accelerate recoveries, which would improve financial health of these companies
- The pricing cap introduced by the RBI (12% margin cap and 1% processing fee cap) coupled with higher provisioning requirements would restrict RoA at 2.5-3%.
- The only way to increase returns would be by improving operating efficiency. Moreover, with leverage being capped at 6-7x due to higher capital requirements, RoE would also be lower. Hence, the superior returns enjoyed by MFIs in the past are unlikely, going forward.

Snapshot of regulatory changes

	Proposed/Recommendations/ Guideline changes	Status	Intent	Impact
1	Capital requirement hiked to 15%	Implemented	■ Higher emphasis on equity capital	■ Ability to leverage curbed ■ Return Ratios to be capped
2	Asset Classification and provisioning norms	Implemented	■ Tighten Risk management practices	■ To impact profitability but balance sheet to strengthen
3	Cap on Margins	Implemented	■ To keep a check on rates charged by MFIs	■ To marginalize return ratios

Sector view and Strategy

Interest rates to gradually decline in FY13: In April 2012, RBI cut policy rates by 50bp (repo at 8%) to revive economic growth. Banks have partially passed on benefits of recent rate actions (50bp repo cut, 125bp CRR cut and 100bp hike in MSF limit) with 25bp cut in lending rates. For lending rates to fall further, decline in cost of funds is imperative. However, liquidity conditions remain tight and deposit growth still low. Higher Reserve money growth (via OMO or fall in CRR) will be key for deposits growth in FY13. Our economist expects a further rate cut of 25bp in June monetary policy and 25bp CRR cut in July monetary policy review.

Macroeconomic environment challenging; expect loan growth of 15-16%: Our interaction with bankers suggests moderation in new sanctions continued even in busy season of FY12. As in FY12, in FY13 too, working capital is likely to be a key driver for corporate loan growth. Lag impact of 2-3 years of continued moderation in capex cycle will have impact on other loan segments.

Asset quality - a key to valuations: While GNPAs have peaked, we expect higher restructuring in 1HFY13 to keep valuations in check. Fall in interest rates and easing of policy logjam will materially alter asset quality, growth outlook, and will improve valuations. We like banks with strong liability franchise, superior capitalization, and stability at the top management level (specifically for PSU banks). In NBFC, we like HFC segment the most due to underlying growth drivers, strong collateral, and cash flow based lending. **Top picks: SBIN**, **PNB**, **ICICIBC**, **YES**, **OBC**,**HDFC** and **IDFC** .

	Rating	CMP (INR)	Mcap (USDb)	EPS (INR)		P/E (x)		P/BV (x)		RoA (%)		RoE (%)	
				FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
ICICIBC*	Buy	801	16.8	56	67	11.0	8.9	1.5	1.3	1.5	1.5	13.2	14.2
HDFCB	Neutral	489	20.9	22	29	22.2	17.0	3.8	3.3	1.7	1.8	18.7	20.7
AXSB	Buy	966	7.3	103	115	9.4	8.4	1.8	1.5	1.6	1.6	20.3	19.7
KMB (cons)	Neutral	550	7.4	25	29	22.2	19.2	3.2	2.7	1.9	1.6	15.4	15.2
YES	Buy	322	2.1	28	34	11.6	9.3	2.4	2.0	1.5	1.5	23.1	23.4
IIB	Buy	305	2.6	17	22	17.8	13.6	3.2	2.6	1.6	1.6	19.2	21.1
VYSB	Buy	336	0.9	30	34	11.1	9.9	1.3	1.2	1.1	1.0	14.3	12.4
FB	Buy	405	1.3	45	52	8.9	7.9	1.2	1.1	1.4	1.3	14.4	14.6
J&KBK	Buy	905	0.8	162	180	5.6	5.0	1.1	0.9	1.4	1.4	20.8	19.7
SIB	Buy	22	0.2	4	4	6.2	4.9	1.2	1.0	1.1	1.1	21.6	22.8
Private Aggregate			**60.2**			**15.4**	**12.7**	**2.4**	**2.2**				
SBIN (cons)*	Buy	1,939	23.7	229	288	8.5	6.7	1.2	1.0	0.9	1.1	15.7	17.2
PNB	Buy	721	4.4	144	159	5.0	4.5	0.9	0.8	1.2	1.1	21.0	18.9
BOI	Neutral	308	3.2	47	55	6.6	5.6	0.9	0.8	0.7	0.8	15.0	15.0
BOB	Neutral	670	5.0	121	122	5.5	5.5	1.0	0.9	1.2	1.0	21.5	17.6
CBK	Buy	392	3.2	74	78	5.3	5.0	0.8	0.7	0.9	0.9	17.0	15.7
UNBK	Buy	201	2.0	32	43	6.2	4.7	0.9	0.7	0.7	0.8	14.8	17.1
IOB	Neutral	79	1.2	13	16	6.0	4.9	0.6	0.5	0.5	0.5	11.1	11.5
OBC	Buy	220	1.2	39	49	5.6	4.5	0.6	0.5	0.7	0.7	10.7	12.2
INBK	Buy	179	1.4	41	44	4.4	4.0	0.8	0.7	1.3	1.3	19.8	18.7
CRPBK	Neutral	405	1.1	102	111	4.0	3.7	0.7	0.6	1.0	0.9	19.5	18.4
ANDB	Buy	104	1.1	24	26	4.3	4.0	0.8	0.7	1.1	1.1	19.2	18.1
IDBI	Neutral	87	2.0	16	18	5.5	4.8	0.6	0.6	0.8	0.8	13.4	12.7
DBNK	Buy	85	0.5	20	23	4.2	3.6	0.7	0.6	0.9	0.9	18.1	17.6
Public Aggregate			**49.9**			**7.1**	**6.0**	**1.0**	**0.9**				
HDFC*	Buy	643	17.3	28	33	16.5	13.4	4.6	4.1	2.8	2.9	27.2	29.9
LICHF	Buy	234	2.1	18	26	12.9	8.9	2.1	1.8	1.8	1.8	20.3	20.0
DEWH	Buy	180	0.4	26	36	6.9	5.0	1.2	0.9	1.3	1.4	17.1	18.0
IDFC	Buy	118	3.3	10	11	11.5	10.5	1.3	1.1	2.9	2.6	13.7	13.3
RECL	Buy	174	3.1	29	34	6.0	5.1	1.2	1.0	3.1	3.1	20.9	21.8
POWF	Buy	149	3.6	23	27	6.6	5.6	0.9	0.8	2.6	2.6	16.5	16.0
SHTF	Buy	496	2.0	56	63	8.9	7.9	1.9	1.6	2.8	2.9	23.1	21.7
MMFS	Neutral	646	1.2	60	78	10.7	8.3	2.2	1.9	3.6	3.6	22.8	24.7
NBFC Aggregate			**33.0**			**12.3**	**10.2**	**2.1**	**1.8**				

*Multiples adj. for value of key ventures/Investments; For ICICI Bank, HDFC Ltd BV is adjusted for investments in subsidiaries

Main report

Regulations pertaining to banks

Intent: Efficiency improvement, better capital utilization & financial inclusion

Impact: Balance sheets to strengthen; leverage to decline

- **Higher emphasis on common equity Tier I (CET1) capital under Basel III: The guidelines call for significant increase in the core Tier I requirement of minimum 10.5% (8% without counter cyclical buffer) by end of FY18 (draft guideline mentioned till FY17) v/s current minimum requirement of 3.6%. Higher common equity requirement and introduction of leverage ratio at 4.5% (3% proposed globally) are by far stricter than global standards.**
- **Dynamic provisions to smoothen earnings; provision requirements conservative: The discussion paper emphasizes that it would be prudent for all banks to create a countercyclical buffer during good times, which could be utilized when asset quality pressure emanates. The RBI has suggested that banks reach 70% PCR before implementation of the DP framework and incrementally make provisions on the basis of loss given default during downturn which is conservative.**
- **While the guidelines would reduce earnings volatility and build in higher risk buffers for banks, in the interim, curtailing of leverage and higher provisioning requirements would lead to lower sustainable return ratios. In our view, profitability of mid-cap PSU banks (leverage of 21x in FY11) would come under pressure (in the near term), whereas private banks would be better placed due to higher capital buffer (lower leverage of 13x in FY11) and strong risk management practices.**
- **Other key policy changes in CY11/FY12 were: (1) deregulation of savings deposit rate, (2) freeing up branch licenses, (3) new banking license discussion paper, and (4) recommendations on changes in priority sector lending norms (5) abolition of prepayment penalty on home loans on floating rate basis and (6) variation on interest rates on deposits to be minimal (between bulk and retail deposits).**

I. Basel III guidelines: Increase core equity contribution

Impact: To strengthen balance sheet; reduce impact of economic downturn

Minimum core equity contribution of 10.5% (8% without counter cyclical buffer) to risk weighted assets by end of FY18

Final guidelines on Basel III places higher emphasis on common equity Tier I (CET1) capital - requirement. The guidelines call for a minimum core equity contribution of 10.5% (8% without counter cyclical buffer) to risk weighted assets by end of FY18 (draft guideline mentioned till FY17) as against current minimum requirement of 3.6%. Introduction of leverage ratio [3% proposed globally and may be at 4.5%+ (earlier proposed at 5%) for Indian banks] supplementing overall risk based capital requirement is also stricter than that of global standards. While most of the banks in India are already above minimum CET1 of 5.5% and on aggregate basis at Tier I of 8% or above, transition should not be an issue in the near term. Private Banks and PSU Banks with higher RoA are better placed as compared to mid-small sized PSU banks.

Also refer our report dated 3 May 2012

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Financials

RBI releases final guidelines for BASEL III

Higher emphasis on common equity; however compliance extended by one year: Under Basel III guidelines banks are required to maintain minimum common Equity Tier I (CET1) capital of 10.5% (8% without counter cyclical buffer) by end of FY18 (draft guideline mentioned till FY17) v/s current minimum requirement of 3.6%. Further qualifying criteria for the other capital instrument (hybrid and Tier II) is also linked with CET1. Banks which do not fulfill CET1 and capital conservation buffer criteria and has higher AT1 and T2 will not be allowed to categorise them as capital funds.

Leverage ratio at 4.5% vs. 5% in draft guidelines: Taking clues from global financial crisis RBI has suggested banks to maintain leverage ratio at 4.5% (draft guidelines suggested of 5% and 3% globally under Basel III). Leverage ratio will include all assets on balance sheet and off balance sheet items at credit conversion factors.

Key deductions to be made from core equity as against overall CAR earlier: Shortfall of provisions to reach expected loss levels under IRB approach to be deducted from CET1. Indian banks have not yet shifted to IRB approach thus, not applicable under BASEL II. Shortfall under defined benefit pension fund should be deducted from CET1 thus, banks will have to take the hit of unamortised liability (occurred on account of second pension option) in FY13 itself (two years in advance). However, under IFRS it was expected to be netted off from the net worth from FY14 onwards.

Other highlights

- Exposure limits are linked to capital funds (CET1+AT1+T2) and it does not include capital conservation buffer and CCB. For adjustments from CET1, till FY17, remainder will continue to have current regulatory treatment. AT1, will be phased out beginning CY13 till FY22 under BASEL III.
- RBI has extended the creation of the capital conservation buffer of 0.625% of RWAs by one year to FY15. Limits have been placed for distribution of capital if CET1 falls in the range of CCB.
- For details on securitisation transaction, investment in subsidiary capitalisation, please refer to our detail note

Our view

Most of the banks in India are already above minimum requirement as stipulated in Basel III thereby, transition should not be an issue in the near term

Impact on sector: (a) Most of the banks in India are already above minimum CET1 of 5.5% and on aggregate basis at Tier I of 8% or above [BASEL III requirement of 7% (CET1 of 5.5% and AT1 of 1.5%) and current regulatory requirement of 6%] and hence, transition should not be an issue in the near term (b) Higher share of CET1 and fall in leverage will lead to a fall in RoEs of select PSU banks (c) Currently, RBI mandates banks to keep the dividend payout ratio below 40% depending upon its CRAR of last 3 year and performance on NNPA front. Banks are given flexibility under BASEL III for dividend payout and it can also be as high as 100% payout. This is positive in case of ICICIBC and FB considering the release of capital from Insurance venture and excess capitalisation.

All the private sector banks at the current levels fulfil the minimum CET1 + CCB requirement

Impact on Private sector banks: All the private sector banks at the current levels fulfil the minimum CET1 + CCB requirement. So far, major Private sector banks have worked with higher Tier I ratio and have recapitalized balance sheet if Tier I ratio reaches ~9%. Private Banks also earn superior ROA as compared to PSU counter parts and hence, transition to BASEL III is a non-issue. Higher capital requirement will also force PSU banks to focus on core parameters and calibrate growth. We expect private banks to effectively capitalise the consolidation phase of PSU banks with rapid expansion of branch and customer acquisition.

Private banks better capitalized than PSU counter parts

Capital Structure of Private banks (Based on descending order of CET1 of FY11)

	FY10					FY11				
	CRAR	Tier I	CET1	AT1	T2	CRAR	Tier I	CET1	AT1	T2
FB	18.4	16.9	16.9	0.0	1.4	16.8	15.6	15.6	0.0	1.2
ICICIBC	19.4	14.4	13.5	0.9	5.0	19.5	13.2	12.4	0.8	6.3
IIB	15.3	9.7	9.7	0.0	5.7	15.9	12.3	12.3	0.0	3.6
HDFCB	17.4	13.3	13.2	0.1	4.1	16.2	12.2	12.1	0.1	4.0
JKBK	15.9	12.8	12.8	0.0	3.1	13.7	11.3	11.3	0.0	2.4
AXSB	15.8	11.2	10.9	0.3	4.6	12.7	9.4	9.2	0.2	3.2
VYSB	14.9	10.1	9.6	0.5	4.8	12.9	9.4	8.9	0.4	3.6
YES	20.6	12.8	11.8	1.0	7.8	16.5	9.7	8.5	1.1	6.8

Source: Company/MOSL

Impact on PSU banks: GOI commitment to keep Tier I ratio at 8% and above and it's holding at 58%+ in PSU banks, should ensure smooth transition to BASEL III by banks in the near term. However, considering the fiscal health of GOI, funding PSU banks on a longer term basis is not a viable option. Thus, banks will have to improve core operating profitability to fund its growth requirement.

In our view, banks with low RoA's and structurally weak balance sheet structure will find it difficult to fulfil BASEL III requirement, resulting in loss of market share and eventual consolidation. In our view, top 6 six PSU banks are better placed to fulfil BASEL III requirement. Alternate measures that can be adopted by GOI, to fulfil BASEL III requirements in PSU banks, in the short term is to convert its PNCPS and IPDI holding into equity.

CET1 high for large PSU banks

GoI will have to find ways to convert AT1 to CET1 for small PSU banks

Capital Structure of PSU banks (Based on descending order of CET1 of FY11)

	FY10					FY11				
	CRAR	Tier I	CET1	AT1	T2	CRAR	Tier I	CET1	AT1	T2
OBC	12.5	9.3	8.6	0.7	3.3	14.2	11.2	10.3	0.9	3.0
CBK	13.4	8.5	8.0	0.6	4.9	15.4	10.9	10.0	0.9	4.5
ANDB	13.9	8.2	7.8	0.4	5.8	14.4	9.7	9.4	0.3	4.7
DB	12.8	8.2	7.3	0.8	4.6	13.4	9.8	9.1	0.7	3.6
BOB	14.4	9.2	8.4	0.8	5.2	14.5	10.0	9.1	0.9	4.5
ALBK	13.6	8.1	7.7	0.4	5.5	13.0	8.6	8.2	0.3	4.4
PJSB	13.1	7.7	6.5	1.2	5.4	13.6	9.3	8.2	1.0	4.3
UNBK	12.5	7.9	7.1	0.8	4.6	13.0	8.7	7.9	0.8	4.3
CRPBK	15.4	9.3	8.2	1.1	6.1	14.1	8.7	7.9	0.8	5.4
PNB	14.2	9.1	8.0	1.1	5.1	12.4	8.4	7.6	0.8	4.0
SBIN (Cons)	13.5	9.3	8.6	0.7	4.2	12.3	8.0	7.4	0.6	4.2
IOB	14.8	8.7	7.7	1.0	6.1	14.6	8.2	7.4	0.7	6.4
BOI	12.9	8.5	7.4	1.0	4.5	12.2	8.3	7.3	1.0	3.8
UNTDB	12.8	8.2	6.8	1.3	4.6	13.1	8.9	7.3	1.6	4.2
VJYBK	12.5	7.7	6.5	1.2	4.8	13.9	9.9	7.2	2.7	4.3
SNDB	12.7	8.2	7.2	1.1	4.5	11.5	7.8	7.0	0.8	3.6
CBOI	12.2	6.8	4.7	2.1	5.4	13.8	8.5	6.6	1.9	5.3
BOMH	12.8	6.4	5.7	0.7	6.4	13.4	8.0	6.2	1.9	5.3
IDBI	11.3	6.2	4.3	1.9	5.1	13.6	8.0	6.1	1.9	5.6
UCO	13.2	7.1	4.9	2.2	6.2	13.7	8.5	5.8	2.7	5.2

Source: Company/MOSL

II. Dynamic Provisioning Framework to create countercyclical buffer

Impact: Balance sheet to be stronger but P&L to be impacted in transition

To smoothen the banks' earnings and reduce the impact of downturn in the economy

The discussion paper on dynamic provisioning (DP) framework was released by the RBI in March-2012, wherein it highlighted the requirement of counter-cyclical provisioning to smoothen the banks' earnings and reduce the impact of downturn in the economy. While the requirement of DP will make bank balance sheets structurally strong and smoothen earnings, some of the norms will impact earnings and put a strain on their capital. The RBI has requested views from industry participants by 15 May 2012, post which it will release draft guidelines on dynamic provisions.

Some of the key inferences / takeaways from the discussion paper are:

- **Introduction of DP to strengthen balance sheet and smoothen earnings:** The discussion paper emphasizes that it would be prudent for all banks to create a counter-cyclical buffer during good times, which could be utilized (subject to certain conditions) when asset quality pressure emanates during an economic downturn and thus reduce earnings volatility. Initial DP would be outstanding provisions made on standard asset and floating provision. However, it has an in-built assumption that banks have reached 70% PCR. Incrementally RBI has suggested credit cost of 1.37%. If actual specific provisions (SP) is lower than 1.37% excess provisions will be transferred to DP and vice-a-versa subject to certain conditions.

Also refer our report dated 3 April 2012

Financials

RBI releases discussion paper on dynamic provisioning framework

- **Proforma credit cost estimated at 1.37%, but may vary from bank to bank:** Based on weighted average estimated loss (EL) of nine individual banks, RBI has arrived at a system-level loss given default (LGD) of 1.37% of loans during a downturn (a more conservative approach which RBI has recommended) and at an LGD of 0.84% of loans during normal times. For the purpose of calculation, model portfolio with corporate loans, retail loans, housing loans and other loans was taken as 49%, 17%, 6% and 28%, respectively. Thereby actual requirement would vary from bank to bank. Further banks might come out with estimated loss assumption based on their internal rating method. Thus, 1.37% cannot be strictly taken as a benchmark for all banks.
- **Utilization of DP restricted:** Banks can only utilize DP to the level prescribed by the RBI (called floor of DP). The actual level of floor DP prescribed by the RBI is 1/3rd of EL (estimated loss - annual credit cost in P&L). To utilize DP, prior RBI approval is required.

Till normal LGD DP should be considered as specific provisions and above normal LGD it should be considered as general provisions

- **Treatment of DP:** The suggested framework for Indian banks is conservative (as credit cost suggested is based on downturn LGD) and the DP framework will include an element of general and specific provisions. The RBI has suggested that till the level of normal LGD (0.84%), DP provisions should be considered as specific provisions and should be used for arriving at net NPA. Above normal LGD to actual levels (1.37%-0.84%), DP provisions should be considered as general provisions, and thus, as tier-II capital.

Dynamic Provision discussion paper also talked about 70% PCR as initial starting point

Earlier steps taken by RBI to increase cushion in balance sheet

- In December 2009, the RBI increased the provisioning requirement of banks to 70% on GNPA (including technical write-offs). This was a prudent measure by the RBI so that banks could create a counter-cyclical buffer in the balance sheet and would be in a much better position to absorb asset quality shocks. The RBI relaxed this requirement in April 2011 and asked banks to maintain 70% PCR based on September 2010 GNPA levels as a form of countercyclical buffer. However, Dynamic Provision discussion paper also talked about 70% PCR as initial starting point.
- At a later stage, the RBI increased the provisioning requirement on different categories of NPAs. In May 2011, the RBI also increased the provisioning requirement on standard restructured loans to 2% from 40bp earlier. While higher provisioning had an intermittent impact on banks' profitability, it enabled them to face headwinds in challenging times.

Our view: To strengthen banks' balance sheets but transition to impact near-term earnings

- Initially, banks would have to shore up their provision coverage ratio (PCR) to 70%, which may impact their profitability, especially in case of state-owned banks, wherein the PCR has declined significantly in the past one year. Assuming amortization of 8 quarters and technical write-offs to be allowed while calculating 70% PCR, the impact on banks' PBT could be 0-13% in FY13 and FY14.
- Currently, we model credit cost of 60-130bp for FY13-14. If the DP framework based on current suggested structure is implemented (at 1.37%), it will impact PBT by 2-30% in FY13 and FY14. The overall impact of DP could be 4-30% in FY13 and FY14. However, over the cycle, DP will considerably reduce earnings volatility and will also make earnings comparable among the banks.
- Higher provisions will impact RoA and RoE of banks in the short-to-medium term. These provisions will need some enhancement in NIMs to ensure that profitability remains intact. Banks with strong risk management systems would gain over the rest, once they convince RBI to lower provisioning requirements for them.
- Smoothening of earnings will be a structural positive as with economic cycle noise over asset quality will come down.

OBC and UNBK are likely to be impacted the most

Impact of higher PCR requirement on PSU banks to be 0-13%

	Provision (incl tech w/off)				Impact on PBT (%)	
	to retain 70% (a)	at end of FY12 (b)	shortfall/ (excess) (a-b)	Assuming 8 qtrs ammortization (impact per year)	FY13	FY14
SBIN	347,122	337,700	9,422	4,711	1.9	1.7
PNB	83,659	74,970	8,689	4,344	5.5	4.5
CBK	73,048	70,492	2,557	1,278	3.0	2.5
BOB	54,163	61,939	-7,776	-3,888	N.A.	N.A.
BOI	71,454	65,513	5,941	2,970	6.6	5.5
UNBK	56,049	49,819	6,229	3,115	8.6	7.4
OBC	44,733	39,314	5,419	2,710	12.9	11.4
INBK	28,048	28,100	-52	-26	N.A.	N.A.
ANDB	18,327	18,623	-296	-148	N.A.	N.A.

While impact calculation is based on 1.37% credit cost assumptions, banks can come out with different downturn LGD under internal rating based approach

Provisioning requirements of 1.37% to impact FY13 and FY14 earnings by 2-30%

(INR m)	Provisions assuming 1.37% on opening loans		Current estimates of provisions		Shortfall / (Excess)		Impact on PBT (%)	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
PSU Banks								
SBIN	118,858	137,876	114,694	118,754	4,164	19,121	1.7	6.7
PNB	40,247	47,492	37,309	39,865	2,938	7,626	3.7	8.0
CBK	31,851	36,629	22,087	27,177	9,765	9,451	22.6	18.5
BOB	39,371	46,457	27,579	34,732	11,791	11,725	16.6	14.3
BOI	34,090	39,545	29,860	30,394	4,230	9,150	9.4	16.9
UNBK	24,370	28,269	18,713	22,099	5,657	6,170	15.6	14.7
OBC	15,341	17,642	12,639	15,036	2,701	2,606	12.8	10.9
INBK	12,374	14,602	11,065	13,323	1,310	1,279	4.8	4.1
ANDB	11,459	13,292	8,799	10,391	2,660	2,901	12.8	12.2
Private Banks								
ICICIBC	34,761	39,589	22,118	26,282	12,643	13,307	12.5	11.2
HDFCB	26,773	32,663	17,338	22,500	9,435	10,162	10.0	9.0
AXSB	23,257	27,908	17,297	22,143	5,960	5,765	8.6	7.1
YES	5,204	6,245	1,766	2,678	3,438	3,567	19.1	16.1
IIB	4,804	6,245	3,143	4,558	1,661	1,687	10.7	8.3
VYSB	3,937	4,724	1,810	2,409	2,127	2,316	28.0	25.7
SIB	3,737	4,634	1,484	2,030	2,253	2,605	29.5	29.1
FB	5,173	6,000	3,972	4,691	1,201	1,310	9.1	8.6

CBK, BOI, UNBK and OBC to be impacted the most in PSU banks

Higher earnings impact on small private sector banks

Overall DP framework could impact profitability by 4-30% for FY13 and FY14

(INR m)	Excess Provision Required if DP comes in current form		Impact on PBT (%)	
	FY13	FY14	FY13	FY14
SBIN	8,875	23,832	3.7	8.4
PNB	7,282	11,971	9.2	12.5
CBK	11,043	10,730	25.6	21.0
BOB	7,903	7,837	11.1	9.6
BOI	7,201	12,121	16.0	22.4
UNBK	8,771	9,284	24.3	22.1
OBC	5,411	5,315	25.7	22.3
INBK	1,284	1,253	4.8	4.1
ANDB	2,512	2,753	12.1	11.6
Private Banks				
ICICIBC	12,643	13,307	12.5	11.2
HDFCB	9,435	10,162	10.0	9.0
AXSB	5,960	5,765	8.6	7.1
YES	3,438	3,567	19.1	16.1
IIB	1,661	1,687	10.7	8.3
VYSB	2,127	2,316	28.0	25.7
SIB	2,253	2,605	29.5	29.1
FB	1,201	1,310	9.1	8.6

Source: Company/MOSL

III. Changes in Priority Sector Lending: Better Financial Inclusion

Impact: Opex to rise; balancing of risk and growth will be a key

In case of small and marginal farmers, banks will have to achieve a target lending of 9% of adjusted net bank credit by FY16; and for the weaker section, the target is 7% by FY14

The recent recommendations of the MV Nair Committee on priority sector lending remove the distinction between direct and indirect agriculture, which is a positive. However, they introduced new sub-segment (small and marginal farmers, weaker section) targets, which will increase the challenges for banks. In case of small and marginal farmers, banks will have to achieve a target lending of 9% of adjusted net bank credit by FY16; and for the weaker section, the target is 7% by FY14. Banks are currently lagging in terms of these targets (state-owned banks achieved 6.3%, while private banks achieved 2.8% in FY11); thereby operations in these segments need to be scaled up. Banks would have to balance risk of asset quality while aiming to achieve the target which would be a challenge. Under the current recommendations, RIDF investment on balancesheet would be consider for calculation of overall PSL target, which is a positive.

PSL target for foreign banks increased to 40% of ANBC from 32% earlier

Status quo for domestic banks; foreign banks' targets scaled up

For domestic commercial banks, the overall priority sector targets have been kept unchanged at 40% of ANBC (adjusted net bank credit). However, the Committee has recommended an increase in the PSL target for foreign banks to 40% of ANBC from 32% earlier. The increase in the PSL targets for foreign banks creates a level playing field by putting them at par with domestic commercial banks. However, given their limited branch network, foreign banks would find it difficult to achieve this target.

Challenges for private sector and foreign banks, to increase

Introduction of sub-segments may increase challenges

The Committee has recommended sub-segment targets for lending to (1) small and marginal farmers within agriculture and allied activities equivalent to 9% to be achieved in a phased manner by 2015-16, and (2) micro enterprises within MSE sector equivalent to 7% to be achieved in a phased manner by 2013-14. Moreover, the committee has recommended that the number of outstanding beneficiary accounts under 'small and marginal farmers' and 'micro enterprises' should each register a minimum annual growth rate of 15%. This would increase challenges for private sector and foreign banks, as their lending to these segments is well below the suggested targets.

Foreign banks PSL targets suggested to be increased to 40% (from 32% currently)

Recommended changes in PSL targets

Targets* for	Domestic SCBs (%)	Foreign Banks (%)
Overall Priority Sector	40	40
Agriculture	18	-
of which, SFMF	9	-
Micro & Small Ent.	-	15
Micro Ent.	7	7
Exports	-	15
Weaker Sections	10	-

* With reference to ANBC - Adjusted Net Bank Credit

Roadmap for achievement of S&MF target

Year	Target for S&MF as % of ANBC
2012-13	6.0
2013-14	7.0
2014-15	8.0
2015-16	9.0

Frequency distribution of lending to small & marginal farmers

Lending to S&MF as % to ANBC	No. of PSBs	No. of Private Banks
As of March 2011		
Below 4%	4.0	11.0
4% to less than 7%	11.0	2.0
7% to less than 9%	6.0	2.0
9% and above	5.0	5.0
Total	**26.0**	**20.0**

Source: RBI

Achieving the target to lend to small marginal farmers will be a huge task

Lending by banks to small & marginal farmers

Year	Loans to SFMF as a % of ANBC		
	PSBs	Private Banks	Domestic SCBs
2007	4.6	0.6	3.8
2008	5.8	1.6	4.9
2009	6.1	2.1	5.4
2010	6.3	2.9	5.7
2011	6.3	2.8	5.7

Source: RBI

Roadmap for achievement of Micro Enterprises target

Year	Target for Micro Enterprises as % of ANBC
2012-13	6
2013-14	7

Frequency distribution of lending to Micro Enterprises

Lending to SFMF as % to ANBC	No. of PSBs	No. of Private Banks
As of March 2011		
Below 4%	5.0	8.0
4% to less than 7%	9.0	3.0
7% and above	12.0	9.0
Total	**26.0**	**20.0**

Source: RBI

Increase in lending to micro enterprises should be a big challenge, considering sharp increase in branch network that will be required

Lending by banks to Micro Enterprises

Year	Loans as a % of ANBC		
	PSB	Private Banks	Domestic SCBs
2007	3.3	1.0	2.9
2008	5.1	2.6	4.6
2009	5.3	2.7	4.8
2010	6.4	3.4	5.9
2011	6.9	4.7	6.5

Source: RBI

IV. Deregulation of savings deposit rate to give higher autonomy to banks

Impact: Superior liability franchise, services and technology will play an important part; Mid-cap PSU banks at risk

Puts an end to administered rates on the liability side

In 2QFY12 monetary policy, the RBI deregulated interest rates on Savings bank and total NRI (including FCNR)deposits, subject to certain conditions. This has been a hallmark change and puts an end to administered rates on the liability side. Savings bank deposits constitute 20-21% and NRI deposits constitute 3-4% of the liabilities of the Indian banking system.

Also refer our report dated 14 February 2011

Conditions for savings bank account pricing in de-regularized environment

- Each bank will have to offer a uniform interest rate on savings bank deposits up to INR0.1m.
- Banks can provide differential rates above INR0.1m (could be different slabs). However, the rate should be uniform across each slab and not vary according to customer profile.
- Banks have been allowed to pay interest rates on savings deposits based on average daily basis, quarter-end basis, month-end basis, etc.

Conditions for NRI deposit account pricing in de-regularized environment

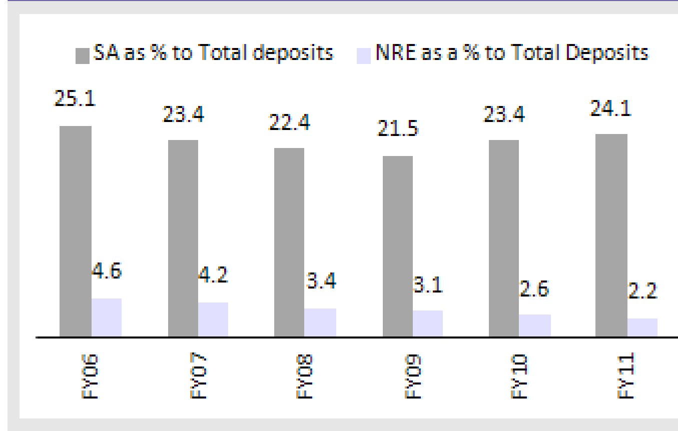
- Banks are free to determine their interest rates on both savings deposits and term deposits of maturity of one year and above under NRE deposit accounts and savings deposits under NRO.
- Interest rates offered by banks on NRE and NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.
- Individual banks should offer uniform rates at all their branches.
- Revised deposit rates will apply only to fresh deposits and on renewal of maturing deposits.

System-wide composition of deposits (FY11)

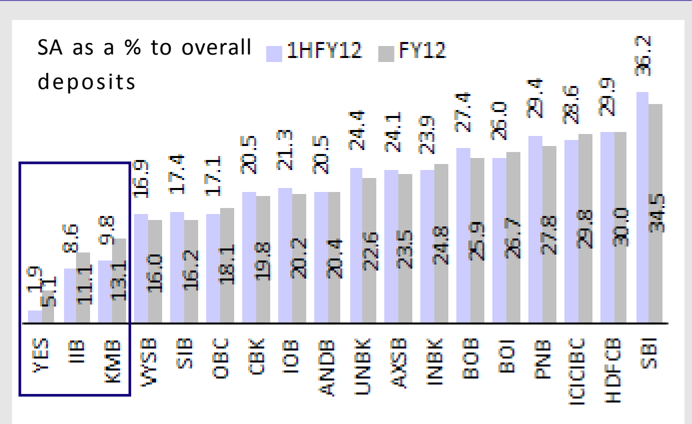
(INR b)	PSU	Private	New Private	Old Private	Foreign	Overall
Deposits	**43,730**	**10,028**	**2,642**	**7,386**	**2,407**	**56,164**
of which						
CASA	**14,931**	**3,881**	**739**	**3,142**	**1,126**	**19,937**
Current	4,101	1,589	242	1,347	729	6,419
Savings	10,830	2,291	497	1,795	397	13,518
Term	**28,799**	**6,147**	**1,903**	**4,244**	**1,281**	**36,227**
CA % to overall deposits	9.4	15.8	9.2	18.2	30.3	11.4
SA % to overall deposits	**24.8**	**22.8**	**18.8**	**24.3**	**16.5**	**24.1**
CASA Ratio (%)	34.1	38.7	28.0	42.5	46.8	35.5
SA % to CASA	**72.5**	**59.0**	**67.3**	**57.1**	**35.3**	**67.8**

Source: Company/MOSL

Savings deposits constitute ~24% of overall deposits



Share of SB deposits for small private sector banks increase



Source: Company/MOSL

Savings bank rate largely unchanged; competitive intensity increased in NRI segment

Our view: Action taken by larger players remains the key

- Deregulation of savings deposits will lead to better service standards across the system, led by competitive forces. Banks that have raised savings bank account rates constitute a very small proportion of the system (YES,IIIB and KMB; aggregate <2%) and are thus, unlikely to cause a rate war.
- In our view, while smaller banks will continue to report a strong growth,on a lower base the game changer would be the action taken by large banks (SBIN, HDFCB, ICICIBC, AXSB, etc).
- In our view, savings deposits is a function of technology, liability franchise, and most importantly, reach in rural areas. Banks like SBIN (with 60%+ CASA ratio in rural areas), PNB, HDFCB, AXSB and BOB will continue to have higher share of savings deposits in the system.
- All banks will remain aggressive in the NRI deposit segment, as a deposit customer in the NRI segment opens up lot of cross-selling opportunities for banks. Even for banks having higher reliance on NRI deposits, the meaningful impact will be only for NRE term deposits (2-3% of overall deposits).

V. Liberalization of licenses to push for financial inclusion

Impact: C/I ratio to rise; effective use of technology holds the key

Statistics indicate that only 55% of India's population has deposit accounts and only 9% has loan accounts with banks. Further, at ~145m, India has the highest number of households that are excluded from banking services. The RBI has repeatedly emphasized the need to focus on spreading the reach of banking services to the un-banked population. Under the current laws in India, every bank requires a license from the RBI for opening a branch. The RBI has used this legal requirement as a regulatory tool for furthering financial inclusion. Statutory approvals for branch licenses in more lucrative centers are linked to the number of branches opened in under-banked districts and states, as also other factors such as fulfilling priority sector obligations, offering no-frills accounts and other parameters to gauge achievements in financial inclusion and in customer service.

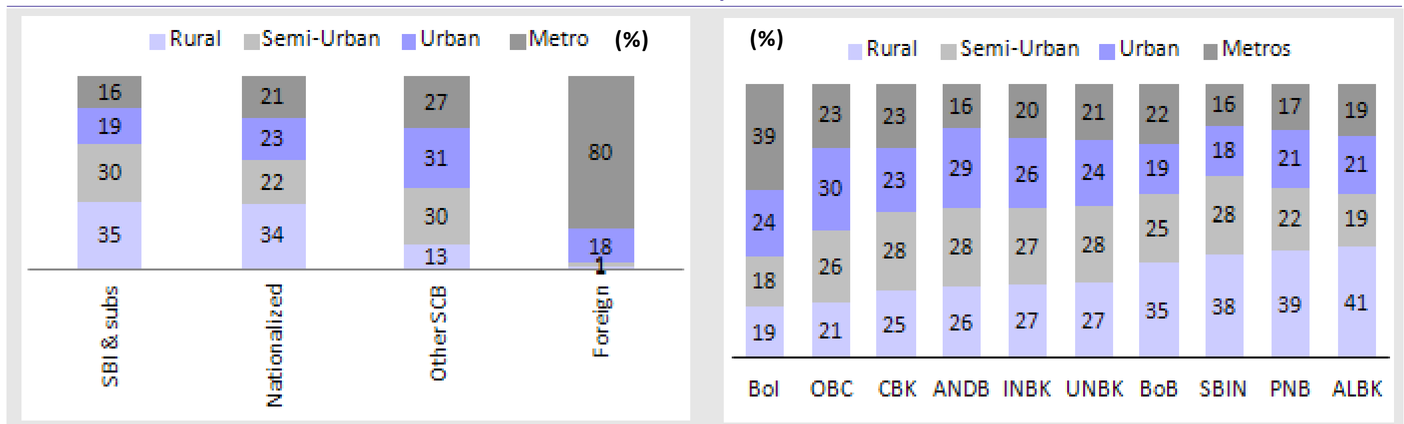
The long-term impact of financial deepening through inclusion is likely to be beneficial for banks. However, in the medium term, such initiatives could weigh on banks profitability

RBI has issued guidelines at various stages

- In May 2011, the RBI mandated banks to allocate at least 25% of the total number of branches to be opened during a year to un-banked rural centers.
- To remove regulatory hindrances, the RBI has freed up licenses further, allowing branches in tier-II cities (population of 50,000-100,000) to be opened without seeking its approval. Earlier, this was applicable only to cities between tier-III and tier-VI, with population of less than 50,000.
- The RBI has floated a paper on new banking licenses, which would be subject to final approval by the government. This is a long awaited discussion paper; however, the RBI's prime objective was increasing financial intermediation.

The long-term impact of financial deepening through inclusion is likely to be beneficial for banks. However, in the medium term, such initiatives could weigh on banks profitability. Recovering the cost of acquiring accounts in rural areas is time-consuming. Rural customers usually open "no frills" accounts, requiring little or no minimum balances. However, costs associated with opening of accounts, regular servicing, manpower, technology, etc would bear impact on profitability. Hence, rural branches take longer to break even, adversely impacting the bank's overall profitability in the medium term. We believe effective use of technology holds the key.

While PSU banks have over 30%+ of their branches in rural areas, private sector banks have ~15% of their branches in rural areas



Source: Company/MOSL

VI.Abolition of prepayment penalty on home loans on a floating rate basis

Impact: Competition in housing loan segment to intensify further

RBI intents to reduce the gap between new and old customers of home loans, thereby it has proposed to remove prepayement penalty on home loans on a floating rate basis. NHB has already implemented the same for housing finance companies thus the recommendatory changes will create a level playing field for HFC's.

VII.Variation in interest rates on bulk and retail deposits to be minimal

Impact: Re-alignment of deposit taking strategy

Wide difference in interest rates offered between retail and bulk deposits and also on marginal difference in maturites has raised concerns over inadequate liquidity management and pricing methodologies followed by the banks. Thereby, RBI adviced banks to ensure that variation in interest rates on single term deposits of INR1.5m and above and other term deposits is minimal. Banks with strong liability franchise and deeper reach would be in an advantageous position.

Regulations pertaining to HFCs

Intent: To strengthen balance sheet and protect customer interest

Impact: Competitive pressure to increase

- **NHB has guided HFCs that customers with the same risk profile should be charged a uniform rate post October 2011. However, special rate schemes launched by them would be outside the ambit of this guideline. Though more clarity is yet to emerge over the implementation of uniform lending rates for old as well as new customers, the guidelines leave ample scope for subjective evaluation and would therefore be difficult to implement.**
- **Waiver of prepayment penalty is unlikely to have a significant impact on P&L, as it constitutes a very small proportion of HFCs' revenues. However, competitive intensity would increase, given that with hardly any product differentiation, the industry is very price sensitive.**
- **Increase in the provisioning requirement for standard and non-performing assets, and increase in capital requirement (if raised to levels applicable to NBFCs) would have a marginal impact on return ratios.**
- **However, in our view HFCs are likely to remain largely unscathed due to their niche focus, robust risk management, and cash flow based lending, with hard collaterals in place.**

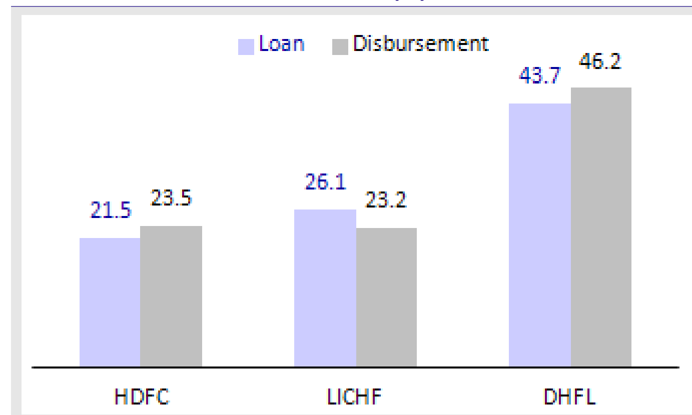
I. Waiver of prepayment penalty to remove arbitrage

Impact: Competition to intensify; minor P&L impact

From the P&L perspective, the prepayment penalty waiver is unlikely to have a material impact on the profitability of HFCs under our coverage, as it constitutes just 3-5% of revenue

National Housing Bank (NHB, the apex regulatory body for housing finance companies in India) has directed housing finance companies (HFCs) to remove prepayment penalty charges on floating rate housing loans pre-closed through own or borrowed funds and on fixed rate housing loans pre-closed through own funds (was applicable earlier as well). From the P&L perspective, the prepayment penalty waiver is unlikely to have a material impact on the profitability of HFCs under our coverage, as it constitutes just 3-5% of revenue. However, it could result in (1) rising ALM issues, as the waiver of prepayment penalty charges could result in higher prepayments (through borrowed funds), and (2) competition intensifying further in the housing finance market, which is already highly price sensitive.

Disbursement CAGR over FY05-12 (%)



Similar floating rates for new home loans led by higher competition

For INR2.5-7.5m	Floating Rate (%)
HDFC	11.0
LICHF	11.0
SBIN	11.0
AXSB	11.0
ICICIBC	11.0

Source: Company/MOSL

II. Uniform floating rates for new and existing borrowers

Impact: Lot of ambiguity; indication of base rate system for HFC's

NHB intends that HFCs charge customers on the basis of average cost of funds rather than the interest rate prevailing at the time of entering into the loan contract

- NHB has guided HFCs that customers with the same credit risk profile should be charged a uniform rate post October 2011. However, ascertaining the risk profile of the customer is left to the company's discretion and leaves scope for subjectivity and gradation of risk.
- In our view, the introduction of uniform rates could be the precursor for a base rate as currently applicable to banking system. NHB intends that HFCs charge customers on the basis of average cost of funds rather than the interest rate prevailing at the time of entering into the loan contract.
- Further, special rate schemes launched by the HFCs would be outside the ambit of this guideline and more clarity is yet to emerge over the implementation of uniform lending rates for old as well as new customers. While the guideline aspires to remove discrimination amongst different customers, its implementation as envisaged would be difficult.

III. Higher provisioning requirement

Impact: To impact profitability, but balance sheets to strengthen

Provisioning requirement for HFCs have increased across loan categories

NHB has increased the provisioning requirement across loan categories for HFCs with the objective of strengthening their balance sheets and bridging the regulatory gap between banks and HFCs. This would result in lower profitability for these companies. Companies like HDFC and LICHF that had excess provisions on their balance sheets were able to absorb the shock of higher provisioning requirement easily. Nevertheless, in 2QFY12, HDFC made a provision of INR2.6b (through reserves), whereas LICHF and DEWH provided INR2.1b (through P&L) and INR728m (INR117m through P&L + INR350m through contingency reserve and INR245m through general reserve), respectively to comply with the increased provisioning requirement.

Changes in provisioning requirement

- **Standard asset provisioning brought in line with banks:** NHB introduced provisioning of 40bp for standard housing loans as against nil earlier. This cannot be netted off against gross NPAs to arrive at net NPAs. For loans other than housing loans, NHB had already increased the provisioning requirement to 40bp in FY11, which was further enhanced to 100bp in FY12.
- **NPA provisions increased:** Further, NHB has increased the provisioning requirement (1) on sub-standard assets from 10% to 15%, and (2) on doubtful assets from 20-50% to 25-100%.
- **Provisioning on dual rate schemes / teaser loans:** On teaser loans, NHB came down hard on the HFCs in August 2011 by increasing the provisioning requirement on dual rate home loans to 2%, making such products less attractive for HFCs. This was done primarily to deter HFCs from luring customers with lower rates, which would later be increased, leading to repayment issues in the future.

IV. Higher capital requirement expected

Impact: Unlikely to have meaningful impact

HFCs adequately capitalized and leverage ratio remains low

- For other non-banking segments, the RBI is moving towards 15% CRAR, with tier-I ratio at 12%. Currently, HFCs are required to maintain 12% CRAR, with tier-I ratio of 6%. Considering higher tier-I ratio for banks (7%+2.5% counter cyclical buffer proposed under Basel III) and NBFCs (10% currently and proposed 12%), we expect NHB to increase tier-I ratio for HFCs as well.
- While capital requirement for HFCs is likely to increase, it will not materially impact return ratios, as HFCs proactively keep higher capital position to maintain credit rating (as credit rating agencies are uncomfortable above 10-12x leverage).

Capital position of HFCs

As on 4QFY12	HDFC	LICHF	DEWH
CAR (%)	14.6	16.0	19.0
Tier I (%)	11.7	10.0	12.7
Leverage (x) (TA / Networth)	8.3	10.9	10.4

Our view: Competition to intensify

- We believe that the regulatory changes, namely waiver of prepayment penalty and increase in provisioning requirement for standard as well as non-performing assets would have a minor impact on return ratios. However, higher provisioning buffer would strengthen balance sheets.
- Waiver of prepayment penalty is also likely to increase competitive intensity and could lead to higher ALM mismatches for HFCs. However, large HFCs with proven track record are unlikely to be impacted materially.
- Considering the regulators' stance of strengthening balance sheets with higher capital requirement, CRAR requirement for HFCs might also increase to the same level as other NBFCs.
- We maintain that the housing finance business is one of the best businesses to operate in, with (a) drivers for high growth in place, (b) lower asset quality risk, and (c) superior return ratios.

Regulations pertaining to NBFCs

Intent: Bridging the regulatory gap; strengthening balance sheets

Impact: Profitability to come under pressure; redefining the business model

- **The RBI has clamped down heavily on gold financiers by capping the loan-to-value (LTV) ratio at 60%, withdrawing priority sector status and increasing capital requirements (minimum tier-I ratio to be maintained at 12% by April 2014). The regulator's intention is to check the supernormal growth in the business and to make the business models more prudent and sustainable. Gold financing companies will have to reinvent their business models and accept the reality of moderation in growth and lower returns.**
- **For NBFC AFC and IFCs RBI has announced/proposed several regulatory changes for non-banking finance companies (NBFCs), with the intent to reduce regulatory arbitrage between banks and NBFCs. Some of the proposed (draft)/final guidelines are: (1) final guidelines on asset securitization, (2) recommendation on priority sector lending, (3) increase in tier-I capital requirement, (4) bringing asset quality and provisioning norms at par with banks, and (5) making norms for NBFCs applicable to state-owned NBFCs.**
- **In case of asset financing companies (AFCs), pressure on profitability would increase due to lower margins and higher asset quality pressure translating into higher credit cost, and lower leverage would cap RoE.**
- **In case of state-owned NBFCs, (1) standard asset provisioning, and (2) asset classification and exposure norms followed by banks, could affect their asset quality and business growth. However, in our view, there could be some dispensation in exposure norms due to the nature of their business. In the light of various regulatory challenges we believe Asset finance companies (AFCs) might need to redesign their business models to adapt to the regulatory changes.**

I. NBFC - Gold financiers

Impact: To reinvent business models; growth and return ratios to decline

Lower LTV, fair practice code and higher CAR would required gold financiers to re-invent their business model

In March 2012, the RBI came out with a separate set of guidelines for gold financing companies. It has capped the loan-to-value (LTV) ratio at 60% for loans against gold. Further, gold financing NBFCs also have to implement the fair practices code, which will increase KYC requirements, and require better governance standards and recovery practices. Moreover, the minimum tier-I capital requirement has been hiked to 12% to be achieved by April 2014.

LTV capped at 60%

Negative implication for margins and growth

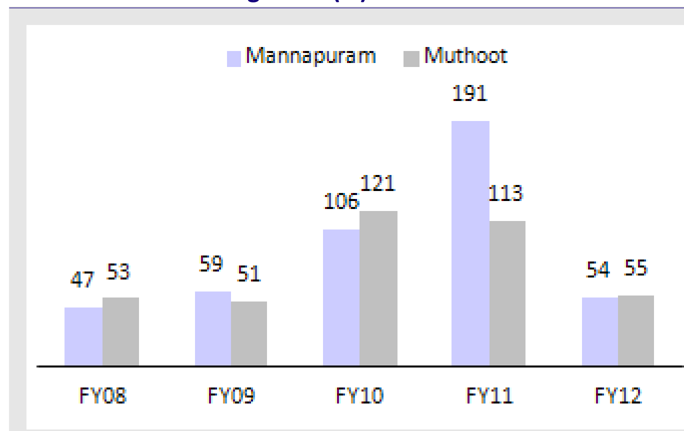
As the guideline of capping LTV was on prospective basis, it did not have any impact on the then existing portfolio of the company, however, it would have a negative implication on business growth and margins, going forward. With lower LTV, the yields on loan portfolios would decline, adversely impacting margins. Further, in terms of business growth, gold financiers would have to generate higher volumes to compensate for the loss in value that would happen due to capping the LTV at 60%.

Priority sector status withdrawn

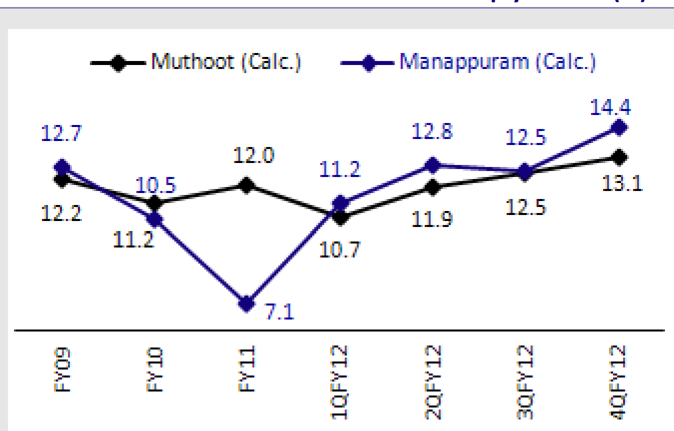
Leading to higher cost of funds and lower margins

Last year, the RBI withdrew the priority sector status (under agriculture loans classification) on loans given by banks to NBFCs for on-lending against gold jewelry and on investments made by banks in securitized assets originated by NBFCs for on-lending against gold jewelry. This has translated into higher borrowing costs for gold loan companies and has adversely impacted their spreads.

Gold financiers: AUM growth (%)



Gold financiers' cost of funds increased sharply in FY12 (%)



Source: Company/MOSL

Regulatory exposure ceiling in a single NBFC to Gold financier reduced

Impact: Unlikely to have major impact as exposure of gold finaciers to banking system is well within the exposure limit.

Regulatory exposure ceiling in a single NBFC to Gold financier reduced to 7.5% of Networth from 10% earlier and banks should have an internal sub-limit on their aggregate exposure to all such NBFCs, having gold loans to the extent of 50% or more of their total financial assets, taken together. As on March 2011, the consolidated networth of the Scheduled Commercial Banks (SCBs) stood at INR5.0t, which translates into a regulatory exposure limit of ~INR500b for single gold financing entity for bank borrowings.

As evident in the table below, overall exposure (including borrowings through assignment route, bank borrowings and borrowings through commercial papers) of Manappuram Finance and Muthoot Finance stands at ~2% and 3% respectively as on March 2012. Hence, excluding bank exposure in the form of assignment / securitization the overall bank exposure would be even lower. Consequently, this is unlikely to have any impact on the borrowing profile of these companies. Moreover, with growth momentum moderating, there is sufficient headroom with these companies to increase their bank exposure.

Consolidated Networth of SCBs

As on FY11	INR b
Capital	592
Reserves & Surplus	4,506
Networth	5,098

Source: Trends & Progress Report, RBI

Manappuram borrowing mix (FY12) (INR b)

Securitization	19
Bank borrowing	72
Retail borrowing	15
CPs	2
Others	5
Total	**112**

Bank Exposure	INR b
Securitization	19
Bank borrowing	72
CPs	2
Total	**93**
As % of Consolidated SCB's NW*	**1.8**

* as a percentage to FY11 networth

Muthoot borrowing mix (FY12) (INR b)

Bank borrowing	92
NCDs	79
Assignment	33
CPs	8
Others	15
Total	**227**

Bank Exposure	INR b
Bank borrowing	92
Assignment	33
CPs	8
Total	**133**
As % of Consolidated SCB's NW*	**2.6**

II. Final guidelines on securitization: Lower MHP - a positive

Impact: Could impact asset financiers growth and margins

RBI has released the final securitization guidelines for banks (which will also be effectively made applicable to NBFCs) based on the feedback received from various stakeholders. While, the guidelines are largely in line with the draft guidelines issued earlier, reduction in MHP is a positive. The Minimum Holding Period (MHP) for loans with different maturities and repayment schedules has been lowered v/s that proposed in the earlier draft guidelines. For loans with monthly repayment schedule (which largely impacts NBFC-AFCs), the MHP has been halved across various loan tenors.

Reducing risk associated with originate to distribute model

The final securitization guidelines clear air over uncertainty related to asset securitization norms for NBFCs. The final guidelines are largely in line with the draft guidelines with some dilution in the minimum holding period (MHP) criterion, which is a positive. For NBFC-AFCs, reduction in MHP augurs well for players like SHTF and MMFS, and would allow them to continue with their securitization activity. However, maintaining status quo on withdrawal of credit enhancement on direct assignment transactions would negatively affect ability to do loan assignments. There is no respite for gold loan companies as final guidelines maintain status quo on disallowing loans with bullet repayment of principal and interest from ambit of securitization and assignment.

Key Highlights

Minimum Holding Period (MHP)

MHP for loans with different maturities and repayment schedules has been lowered v/s that proposed in the earlier draft guidelines

The Minimum Holding Period (MHP) for loans with different maturities and repayment schedules has been lowered v/s that proposed in the earlier draft guidelines. For loans with monthly repayment schedule (which largely affects NBFC-AFCs), the MHP has been halved across various loan tenors. Reduction in MHP would not hamper the ability of NBFC-AFCs to securitize loans due to higher holding period, which is a positive. The MHP, in the final guidelines, has been defined with reference to the number of installments to be paid prior to securitization. MHP applicable to various loans will depend upon the tenor and repayment frequency.

MHP has been halved across various loan tenors

	Minimum number of instalments to be paid before securitisation			
	Repayment frequency			
	Weekly	Fortnightly	Monthly	Quarterly
Loans with original maturity up to 2yrs	12	6	3	2
Loans with original maturity of more than 2yrs and up to 5yrs	18	9	6	3
Loans with original maturity of more than 5yrs	0	0	12	4

The RBI has proposed a MRR of 5-10% based on the maturity of the asset

Minimum Retention Ratio (MRR)

The Minimum Retention Ratio criterion has been kept unchanged by the RBI from what was proposed in the draft guidelines. The RBI has proposed a MRR of 5-10% based on the maturity of the asset. The MRR guideline ensures that the originator has a continuing stake in the performance of securitized assets so as to ensure that proper due diligence is carried out on the part of the originator of loans before securitization. We believe this is unlikely to have a material impact as the proposed MRR also includes the credit enhancements and first loss, which companies already provide for currently (although lower than 10%). As a result, the companies only have to bear the incremental cost on securitization of assets, which is unlikely to create a significant impact on their earnings.

Minimum Retention Ratio (MRR) Criterion

Loans with original maturity of 24 months or less	5% of the book value of the loans being securitised
Loans with original maturity of more than 24 months	10% of the book value of the loans being securitised

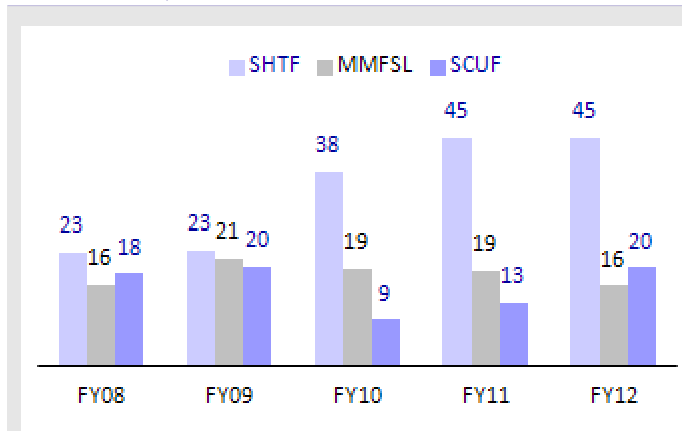
Other Proposed Measures:

Booking of Profit Upfront: RBI proposes to allow limited recognition of cash profits arising from securitization transactions (subject to various conditions). This is equivalent to amortizing income / profit through securitization of assets over the asset life. This will not have any material impact for players such as SHTF and MMFS as they are already amortizing the income over the life of the asset.

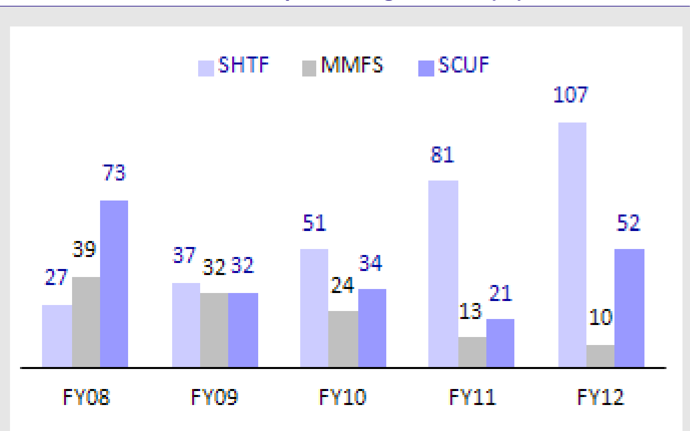
Tightening disclosure norms: RBI proposes to tighten disclosure norms by making it mandatory for the originator to disclose weighted average holding period of the assets securitized and the level of their MRR in the securitization, materially relevant data on the credit quality and performance of the individual underlying exposures, etc besides various disclosures to be made in the annual accounts of the originator.

Reset of Credit Enhancement: RBI would come out with a separate circular on reset of credit enhancements in case of securitization transactions.

Securitization portfolio of NBFCs (%)



Securitization income as percentage of PBT (%)



Source: Company/MOSL

Banks exposure to NBFC to be capped at 5%

Loan extended against gold jewelry by NBFC's excluded from PSL

MV Nair Committee recommendations

Growth and margins of asset financers could be impacted

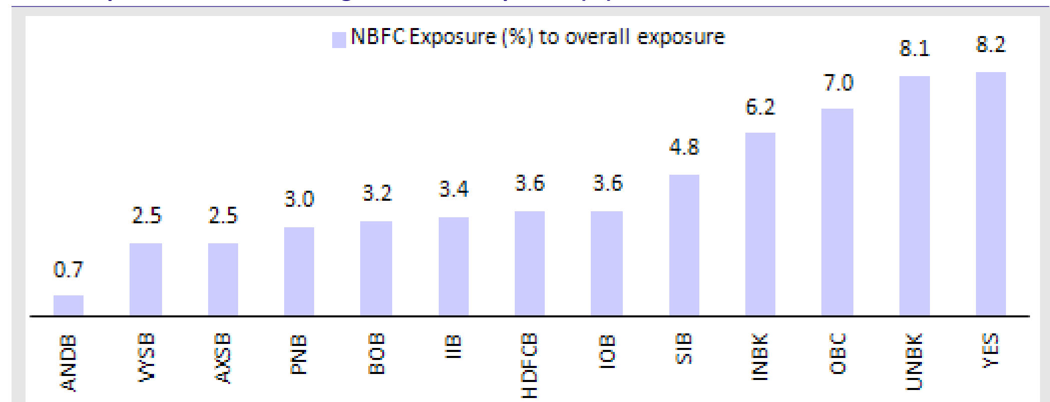
The MV Nair Committee has recommended that bank loans sanctioned to non-bank financial intermediaries for on-lending to specified segments may be reckoned for classification under priority sector up to a maximum of 5% of adjusted net bank credit (ANBC), subject to adherence to the applicable terms and conditions.

1. For banks currently having a portfolio of on-lending, buyouts and securitization in excess of the proposed 5%, the Committee proposes reducing such a portfolio by at least 1% of ANBC every year for reckoning under priority sector. It has also stipulated that any new on-lending, buyouts and securitization by such banks would not be reckoned for priority sector, until such time their portfolio of on-lending, buyouts and securitization is reduced to 5% of ANBC.
2. Loans extended against gold jewelry (LAG) by NBFCs and other intermediaries may continue to be excluded from priority sector classification. This keeps gold loan companies out of the priority sector purview.
3. Asset finance companies (AFCs) should maintain at least 65% of their AUMs on the balance sheet to be eligible for priority sector classification.

Some of the conditions to be fulfilled for classifying bank lending to non-banking financial intermediaries as priority-sector lending are:

1. Banks undertaking buyouts, investment in securitized assets and extending loans for on-lending should conduct due diligence on the underlying portfolio on a minimum sample of 15% of the underlying assets for validation of the end-use including the eligibility under priority sector through officials of the bank. This should be supplemented with a certificate from the management of the NBFC with authorization from the Board of the NBFC and a Chartered Accountant's certificate confirming the priority sector nature of the underlying portfolio.
2. The interest rate spread cap under on-lending securitization and portfolio buyout under direct assignment for (1) NBFC-HFCs is 3.5%, and (2) NBFC-AFCs is at 6%.
3. The key positive is that RIDF investment on the balance sheet will be considered to calculate the overall target of priority sector lending. Further, it is proposed to link the interest rate on RIDF investment to Repo rate. This will lead to an increase in the interest earned on RIDF investment and limit the negative carry.

Banks exposure to non-banking financial companies (%)



Note: Exposure as on Sep-11; Except for AXSB, PNB and UNBK

Source: Company

Our view: Margins could be adversely impacted for AFCs

- With interest spread cap of 6% for NBFC-AFCs, the momentum of securitization could be adversely impacted for players like SHTF (very strong in financing of used vehicles). From the margin perspective, the NBFC-AFCs are unlikely to gain significantly, as incremental borrowings under priority sector status have to be utilized for creating assets with an interest spread cap of 6%.
- Consequently, factors such as minimum 65% of the AUM should be on balance sheet, interest spread cap of 6%, bank lending to NBFCs classified under priority sector within a cap of 5% could impact AFCs like SHTF that have higher reliance on securitization income.

III. Recommendation to increase tier-I capital for CRAR purposes

Tier-I capital proposed to be increased to 12% as against 10% currently

Impact: To reduce ability to leverage and strengthen the balance sheet

One of the key recommendations of the Usha Thorat Committee is to increase the tier-I capital for CRAR purposes to 12% to be achieved in three years. Currently, NBFCs are required to maintain a total CAR of 15%, with minimum tier-I capital of 10%. An increase in tier-I capital ratio would call for setting aside higher capital, curbing the ability to leverage. The tier-I ratio for most NBFCs is currently well in excess of 12% and while they may not have to raise fresh capital in a hurry, reduction in leverage could impact growth and return ratios.

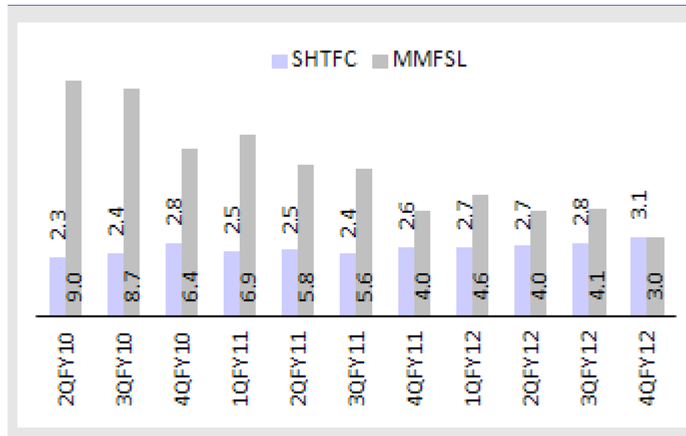
IV. Asset classification, provisioning norms to be brought at par with banks

NPA recognition norms proposed to be brought down to 90 days overdue method as against 180 days overdue method followed currently

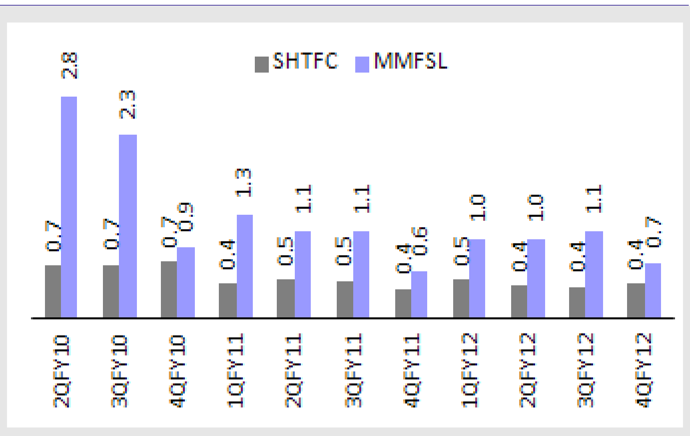
Impact: Could result in higher NPAs, pressure on return ratios

Currently, NBFCs disclose NPAs based on 180 days overdue method. The Usha Thorat Committee has recommended bringing asset classification as well as provisioning norms at par with banks in a phased manner. With tightening of asset classification norms, NBFCs will have to disclose NPAs based on 90 days overdue method. While some NBFCs (SREI Infra, for instance) already follow conservative accounting practices and disclose NPAs based on 90 days overdue method, others could see a sharp increase in NPAs due to change in classification norms. Moreover, the proposed change also intends to bring in standard and NPA provisioning norms in line with those of banks. As the regulatory gap between banks and NBFCs shrinks, the superior return ratios enjoyed by the NBFCs would come under pressure in the near term.

Gross NPA movement (%)

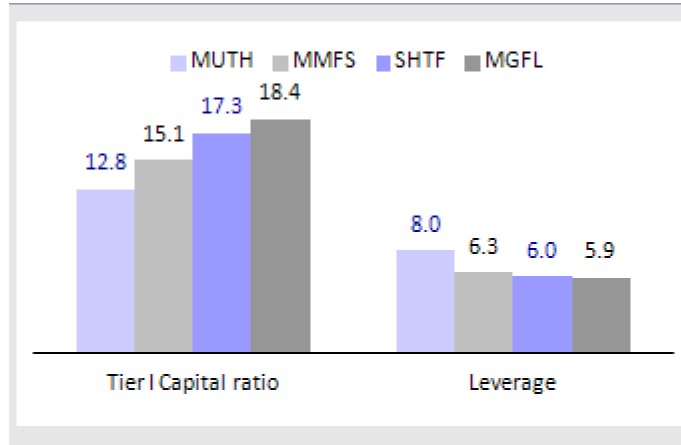


Net NPA movement (%)

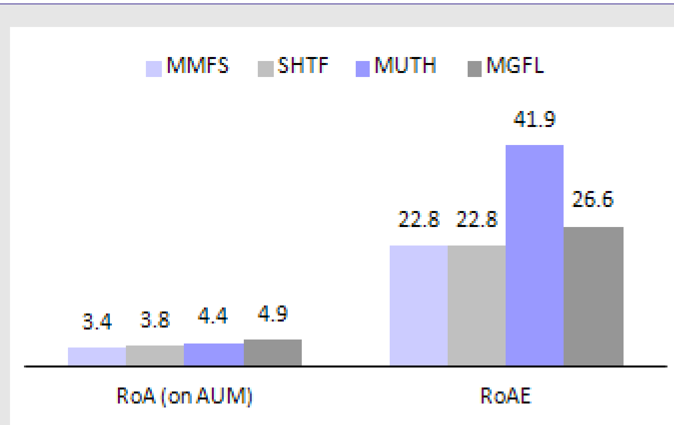


Source: Company/MOSL

Leverage (on AUM) and tier-I ratio of NBFCs (%, x)



Average RoA and RoE over FY09-12 (%)



Source: Company/MOSL

V. State-owned NBFCs also to comply with applicable regulatory framework

Impact: Return ratios of companies like POWF and RECL could be adversely impacted

Change in regulatory stance could impact return ratios; however some dispensation will be allowed in our view

The Usha Thorat Committee has also recommended that government-owned entities (POWF, RECL) that qualify as NBFCs should comply with the regulatory framework applicable to NBFCs at the earliest. Currently, POWF and RECL do not make any standard asset provisions on their balance sheet. However, if the proposed guidelines come into effect, POWF and RECL would have to make standard asset provisions at the rate of 40bp. The incremental provisioning requirement could translate into a 12-16bp impact on their RoA. Moreover, POWF and RECL would also have to follow the asset classification and exposure norms followed by banks, which could affect their asset quality and business growth. However, there could be some dispensation in exposure norms, these companies being NBFC-IFCs in nature.

Other regulatory recommendations

- Tax treatment for provisions made by NBFCs for regulatory purposes should be similar to banks. This would allow them to get tax benefits on write-offs.
- NBFCs may be allowed benefits under the SARFAESI Act, 2002, providing them with greater autonomy to recover bad loans.
- The twin criteria of assets and income for determining the principal business of an NBFC should be increased to 75% of total assets and 75% of total income. A time period of three years may be given to fulfill revised principal business criteria.
- Any transfer of shareholding (direct or indirect) of 25% and above, change in control, merger or acquisition of any registered NBFC should have prior RBI approval.
- NBFCs with assets of INR10b and above should be inspected comprehensively on an annual basis, with an annual stress test carried out to ascertain their vulnerability.
- Disclosures for NBFCs with assets over INR1b may include provision coverage ratio, liquidity ratio, asset-liability profile, extent of financing of parent company products, movement of non-performing assets (NPAs), off-balance sheet exposures, structured products, and securitizations/assignments.

Regulations pertaining to MFIs

Intent: Assuaging the regulatory overhang on the sector

Impact: Growth and profitability to be impacted

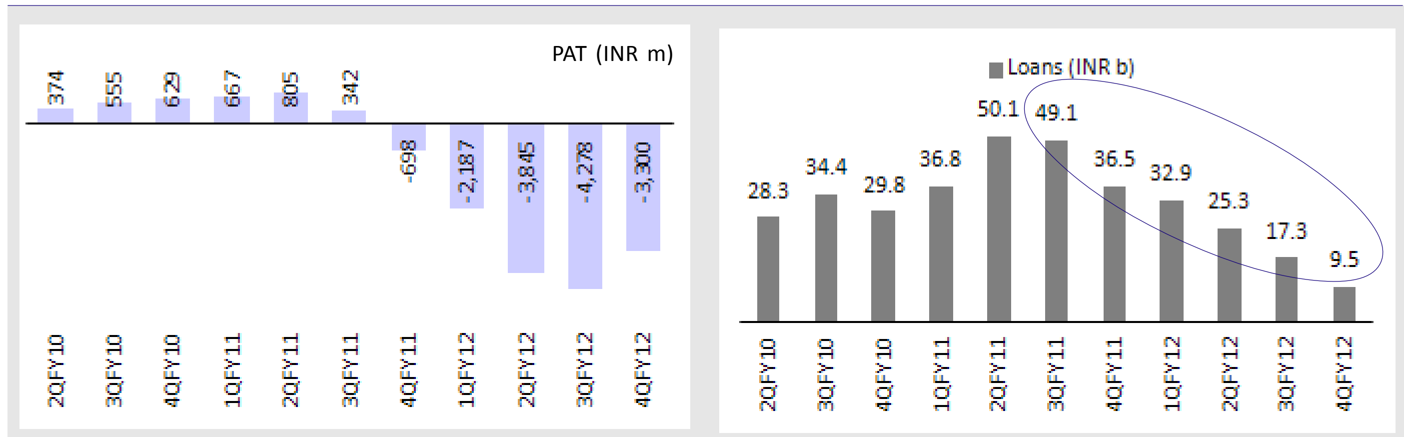
- **The RBI has introduced a separate category of NBFCs, Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI), and has issued a separate set of operational guidelines including margin and interest rate cap, asset classification and provisioning norms, and capital requirements.**
- **Clearing of the Microfinance Bill by the Cabinet which proposes to make RBI as the sole regulator too augurs well for the sector.**
- **The pricing cap coupled with higher provisioning requirements would restrict RoA at 2.5-3%. Hence, improving operating efficiency is a must.**
- **Moreover, with leverage being capped at 6-7x due to higher capital requirements, RoE would also be lower. Hence, the superior returns enjoyed by MFIs in the past are unlikely, going forward.**

NBFC-MFI guidelines - addressing structural issues in MFI funding

Introduction of NBFC-MFI guidelines reduces regulatory overhang

The RBI has introduced a separate category of NBFCs, Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI), and has issued a separate set of operational guidelines including margin and interest rate cap, asset classification and provisioning norms, and capital requirements. The guidelines are largely on the lines of the Malegam Committee recommendations and were largely on expected lines. These have been implemented on all MFIs with immediate effect. However, the reluctance of the state governments to repeal their respective Acts (as in the case of the Andhra Pradesh government) and lack of clarity over which regulation supersedes the others remains an impending issue.

Impact of AP regulation on profitability and growth of SKS Microfinance



Source: Company/MOSL

I. Capital requirement hiked to 15%

Impact: Return ratios to be capped

Strengthening the balance sheet by increasing capital requirement

All new NBFC-MFIs will have to maintain a capital adequacy ratio consisting of tier-I and tier-II capital of at least 15% of aggregate risk weighted assets. The total of tier-II capital at any point of time should not exceed 100% of tier-I capital. For NBFC-MFIs, with asset size less than INR1b the stipulation is applicable from this year (1 April 2012), whereas those with asset size of INR1b were already required to maintain minimum CRAR of 15%. The capital requirement for NBFC-MFIs that have more than

25% loan portfolio in the state of Andhra Pradesh (AP) will be at 12% only for FY12. Thereafter, they have to maintain CRAR at 15%. This would result in lower leverage for MFIs, thereby capping return ratios.

II. Asset classification and provisioning norms tightened

Impact: To impact profitability, but balance sheets to strengthen

NPA recognition norms made more stringent

As per the new guidelines, NBFC-MFIs have to classify an asset as non-performing if interest/principal payment has remained overdue for a period of 90 days or more from 1 April 2013 onwards as against 180 days currently. The aggregate loan provision to be maintained by NBFC-MFIs at any point of time should not be less than the higher of (a) 1% of the outstanding loan portfolio or (b) 50% of the aggregate loan installments overdue for more than 90 days and less than 180 days and 100% of the aggregate loan installments overdue for 180 days or more. Currently, these companies have to make standard asset provisions of 0.25%, 10% for substandard assets (180-720 days) and 100% for loss assets (more than 720 days).

III. Cap on pricing

Impact: To marginalize return ratios

Margins to be impacted; return ratios to go down

All NBFC-MFIs will have to maintain an aggregate margin cap of not more than 12%. Interest on individual loans cannot exceed 26% per annum and calculated on a reducing balance basis. Processing charges cannot be more than 1% of gross loan amount. Processing charges need not be included in the margin cap or interest cap. NBFC-MFIs shall recover only the actual cost of insurance for group, or livestock, life, health for borrower and spouse. Administrative charges, where recovered, shall be as per IRDA guidelines. All these factors would marginalize return ratios of MFIs.

Our View: To bring stability to business; but return ratios to moderate

- Though the directions are largely in line with the Malegam Committee recommendations, we believe the move is positive.
- The cabinet has cleared the Microfinance Bill which proposes to make RBI as the sole regulator for microfinance companies. This would end the uncertainty for microfinance companies from the regulatory standpoint and also help them accelerate recoveries, which would improve financial health of these companies.
- The RBI has brought the micro lending business under the regulatory fold and has restricted the profitability of micro finance companies by introducing various pricing caps.
- The pricing cap introduced by the RBI (12% margin cap and 1% processing fee cap) coupled with higher provisioning requirements would restrict RoA at 2.5-3%. The only way to increase returns would be by improving operating efficiency. Moreover, with leverage being capped at 6-7x due to higher capital requirements, RoE would also be lower. Hence, the superior returns enjoyed by MFIs in the past are unlikely, going forward.

Annexure

Fair practices code tightened further

Aimed at protecting consumer interest; onus lies on NBFCs

The RBI has introduced various changes in the fair practices code, with the intent to increase disclosures and tigten KYC norms. We enumerate a few important ones:

1. Applications for loans should be in the vernacular language or a language understood by the borrower and should cover the terms and conditions offered by competitive NBFCs. Further, the interest rate that would be charged and its method of calculation should be clearly stated.
2. A copy of the loan agreement needs to be provided to the applicant.
3. Any changes in terms and conditions should be given in writing and any change in the terms of interest rate should be on prospective basis.
4. In case of receipt of request from the borrower for transfer of loan account, the consent/objection should be communicated to the borrower in 21 days from the date of receipt.
5. The recovery mechanism should not be coercive and the staff should be adequately trained to deal with the customer appropriately.
6. Appropriate grievance cell should be set up within the organization to resolve any disputes.
7. NBFCs should structure a model taking into account cost of funds, risk premium and margin to determine the interest rate charged on loans. Different rates charged to different categories of borrowers should be explicitly communicated in the sanction letter.
8. The rates of interest and the approach for gradation of risks should also be made available on the websites of the companies or published in relevant newspapers. The information published on the website or otherwise published should be updated whenever there is a change in the rates of interest.
9. The rate of interest indicated should be an annualized rate so that the borrower is aware of the exact rate that would be charged.

Fair practices code for repossession of collateral (vehicle financiers)

NBFCs must have a built in repossession clause in the contract/loan agreement with the borrower, which must be legally enforceable. Transparency needs to be maintained and the loan agreement should contain the clauses in regard to (a) notice period before taking possession, (b) circumstances under which the notice period can be waived, (c) the procedure for taking possession of the security, (d) a provision regarding final chance to be given to the borrower for repayment of loan before the sale/ auction of the property, (e) the procedure for giving repossession to the borrower, and (f) the procedure for sale/auction of the property.

Fair practices code for gold financiers

While lending to individuals against gold jewelry, NBFCs should adopt the following guidelines in addition to the general guidelines formed for NBFCs in general. These are:

1. Due diligence and KYC norms should be carried out
2. Internal systems to satisfy ownership of the gold jewelry should be in place
3. Loans against collateral of gold should not be extended by branches that do not have appropriate facility for storage of the jewelry
4. The jewelry accepted as collateral should be appropriately insured
5. In case of gold being auctioned, the NBFCs themselves should not participate

Fair practices code for NBFC-MFIs

- **Transparent pricing:** There would be only three components in the pricing of the loan - the interest charge, the processing charge, and the insurance premium (which includes the administrative charges in respect thereof). There would be no penalty charged on delayed payment. NBFC-MFIs should not collect any security deposit/margin from the borrower.
- **Better disclosures:** The effective rate of interest charged by the NBFC-MFI should be prominently displayed in all its offices, in the documents issued by it and on its website.
- **Multiple lending:** NBFC-MFIs can lend to individual borrowers who are not members of joint liability group (JLG)/self help group (SHG) or to borrowers that are members of JLG/SHG (but not more than one SHG/JLG). Not more than two NBFC-MFIs should lend to the same borrower.
- **Non-coercive methods of recovery:** Recovery should normally be made only at a central designated place. The field staff should be allowed to make recovery at the place of residence or work of the borrower only if the borrower fails to appear at the central designated place on two or more successive occasions. This would be beneficial to NBFC-MFIs, as under the AP MFI Act, the microfinance companies were restricted from visiting the borrower's residence in case the borrower failed to show up at the time of repayment.

Financials ready reckoner

Classification Norms

	Banks/HFCs	NBFCs	PFC	REC
Non-performing ^	90 days past overdue	180 days past overdue	180 days past overdue	180 days past overdue
Sub-standard assets	NPA for not more than 12 months	NPA for not more than 18 months	NPA for not more than 18 months	NPA for not more than 18 months
Doubtful Assets	Sub-std for more than 12 months	Sub-std for more than 18 months	Sub-std for more than 18 months	Sub-std for more than 18 months
Loss Assets	Identified as a loss asset and fully provided for and written off	Identified as a loss asset to the extent that is not written off	Identified as a loss asset or doubtful for more than 3 years, whichever is earlier	Identified as a loss asset or doubtful for more than 5 years, whichever is earlier

^ For State & Central utilities, NPA recognition is 360 days past overdue

For purposes of application of prudential norms, facilities granted to State/Central Sector entities are considered loan wise, while others are considered borrowerwise

Provisioning Norms (%)

	Banks/HFCs	NBFCs	PFC	REC
Standard Assets	0.40	0.25	NIL	NIL
Sub-standard assets	15	10	10	10
Doubtful Assets				
Upto one year	25	20	20	20
1 to 3 years	40	30	30	30
More than 3 years	100	100	100	50
Loss Assets	100	100	100	100

Exposure Limits as % of Net worth

	Banks	NBFC-ND-SI	NBFC-IFC
Single borrower limit	15% (+5%)	15% (+5%)	25%
Single group borrower limit	40% (+10%)	25% (+10%)	40%
Investment ceilings			
Shares of a company	15% (+5%)	15% (+5%)	15% (+5%)
Shares of a single group of cos.	25% (+10%)	25% (+10%)	25% (+10%)
Loans & investments together			
Single borrower limit	25% (+5%)	25% (+5%)	30%
Single group borrower limit	40% (+10%)	40% (+10%)	50%
Single borrower limit in case of RECL and POWF:			
- State Power Utilities			
- State Governments			100%-250%
- Central or State Govt Undertakings			

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