



# **THE NEWSMAKER**

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## **CONTENTS**

- A) IS LIC HOUSING A GOOD BUY CONSIDERING IT GETS BANKING LICENSE?** - page 1  
*by Suresh S., Director, DMS Financial Services Co.P.Ltd.*
- B) BASE RATE – PART SUNSHINE, PART CLOUDS** - page 2  
*by Padmalatha S.*
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## **IS LIC HOUSING A GOOD BUY CONSIDERING IT GETS BANKING LICENSE?**

*by Suresh S.*  
**Director, DMS Financial Services Co. (P) Ltd.**

There are widespread rumours that LIC Housing Finance Ltd.(LICHF) may seek Banking license after the Finance Minister announced that the government would be ready to issue new licenses.

The 1993 release of new licenses saw players like ICICI Bank, HDFC Bank, UTI Bank, Indusind Bank, TimesBank and Global Trust bank enter the fray. The next phase was in 2002 and saw Kotak Mahindra Bank and Yes Bank make their forays.

Does LICHF make a good investment candidate?

The answer is Yes!

The reasons are broadly divided into four categories:

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### What are relevant weaknesses of LICHF today:

- Competition in the Housing Finance segment is loaded against private players who need to compete with banks.
- LICHF needs to maintain profitability and asset quality in a very competitive environment.
- Banks offer Teaser schemes where rates of interest are very low fixed rates in the initial years. This enables them to penetrate the market.
- They have the advantage of very low cost of capital. For example State Bank of India is reportedly planning to declare a Base rate of a little less than 8%.
- LICHF can therefore get competitive edge if it gets converted to a Bank. A 1% reduced cost of capital on its expected loan outstanding portfolio end of 2010-11 of Rs.47600 crores is Rs.476 crores (before tax). Compare this with its actual PAT of 2008-09 of Rs.532 crores.

### Group backing:

- LIC has a 36.54% shareholding. It is one of the most successful business models in India and the emergence of private players after opening up of Life insurance to private players has not thrown it off balance.
- Life Insurance Corporation by itself cannot start banking business.
- It is one of the largest mutual fund owners. If the Claims business and the Mutual funds business is routed through this new bank, there will be significant synergies to LICHF.

### Present Profitability is high:

- Q4 net Profit has been up 36% at Rs.213 crores.
- Growth rate in Mortgage loans is expected to be 25% for 2010-11.(476.0 billion, which is 476000 million which is 47600 crores)
- Net profit growth is expected to be 29% at Rs.8.6 billion, and with projected EPS of Rs. 91, at present Market price of Rs.951, the PE is 10.5(FV Rs. 10). Compare this with veteran HDFC having for same Face Value Rs.10, EPS of Rs.91.65 (TTM) giving PE 30.9 for Market price of Rs.2840 (end April 2010).

Rs./crores 31<sup>st</sup> Mar. 2009 or Year 08-09 as the case may be

	Share capital	Reserves	Net worth	Total liabilities
HDFC	284	12853	13137	96993
LICHF	85	2149	2234	27656
	Home Loans outstanding	Total income	Interest	PAT
HDFC	89290	11232	7671	2282
LICHF	28086	2904	2017	532

- The Net worth of HDFC is 5.8 times the Networth of LICHF but the Total Liabilities is only 3.5 times. This means LICHF is much more highly levered as compared to HDFC and therefore can generate greater EPS. Also, the Home Loans Portfolio of HDFC is only 3.2 times that of LICHF. PAT to Share Capital of HDFC is 8.03 as compared to 6.3 of LICHF.
- The report of Care states that rating for LICHF is the highest AAA considering its track record and healthy market share in Housing Finance .It is adequately capitalized, has comfortable liquidity position, low operating costs and there is improvement in asset quality.

**Status in Housing Finance industry:**

- Although it started as late as 1989, 12 years after HDFC, LICHF is today among the top three housing finance players.
- On various parameters it compares very well with HDFC.

Parameter	LICHF	HDFC
CAR	13.5%	15.1%
Gross NPA	1.07%	0.81%

- Over 33 years HDFC has built up reserves of Rs. 12853 crores whereas LICHF has built up Rs.2149 crores in 21 years. HDFC’s reserves is 45 times Share Capital for HDFC and 25 times for LICHF.

LICHF neither denies nor confirms it is considering the Banking proposal. The Company has clarified that it has not made any application to RBI for Banking license. It would take a decision only after RBI notifies the guidelines for issuing banking license.

In anticipation of its doing so, it offers good potential for investors seeking long-term growth.

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**BASE RATE – PART SUNSHINE, PART CLOUDS**

***by Padmalatha S.***

The banking sector got a short term breather when the implementation date of the ‘base rate regime’ was pushed to July 1. But come July, banks and borrowers may have to contend with more confusion than the clarity or transparency that the new system professes to usher in. In its October 2009 report, the Working group set up to review the current BPLR system listed the major issues as [a] large amounts of sub BPLR lending by individual banks, [b] lack of transparency, [c] tendency for downward stickiness, and [d] cross subsidization in lending. The alternative, the ‘base rate’ suggested in the report, is expected to be more forward looking and transparent, while adequately addressing the above issues.

The RBI's draft guidelines [February 2010] on the introduction of the base rate deviates from the formula provided by the Working group for calculation of the base rate. The working group computes the base rate [page 38] as the one year deposit rate less CASA adjustment, with negative carry on CRR/SLR, unallocated overhead costs and average return on net worth added to the result. The RBI guidelines advocates the computation using cost of deposits added to negative carry on CRR/SLR, unallocated overhead costs and average return on net worth.

There are several issues with the above mode of computation, some of which are listed below:

- The Working group's contention that the 1 year deposit rate is forward looking and transparent can be theoretically true. But consider the practical problems that banks could face. In a deregulated interest setting, and in the interest of asset liability matching, certain banks may strategically want to encourage longer tenure deposits and may therefore want to offer higher interest rates for deposits of over two years. In such a case, they may want to pay lower rates on shorter term deposits. This implies that their base rate would be low as well, which could impact their profitability. The opposite could happen in case of banks wanting more short term resources. Their base rates could turn out to be higher, in which case these banks may not be preferred by the market. Further, RBI data shows that deposit rates for all tenors have been quite volatile over time and bank groups. An obvious option is to regulate the one year deposit rate, which would go against the grain of deregulation.
- The RBI's draft guidelines make no mention of the one year rate. Instead, the cost of deposits is used. The working group had dismissed the historical cost of deposits as 'backward looking and sticky'. By using the cost of deposits, the RBI almost returns to the BPLR concept.
- The RBI's draft guidelines do not mention CASA adjustment, which is academically sensible, but practically infeasible. CASA keeps fluctuating in banks. A sudden large current deposit could tilt the proportion. How often does the adjustment have to be made? In case of an annual adjustment period, the bank will be ignoring intra year fluctuations, or will be influenced by end period balances. In fact banks may be tempted to 'dress' the CASA balances to reflect a higher base rate. Given the fleeting nature of these liabilities, confusion would result from this practice.
- To compute 'negative carry on CRR/SLR' the 364 day T Bill rate is taken as representative of the income earned from SLR investment. However, RBI data shows substantial volatility in the outstanding amounts and yields on these securities. Further, latest data also show that banks do not prefer investing in 364 day T Bills. Hence, assessing the negative carry based on a small portion of volatile [though transparent] movements in T Bills may not be realistic.
- The RBI draft guidelines include under 'unallocated overhead cost'[page 1] salaries of administrative corporate office personnel, directors'/auditors' fees, legal and premises expenses, depreciation, printing, stationery, advertising, communication and IT

expenses, and cost for deposit insurance. The ratio of this cost to ‘deployable deposits’ is added to the base rate. While the overheads may not change much over the short term and can be disclosed, there are two problems associated with this method – one, by simply increasing the overheads [amounting to decreasing cost control], banks can levy a higher base rate, and two, the deployable deposits will fluctuate over time, necessitating several changes to this rate.

- The average return on net worth is computed in two parts – net profit /net worth multiplied by net worth/total liabilities. Algebraically, this yields not the return on net worth but the return on total liabilities. Second, this is not a forward looking estimate of banks’ spreads – rather it limits the banks’ ability to legitimately look for more profit.
- Banks have to lend for various purposes, ranging from the very short term demand loans to the long term infrastructure loans. Long term assets may have to be matched by long term liabilities sourced from borrowings from the domestic or international market. In such cases, the ‘one year card rate’ or ‘cost of deposits’ will cease to be relevant, and the base rate itself might be over or understated.
- The ‘load’ on base rate suggested by the Working group and RBI include product-specific operating costs, credit risk premium and tenor premium. Standard procedures for these computations have not been prescribed.

Overall, in an attempt to improve on the BPLR’s perceived infirmities, the base rate appears to have brought in fresh issues that could defeat the primary motives of greater transparency and fairness to banks and borrowers.

More important, the ICAAP [Internal Capital Adequacy Assessment Process] to be adopted by all banks from 2009 and supervised by RBI, may receive a setback.

RBI has already specified timelines for banks to move into more advanced approaches for capital determination [Pillar 1 of Basel II]. These approaches rely more on the banks’ own assessment of capital based on all the risks impacting their business [‘economic capital’], rather than on the current form of regulatory capital. The ICAAP is envisioned as an integral part of the decision making process in banks, including loan pricing decisions.

With banks having to move to advanced levels of risk measurement and management, RBI has to assess the risk management process under the SRP [Supervisory Review Process under Pillar 2 of Basel II]. A method like the ‘base rate’, with several simplifying, and sometimes unrealistic assumptions could be a setback to the process of upgrading banks’ internal risk assessment and pricing skills.

### **How to???**

Then what is the way forward? If the BPLR has drawbacks, and the base rate is flawed, what should the benchmark rate be? In the long term, of course, bond, credit and derivatives markets would have to develop to throw up a single market determined rate like the LIBOR. The flip side, there are issues even with the LIBOR [according to the British Bankers

Association], which goes to show that pricing financial products or arriving at a single, consistent benchmark rate is not all that easy.

However, once banks begin pricing loans based on their 'economic capital', the 'minimum' interest rate charged to a borrower would have to ensure that shareholder value is increased [or at least maintained]. Depending on the product, the internal credit process policy, and the value of the customer relationship, banks may decide to override the loan pricing decision. But such exceptions should be strictly monitored.

But in the near term, the regulator has the following options:

- Continue with BPLR, with some checks. For example, banks will have to specify whether the cost of funds used is the average or marginal cost of funds. If sub BPLR lending is necessitated, banks should justify to RBI the rationale for such lending, using customer profitability analysis or portfolio optimisation tools.
- The suggestion made to the working group of having sector specific BPLRs though cumbersome, could be considered.
- Introduce the base rate, but remove the limiting assumptions, in which case, the rate would tend toward the BPLR with some refinements.

Surely, simplification or transparency cannot be at the cost of prudent risk management in banks?

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### **Services offered by DMS Financial Services Co. (P) Ltd.**

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**For details, please contact Mr.Karthi on 044-24995672.**