

Review of Monetary Policy (03 May 2011)

Changes in Key Interest Rates

RBI increased repo and reverse repo rates by 50 basis points each from 6.75 percent to 7.25 percent and 5.75 percent to 6.25 percent respectively. Meanwhile CRR, SLR and Bank Rate have been retained to their existing levels.

Policy Rate	Change	Effective Rate
CRR	Unchanged	6.0%
Repo rate	+50 basis point	7.25%
Reverse Repo rate	+50 basis point	6.25%
Bank rate	Unchanged	6.0%

As per RBI the expected outcomes of the actions are:

- To control the demand side inflationary pressures and to minimize risk to growth.
- To sustain growth in the medium term and to maintain an interest rate regime consistent with price, output and financial stability.

Some of the key highlights of the policy are:

- RBI Policy shifted to single rate regime. There will be only one independently varying policy rate which will be the repo rate. The reverse repo rate will continue to be operative but it will be pegged at a fixed 100 bps point below the repo rate. This indicates that with every hike in repo rate reverse repo rate will be automatically increased to the same extent. We believe that this move is expected to reduce the volatility in the short term rates.
- RBI has increased the savings bank deposit interest rate from current 3.5% to 4.0% with an immediate effect. The increase in savings banks rate will increase the bank's cost of funds which will impact the banks' NIMs by 10-12 bps on an average (depending on the proportion of savings a/c in total deposits). Banks will have to pass on the increase in cost to its customers in order to minimize the impact.
- RBI has projected FY12 GDP growth to be in the range of 7.4-8.5%. Finance Ministry in its economic survey had mentioned that GDP growth will be around 9% for FY12. The current RBI projection is way below the Finance Ministry estimate.
- Banks credit growth is projected to be at 19% and deposit growth to be at 17% for FY12 as against credit growth of 21% in FY11. This indicates a slowdown in credit off take of the banks.
- RBI has projected FY12 money supply growth at 16%.

- Investment in debt mutual funds will be subject to a cap of 10% of the net worth as on March 31 2010. However, banks which already have investments in excess to 10% will be allowed an extension of 6 months to comply with this requirement.
- WPI inflation has been projected at 6.0% for FY12 with an upward bias. However, RBI added that inflation will remain elevated in H1FY12 (approximately 9% factoring in fuel price hikes) before it starts to gradually cool down in second half.
- RBI has proposed to enhance the provisioning requirements on certain NPAs and restructured advances. Higher provisioning will impact the profitability of the bank especially the banks with lower Provision Coverage Ratio (PCR) like SBI and Dena Bank and higher restructured assets like IDBI Bank and ICICI Bank.
- Provisioning on banks' secured portion of loans has been increased as follows:

	Existing	Proposed
Substandard loan provisioning	10%	15%
Upto 1 year	20%	25%
1-3 years	30%	40%

- Moreover, additional 10% provision has to be made on unsecured sub-standard loans and 2% provision on restructured loans in standard assets for first 2 years.
- RBI mentioned that it would adhere to begin BASEL-III implementation from January 2013 and is preparing norms for internal rating under Basel-III for banks.
- RBI further indicated that bank loans to micro finance companies from April 1 2011 onwards will be considered as priority sector only if the prescribed percentage of their total assets are in the nature of "qualifying assets" and they adhere to the "pricing of interest" guidelines to be issued.
- According to RBI global recovery is expected to continue in 2011. However, growth is expected to slow down marginally from its pace in 2010. Growth is projected to decelerate in advanced economies due to weakening of the effects of fiscal stimuli, high oil prices and other rising commodity prices.
- Growth in Emerging Market Economies is also expected to decelerate on account of monetary tightening and rising commodity prices.

Conclusion

RBI announced a series of policy actions which includes both monetary and regulatory to contain inflation expectation and to bring stability in the system. The increase in policy rate coupled with increase in costs of funds due to increase in savings rate will increase lending rate in the system. This may slow down the demand for credit growth in the system. RBI's monetary action alone may not be sufficient to cool off the rising inflation as it is also driven by increase in input costs. We believe the increasing cost of fund and additional provision requirement will have direct negative impact on the banking stocks and particularly PSU banks. In our view the bank's margins and profitability will be affected negatively in the short term. In addition, it will also have an impact on interest sensitive sectors such as auto and real estate.

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