Banks and NBFCs

Yet another watershed moment?

In its recently released report, the RBI's Internal Working Group (IWG) has proposed several recommendations to harmonise the ownership guidelines, regulatory landscape, and corporate microstructure of Indian private banks. We explore the key implications of the findings and recommendations and the likely winners.

Perhaps the most significant set of recommendations, in line with the intent to increase the number and diversity of private banks, is the RBI laying out two potential routes for the entry of new private banks by allowing large corporate houses to set up banks and large NBFCs to become banks. We believe that potential new banks are more likely to choose the 'NBFC-Bank route' as the entry of industrial houses will require a slew of changes to the extant legislative, regulatory and supervisory frameworks. The recommendations proposed by the IWG are especially significant given that no non-financial institution was able to float a bank under the 2013 licensing guidelines and no NBFC has successfully converted into a bank under the extant 2016 'On-tap' licensing guidelines. While large NBFCs aspiring for banking licenses will face near-term challenges, conversion into a bank should be viewed as a desirable long-term strategy, in our opinion. Amongst banks within our coverage, DCBB and IIB stand to benefit from the recommended increase in the limit on promoter shareholding.

A medium-term rise in competitive intensity notwithstanding, our long-term thesis continues to favour large private banks on the back of their stronger balance sheets and stable liability franchises.

- **Relaxation of promoter holding norms recommended:** Under the extant licensing guidelines for private banks and SFBs, promoters are required to bring down their holding to at least 15% within 15 years. The IWG recommends that this cap be raised to 26% as this would balance the need of diversified ownership with more skin in the game for the promoter. This is consistent with the outcome in the KMB promoter shareholding matter, it would not be entirely unreasonable to expect this recommendation to translate into actual policy. Within our coverage, we believe that DCBB and IIB, whose promoters have already expressed interest in increasing their stake, will stand to benefit from such a policy change.
- **Will the RBI finally permit ownership of banks by large corporate houses?** Historically, the RBI has maintained a cautious stance on this matter, in view of the 'serious risks, governance concerns, and conflict of interest that could arise'. We resonate with the regulator's outlook and believe that such caution is well-founded. Despite briefly allowing industrial and business houses to apply for a banking license under the 2013 edition of its licensing guidelines, the RBI granted a banking license only to two entities - IDFCBK and BANDHAN, both erstwhile financial institutions. At the time, several other corporates either unsuccessfully applied or withdrew their applications, in some cases citing excessive regulatory requirements.
- Set against this background, the IWG's report builds a strong case for increasing the role and number of private banks to further economic development- *this is not surprising*. Acknowledging the capital, managerial expertise and strategic thinking that large industrial houses could bring to the table, the IWG recommends that large corporate/ industrial houses be permitted to promote banks only after necessary amendments to the Banking Regulation Act (the act) are made.

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- **Is this a watershed moment for the banking industry?** Contrary to the opinion of experts, the IWG has recommended allowing large corporate houses to set up banks. Despite the RBI's fresh attempt at welcoming industrial houses to apply for a banking license, we remain relatively sceptical of this route playing out meaningfully in the near-term. While several large domestic conglomerates stand to gain from having a banking license, we believe that the RBI will continue to remain selective and cautious in its approach to allowing industrial houses. Taking a cue from unsuccessful / withdrawn applications under the 2013 edition, we believe that the likely amendments to the legislative, regulatory and supervisory framework for large corporate houses will be significantly demanding from a compliance perspective. For large corporate houses looking to enter the space, acquisition may be a more attractive route and a few mid-tier banks serve as interesting potential targets.
- **Conversion of NBFCs to banks- a more likely route:** The IWG recommends allowing 'well-run large NBFCs' (asset size more than Rs 500bn), including those owned by large corporate houses to convert into banks. This recommendation is not surprising, especially in light of **recent remarks by one of the RBI Deputy Governors**. Given that NBFCs were already permitted to convert under extant licensing guidelines, it remains to be seen how the new guidelines differ in terms of compliance requirements or in terms of incentivising NBFCs to convert. The IWG also recommends 'scale-based' regulation of NBFCs with a tighter 'bank-like' regulatory framework for larger NBFCs, eliminating any regulatory arbitrage.
- We opine that an NBFC's decision to convert into a bank hinges on the trade-off between sustainability (lower mortality risk) and higher regulatory (CRR/SLR) and compliance (tighter supervision) and operating costs (arguably transient). Although large well-run NBFCs are, by definition well-funded, we believe such conversion represents a desirable long-term outcome for such entities to ensure sustainable growth. Exhibit 1 carries our indicative framework that helps assess the likelihood of large NBFCs converting into banks.
- **IWG recommends NOFHC structure:** The IWG recommends that NOFHCs should continue to be the preferred structure for all new 'Universal Banks'. Further, banks currently under the NOFHC structure, which do not have other group entities within their fold could be permitted to exit said structure. We believe that the IWG recommendations, in their current shape, are vague on whether the NOFHC structure applies to SFBs - in case this eventually applies to SFBs, UJJIVAN and EQUITAS will be positively impacted.

Exhibit 1: Indicative framework for evaluating the conversion of select NBFCs into banks.

Company	Sponsor	Deposit-taking experience	Connected entities	Regulated entities	Likelihood of applying for a banking license	Likelihood of securing a banking license
BAF	Industrial group	✓	✓	✓	Very likely	Likely
SHTF	Industrial group	✓	✓	×	Unlikely	NA
LTFH	Industrial group	×	✓	✓	Very likely	Unlikely
MMFS	Industrial group	✓	✓	✓	Likely	Unlikely
CIFC	Industrial group	×	✓	✓	Likely	Likely
MUTH	Financial group	×	×	×	Very likely	Unlikely
ABCL	Industrial group	×	✓	✓	Very likely	Unlikely

Peer Set Comparison

	MCap (Rs bn)	CMP (Rs)	Rating	TP (Rs)	ABV (Rs)			P/E (x)			P/ABV (x)			ROAE (%)			ROAA (%)		
					FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Banks																			
AUBANK	268	880	ADD	770	155	182	212	33.7	32.8	24.7	5.61	4.75	4.09	16.6	14.6	16.8	1.36	1.54	1.71
AXSB#	1,860	608	BUY	616	306	348	396	24.0	14.3	11.6	1.93	1.68	1.49	8.0	11.5	12.9	0.80	1.23	1.36
BANDHAN	564	350	BUY	377	106	129	157	19.1	15.3	11.3	3.29	2.72	2.23	17.7	18.5	20.8	2.96	3.11	3.50
CUBK	135	183	BUY	199	66	78	89	25.2	17.7	14.6	2.78	2.35	2.04	9.6	12.3	13.3	1.04	1.38	1.50
DCBB	29	93	ADD	123	94	115	130	9.3	7.5	6.1	0.99	0.81	0.72	8.7	9.8	11.0	0.79	0.90	0.97
FB	116	58	BUY	78	66	76	85	9.6	7.4	6.1	0.89	0.77	0.68	8.0	9.6	10.7	0.64	0.76	0.84
ICICIBC#	3,310	480	BUY	503	189	214	242	15.8	13.7	11.4	1.89	1.65	1.43	11.1	10.8	11.4	1.34	1.39	1.48
IIB	625	810	REDUCE	690	514	567	622	21.4	13.4	10.8	1.58	1.43	1.30	7.7	10.4	11.7	0.91	1.33	1.47
KMB#	3,737	1,889	ADD	1,426	292	332	375	47.6	42.2	35.5	5.51	4.78	4.16	12.5	11.5	12.0	1.77	1.78	1.88
KVB	29	36	REDUCE	38	54	64	70	9.0	6.6	4.8	0.67	0.56	0.51	4.8	6.5	8.6	0.46	0.58	0.73
RBK	126	212	REDUCE	179	195	211	228	22.7	14.7	10.8	1.09	1.00	0.93	4.8	6.6	8.3	0.60	0.83	1.00
SBIN#	2,167	243	BUY	317	189	227	254	7.0	4.3	3.6	0.63	0.52	0.46	6.3	9.5	10.3	0.37	0.55	0.61
UJJIVANS	58	34	ADD	42	17	20	23	24.4	18.7	10.5	1.94	1.69	1.45	7.7	9.2	14.6	1.20	1.31	1.90
NBFCs																			
BAF	2,830	4,718	ADD	3,647	567	698	838	65.9	40.6	31.7	8.32	6.76	5.63	12.5	17.5	18.8	2.55	3.70	3.96
CIFC	278	339	BUY	319	97	121	143	17.4	16.3	14.4	3.51	2.80	2.37	17.9	16.3	16.0	2.41	2.37	2.41
CREDAG	116	737	ADD	793	251	285	338	39.7	21.8	13.9	2.93	2.58	2.18	8.7	12.4	16.8	2.12	3.20	4.09
MMFS#	191	155	BUY	175	87	109	134	21.4	11.8	9.3	1.58	1.25	1.02	5.9	9.0	10.5	1.02	1.67	1.90
SHTF	236	934	ADD	880	594	744	896	10.9	8.4	7.2	1.57	1.26	1.04	11.0	12.4	12.9	1.85	2.24	2.38
INDOSTAR	40	294	REDUCE	303	254	276	303	26.8	16.5	11.2	1.16	1.06	0.97	5.2	5.8	7.9	1.47	2.21	2.85
LICHF	166	329	REDUCE	341	301	321	382	7.2	6.4	5.1	1.09	1.02	0.86	12.1	12.3	13.7	1.03	1.07	1.20
REPCO	15	233	ADD	282	273	321	377	5.5	5.1	4.6	0.85	0.73	0.62	13.8	13.1	12.8	2.12	2.14	2.20

Source: Company, HSIE Research, # Adjusted for subsidiaries value

Rating Criteria

BUY: >+15% return potential

ADD: +5% to +15% return potential

REDUCE: -10% to +5% return potential

SELL: >10% Downside return potential

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