Financial Services

Sector Update

November 24, 2020

NBFCs conversion into Bank: premature call

We reckon NBFCs conversion into banks would imply limited scope, stringent norms and lower returns. Unlike previous occasion, permit for industrial houses to opt for banking license and increased cap on promoter stake increase the scope of eligibility. While this would imply significant changes to the Banking Regulation Act, the details of which are awaited by most, licenses are not likely to come easy especially to the corporate houses. Conversion into a bank will be a call on trade-off between operational flexibility and a gradual liability franchise built which NBFCs have to take. While corporate led diversified NBFC models (likes of LTFH, PEL, ABCapital, Tata Capital) would be greater beneficiaries of such conversion, core business focused NBFCs would maintain the original format. We maintain positive bias towards quality NBFCs; viz, SBICARD, MUTH, HDFC, CIFC, BAF.

Our interactions with various NBFCs in the space are as hereunder:

- **Reaction to RBI's move**: (a) RBI step is somewhat baffling as one hand it intends to consolidate banks, and on the other continues to encourage on tap bank licenses and formation of more banks. (b) RBI's move to provide licenses to industrial houses is a welcoming step and an opportunity for the ones who lost out on opportunity to convert into a bank on the previous occasion.

- **Reaction by NBFCs:** NBFCs wouldn't jump on the news (SHTF not in a rush; CIFC, LICHF awaiting detailed guidelines). There are two sets here, (i) ones intending to convert into a bank (MMFS, we spoke to, would be conducting board meeting to reexamine the process, eligibility and more). NBFCs opting for bank licenses would undertake thorough due diligence and radical examination of business by itself to put up with the fit and proper criteria of the RBI. (ii) Another set who has no banking ambition (Sundaram Finance, we spoke to, is happy to remain and operate as an NBFC just the way the Co. remains since over 65 years). Ones with core business focus and expertise would continue to operate as NBFCs.

- **Key challenges:** Multiple challenges; key ones: (a) Building liability franchise as alongside SBI/HDFCB/ICICI and SFBs and chasing CASA will be biggest challenge for the new banks. NBFCs with asset base of Rs500-800bn would have to augment low cost resources, so invariably asset mix would also have to undergo change too. (b) While priority sector lending fulfillment should not be an issue for many, meeting up CRR/SLR from day 1 is a bigger challenge.

- **Big miss:** Apart from regulatory stringent norms that would apply as a bank, NBFCs would miss the leisure of wholesale funding.

- **NBFC as a bank: Call to convert into a bank would imply a trade-off between operational flexibility and steady liability franchise for an NBFC**. A bank being predominantly a branch model and NBFCs more of a feet-on-street, operational costs and augmentation of human capital for establishment of such a branch model is the foremost priority.

- **NBFCs will co-exist:** Diverse country like India requires different order of credit deliverance with respect to different geographies and demographics. While bank is the primary channel of credit, several other ancillary credit institutions as also pawnbrokers will co-exist as there remains some credit gap at some level.

Shweta Daptardar
shwetadaptardar@plindia.com | 91-22-66322245

The Reserve Bank of India (RBI) had constituted an Internal Working Group to review extent ownership guidelines and corporate structure for Indian private sector banks. Key recommendations are as below:

- Cap on promoters' stake in the long run (15 years) may be raised from the 15% to 26% of the paid-up voting equity share capital of the bank.
- For Non-promoter shareholding, a uniform cap of 15% of the paid-up voting equity share capital of the bank may be prescribed for all types of shareholders.
- Large corporate/industrial houses may be allowed as promoters of banks only after necessary amendments to the Banking Regulation Act, 1949 to prevent connected lending and exposures between the banks and other financial and non-financial group entities; and strengthening of the supervisory mechanism for large conglomerates, including consolidated supervision.
- Large NBFCs, with an asset size of Rs. 500bn and above, including those which are owned by a corporate house, may be considered for conversion into banks subject to completion of 10 years of operations and meeting due diligence criteria and compliance.
- For Payments Banks intending to convert to a SFB, track record of 3 years of experience as Payments Bank may be considered as sufficient.
- SFBs and Payments Banks may be listed within '6 years from the date of reaching net worth equivalent to prevalent entry capital requirement prescribed for universal banks' or '10 years from the date of commencement of operations', whichever is earlier.
- The minimum initial capital requirement for licensing new banks should be enhanced from Rs. 5bn crore to Rs. 10bn for universal banks, and from Rs. 2bn to Rs. 3bn for SFBs.
- Non-operative Financial Holding Company (NOFHC) should continue to be the preferred structure for all new licenses to be issued for universal banks. However, it should be mandatory only in cases where the individual promoters/ promoting entities/ converting entities have other group entities.
- While banks licensed before 2013 may move to an NOFHC structure at their discretion, once the NOFHC structure attains a tax-neutral status, all banks licensed before 2013 shall move to the NOFHC structure within 5 years from announcement of tax-neutrality.
- Till the NOFHC structure is made feasible and operational, the concerns with regard to banks undertaking different activities through subsidiaries/ JV/ associates need to be addressed through suitable regulations.
- Banks currently under NOFHC structure may be allowed to exit from such a structure if they do not have other group entities in their fold.
- RBI may take steps to ensure harmonization and uniformity in different licensing guidelines, to the extent possible. Whenever new licensing guidelines are issued, if new rules are more relaxed, benefit should be given to existing banks, and if new rules are tougher, legacy banks should also conform to new tighter regulations.

Analyst Coverage Universe

Sr. No.	Company Name	Rating	TP (Rs)	Share Price (Rs)
1	Bajaj Finance	BUY	3,805	3,233
2	Cholamandalam Investment and Finance Company	BUY	310	273
3	HDFC	Accumulate	2,185	2,041
4	L&T Finance Holdings	Sell	52	65
5	LIC Housing Finance	Hold	316	324
6	Mahindra & Mahindra Financial Services	Reduce	124	131
7	Manappuram Finance	Accumulate	196	162
8	SBI Cards and Payment Services	Accumulate	895	852
9	Shriram Transport Finance	Accumulate	809	693

PL's Recommendation Nomenclature

Buy : > 15%
Accumulate : 5% to 15%
Hold : +5% to -5%
Reduce : -5% to -15%
Sell : < -15%
Not Rated (NR) : No specific call on the stock
Under Review (UR) : Rating likely to change shortly

ANALYST CERTIFICATION

(Indian Clients)

We/I Ms. Shweta Daptardar- MBA-Finance Research Analysts, authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

(US Clients)

The research analysts, with respect to each issuer and its securities covered by them in this research report, certify that: All of the views expressed in this research report accurately reflect his or her or their personal views about all of the issuers and their securities; and No part of his or her or their compensation was, is or will be directly related to the specific recommendation or views expressed in this research report.

DISCLAIMER

Indian Clients

Prabhudas Lilladher Pvt. Ltd, Mumbai, India (hereinafter referred to as "PL") is engaged in the business of Stock Broking, Portfolio Manager, Depository Participant and distribution for third party financial products. PL is a subsidiary of Prabhudas Lilladher Advisory Services Pvt Ltd. which has its various subsidiaries engaged in business of commodity broking, investment banking, financial services (margin funding) and distribution of third party financial/other products, details in respect of which are available at www.plindia.com.

This document has been prepared by the Research Division of PL and is meant for use by the recipient only as information and is not for circulation. This document is not to be reported or copied or made available to others without prior permission of PL. It should not be considered or taken as an offer to sell or a solicitation to buy or sell any security.

The information contained in this report has been obtained from sources that are considered to be reliable. However, PL has not independently verified the accuracy or completeness of the same. Neither PL nor any of its affiliates, its directors or its employees accepts any responsibility of whatsoever nature for the information, statements and opinion given, made available or expressed herein or for any omission therein.

Recipients of this report should be aware that past performance is not necessarily a guide to future performance and value of investments can go down as well. The suitability or otherwise of any investments will depend upon the recipient's particular circumstances and, in case of doubt, advice should be sought from an independent expert/advisor.

Either PL or its affiliates or its directors or its employees or its representatives or its clients or their relatives may have position(s), make market, act as principal or engage in transactions of securities of companies referred to in this report and they may have used the research material prior to publication.

PL may from time to time solicit or perform investment banking or other services for any company mentioned in this document.

PL is in the process of applying for certificate of registration as Research Analyst under Securities and Exchange Board of India (Research Analysts) Regulations, 2014

PL submits that no material disciplinary action has been taken on us by any Regulatory Authority impacting Equity Research Analysis activities.

PL or its research analysts or its associates or his relatives do not have any financial interest in the subject company.

PL or its research analysts or its associates or his relatives do not have actual/beneficial ownership of one per cent or more securities of the subject company at the end of the month immediately preceding the date of publication of the research report.

PL or its research analysts or its associates or his relatives do not have any material conflict of interest at the time of publication of the research report.

PL or its associates might have received compensation from the subject company in the past twelve months.

PL or its associates might have managed or co-managed public offering of securities for the subject company in the past twelve months or mandated by the subject company for any other assignment in the past twelve months.

PL or its associates might have received any compensation for investment banking or merchant banking or brokerage services from the subject company in the past twelve months.

PL or its associates might have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past twelve months

PL or its associates might have received any compensation or other benefits from the subject company or third party in connection with the research report.

PL encourages independence in research report preparation and strives to minimize conflict in preparation of research report. PL or its analysts did not receive any compensation or other benefits from the subject Company or third party in connection with the preparation of the research report. PL or its Research Analysts do not have any material conflict of interest at the time of publication of this report.

It is confirmed that Ms. Shweta Daptardar- MBA-Finance Research Analysts of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months

Compensation of our Research Analysts is not based on any specific merchant banking, investment banking or brokerage service transactions.

The Research analysts for this report certifies that all of the views expressed in this report accurately reflect his or her personal views about the subject company or companies and its or their securities, and no part of his or her compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report.

The research analysts for this report has not served as an officer, director or employee of the subject company PL or its research analysts have not engaged in market making activity for the subject company

Our sales people, traders, and other professionals or affiliates may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest.

PL and its associates, their directors and employees may (a) from time to time, have a long or short position in, and buy or sell the securities of the subject company or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the subject company or act as an advisor or lender/borrower to the subject company or may have any other potential conflict of interests with respect to any recommendation and other related information and opinions.

US Clients

This research report is a product of Prabhudas Lilladher Pvt. Ltd., which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

This report is intended for distribution by Prabhudas Lilladher Pvt. Ltd. only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.

In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, Prabhudas Lilladher Pvt. Ltd. has entered into an agreement with a U.S. registered broker-dealer, Marco Polo Securities Inc. ("Marco Polo").

Transactions in securities discussed in this research report should be effected through Marco Polo or another U.S. registered broker dealer.

Prabhudas Lilladher Pvt. Ltd.

3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India | Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

www.plindia.com