HDFC BANK

Can cut rates only when deposit rates cool: HDFC Bank

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- By Saikat Das and Santosh Nair

HDFC Bank has been on a branch expansion spree in semi-urban and rural places over the last couple of years, outpacing rivals, as it hopes to reap rich dividends from the wealth creation in these centres when economic growth picks up in the coming years.

"Looking at the next 5-10 years, we do believe that if you are going to have a 6-8 percent GDP growth, you are bound to have trickle down effect of that into more and more semi-urban and rural locations," Paresh Sukthankar, Executive Director, HDFC Bank said in an interview to moneycontrol.com.

HDFC Bank shares outperformed those of peers by a wide margin for a long time after the market meltdown in 2008 triggered by the global financial crisis. But the law of averages finally seems to be catching up, as investors fret about valuations. Over the last one year, the stock has risen about 27 percent while rival private sector players like ICICI Bank, Axis Bank, Yes Bank, IndusInd Bank and Kotak Mahindra have gained between 30-52 percent.

Analysts say HDFC Bank's fundamentals remain sound, but current prices are fully reflecting the positives.

Sukthankar is confident that his bank will continue to grow faster than the industry average, but cautions that the rate of growth be a function of how the economy does.

Responding to criticism that HDFC Bank has managed to protect its asset quality by shying away from long term loans to capital intensive sectors, Sukthankar said the bank's portfolio only reflects the key drivers of the economy.

"As the investment cycle picks up again, between our own balance sheet and our investment banking capabilities, we will be happy to participate what we believe are bankable projects with the sponsors that we are comfortable with," Sukthankar said.

Edited excerpts of the interview:

Q: Your bank has been consistently outperforming rivals in terms of earnings growth and asset quality, even in a difficult operating environment. What is the secret sauce?

A: If there was a simple recipe to this I am sure it would have got replicated. There is no one secret or couple of specific issues. One of the key contributors to this relatively more stable performance has been the diversification of our businesses. If you look at it from a lending point of view or an asset point of view, our business is almost half and half between wholesale and retail. I think that is important because if you look at the last 10 or 15 years that you are talking about, for almost 7-8 years till 2-3 years back, retail was the mantra. Then you went through a phase where post 2008-2009, when a lot of retail portfolios gave trouble for a number of banks—both domestic and foreign—and as a result retail became outcast of sorts and people were not looking to grow their retail books.

That was the time when capex cycle, infrastructure and new projects and so on were pretty much the key drivers of loan growth for the banking system. That happened for about four years or so. Again now in the last year or so because there have been some apprehensions about what is happening on the infrastructure side, on the capex cycle and the policy environment and so on. Clearly once again banks are re-focusing on retail.

In the last few years, in those 2-3 years when retail at an industry level came down, our retail was growing a little slower than 20 percent, but corporate was growing at about 25 percent. So, again we maintained our growth rates.

The point is that even in years or during periods when of one of the businesses is looking significantly more attractive than the other, we continue to invest in and grow the other business, although rates of growth may vary.

If you then look at the other reason why banks go through volatility in businesses and earnings, it is because of what happens on the funding side. We are essentially a deposit funded bank. We are not dependent on wholesale borrowings or foreign currency bonds and stuff like that. Within deposits again there is high proportion of retail—current and savings accounts(CASA)—which provides certain stability to the funding patterns. So we are a little less vulnerable to the volatility in interest rates than perhaps those who are more dependent on wholesale (bulk) deposits or wholesale borrowings. That again then gives us certain stability to our margins.

Besides, we have been growing our distribution network; so we are gaining market share.

Q: The rate of deposit growth has been slackening, making it difficult for banks to cut lending rates. Do you see this trend changing anytime soon?

A: Deposit growth has been sort of sluggish at a system level and it has certainly been slower and lagging loan growth. So, if you look at the last numbers which came out, you had deposit growth still at a system level at 13 percent or little less than that and loan growth was around 15-16 percent. So, there is some concern that deposit growth is not keeping pace with loan growth.

While we all have cut some interest rates and so on, for this to continue you certainly need a further reduction in the liquidity deficit which is there in the banking system which means either deposit growth picks up or you have further CRR cuts or some further liquidity which comes in through the OMO (open market operations) or other route and reduces the LAF (liquidity adjustment factor) borrowings to perhaps closer to Rs 30000-40000 crore (from around Rs 1 lakh crore at present). Then banks will say: okay at these rates we have got enough deposits, why not drop deposit rates. Because the only way you can drop your base rate on the lending side is if your deposit rates come down.

As far as we are concerned, our deposit growth has been certainly healthier than the system deposit growth. But even then, if you look at our deposit growth, it was around 22 percent as of December. So, we were clearly higher than the

overall system, marginally slower than our loan growth which was around 24 percent. There was marginal difference of course, but we also had some tier-II capital and so on. So, we were more than comfortably funded. While both our loan growth and our deposit growth are ahead of the system so to that extent we have been able to source enough deposits, the fact is that at a system level if you need to see the transmission of lower rates on a continued basis, you would have to see further easing of liquidity. If there is not enough of deposit flows into the system at these interest rates then at lower interest rates there would be that much of a lower attractiveness of the retail deposit or of the saver to put money into bank deposits.

Q: You have opened around 1000 branches in the last two years, compared to an average of 300-400 by your rivals. Why the emphasis on the brick and mortar model?

A: We have also traditionally done an average of somewhere around 300-350 branches. In the last couple of years we clearly stepped up. A large part of this increased or an enhanced growth rate in distribution has been our focus on the semi-urban and rural markets. A good 70-80 percent of these new branches would be in new locations, in new cities which we were not in previously.

That also positions us better in terms of our priority sector lending (PSL) requirements, and whatever financial inclusion targets that we have.

We clearly believe that there is a reasonably large relatively under penetrated market in the semi-urban and rural areas. You must remember that these markets are intrinsically smaller, but collectively it will certainly make a difference.

If you look at it from a slightly more strategic point of view, today it has got a certain potential, but if you look at the next five, ten years then we do believe that if you are going to have a 6-8 percent GDP growth, you are bound to have trickle down effect of that into more and more semi-urban and rural locations. Equally from the other side when you look at better price realisations from an agriculture point of view, when you look at the government focus in terms of better supply chains, better developmental activities which are again rural based, you are going to see also greater income generation, wealth creation and the need for basic banking services which are currently not available there.

All of these things (opening more branches) cost us and we have seen some deterioration in our cost to income ratio as a result of that. But that is something we are willing to live with because we believe it is an investment which will hold us in good stead in future.

Q: In your last quarter, your bank recorded the highest return on assets (RoA), 1.8 percent. How do you propose to sustain this?

A: I am not saying whether we are going to maintain a certain RoA or we are going to increase it or reduce it. As a policy we don't have guidance on any particular number.

We have grown 3-6 percentage points faster than the banking system. If you look at our own rate of balance sheet growth, we have grown at 25-30 percent when the system was growing at 20 percent-odd. If the system now is growing at 15-16 percent, we have grown at 22 percent. Are we going to target an absolute rate of growth, whether it is for RoA or for any other purpose? The answer is no because as a bank if you try and be completely insulated from what are the cyclical moves in the economy, you will end up making some mistakes in terms asset quality or something else. We believe we will continue to outpace the banking system but the rates of growth will be a function of how the economy does.

In terms of what could be a driver going forward, factors like cost to income ratio, or the entire operating cost structure, also matter. We have invested a lot in the last few years, and bank branches take 2-3 years at least to breakeven. We keep adding branches, but the proportion of the newer branches or the branches which are yet to breakeven as a

function of the base will probably come lower because you have already added a large number.

As we continue to execute our plans and as our existing branches continue to breakeven and so on, we believe there is room for us to become more efficient, to have higher productivity from our existing investments and therefore to improve, say on the cost to income ratio side and so on.

When you talk about the peak RoAs that we have hit, one of the reasons for that has also been the fact that in the last year, year and a half, we have seen significantly lower credit costs than what has been our own average. To that extent when you look at a particular quarter you may have some spike because you have bond gains or some spike because your credit costs are lower and so on and so forth. However, the fact that we have moved from 1.3-1.4 to a slightly higher range of RoAs is certainly something that we have done not on a single quarter basis, but probably over the last six, seven quarters. I don't think 1.8 or 1.4 is necessarily a wide range or it is a reasonable range, but how much we do in any successive quarter thereafter, we will have to wait and watch.

Q: Your bank's asset quality is among the best in the industry. But your critics say that you are not into long-term lending. So your asset quality is naturally protected; what is your comment?

A: That is certainly a view, so I respect whatever view people have. But you must realise that the fact that we have grown faster than the banking system and we have had the luxury or we have had the ability to select what businesses we want to be in and despite not necessarily having grown as fast as everybody in everything if we have been able to grow faster than the system, that is part of the management's ability to deliver and execute.

Having said that, that is probably more true till about four or five years back and progressively that grudge that people might have had against us might have also come off a little because in the last few years we have certainly increased—more than term, people were talking about project finance or infrastructure and stuff like that—our lending in those areas. We have begun lending to power projects; we have got some exposure to infrastructure whether it is roads, whether it is power, telecom and so on. What we have done is because we didn't look at this as the only driver of growth or the main driver of growth, we exposed ourselves to these sectors to the extent that we believed there were adequate bankable opportunities for us and to a large extent our business or our portfolio essentially reflects what the Indian economy is all about.

We believe India is much more of a domestic consumption story with some upside and a need for higher investments, higher capex, higher infrastructure. But if today in your composition of the industry, if between consumption and investment and government, you look at the C plus I plus G sort of a thing in the economy, the only reason why India still continued to do reasonably well through different cycles is because the consumption was intact. Larger part of our business, be it corporate side or retail side, mirrors what the economy is. For the sake of argument, if the share of investment is 20 percent, and if you decide that you have 50 percent of lending to that segment, you may end up taking higher risk, which we believe, may not be bankable.

Q: What are your plans for project financing? How large is this currently?

A: In the recent past, there have not been so many green field project opportunities in the market place. But there have been a fair amount of brown field expansions wherein we continue to participate and are willing to participate.

And as the investment cycle picks up again, between our own balance sheet and our investment banking capabilities, we will be happy to participate what we believe are bankable projects with the sponsors that we are comfortable with.

Today project financing would be certainly in the single digit. If we broadly look at our wholesale book, around 70% odd percent would be working capital and trade finance and 25-30% would be term loans. Within that term loans, only one third is the project finance at around 9-10%.

Q: What is the broader view on non performing asset (NPA) problem in the banking industry? Is there a systemic risk as many economists and rating agencies have been pointing out?

A: I am more than convinced that there is no systemic risk from the (current) level of NPAs. The reason is quite simple. If you look at the current level of NPAs, let us say, 3 odd percent gross NPAs and 5-6 percent restructured loans. For the sake of argument, let say, 20 percent of restructured loans become NPAs over a period of time. So, you could have 1-1.5 percent falling into NPAs from the restructured loans. Even in that kind of situation, the incremental NPAs and provisions requirement could be pretty much be met by the banking system from the year's profit. And you know, there were a couple of bumper years in terms of bond yields. In which case, banks would all the more be in a position to do it.

There is no risk in terms of banking system and in term of their capital. However, individuals banks could be affected in terms of their profits and losses based on their provisions.

Broadly, we are pretty much at bottom from asset deterioration perspective, I think. Whether the numbers can get worse, that is certainly a possibility.

The deterioration that has taken place is clearly due to two set of factors: One, just a slow down in the economy. A 4 percent drop in GDP over two years clearly will have implications on businesses and individuals. Thereby, it will to deterioration of asset quality.

The other set of factors which are quite independent of slowdown where you have quite specific project, sector or business groups or customers who have been impacted because they are very highly leveraged or they are in the throes of substantial amount of capex having no chance to raise the equity. Or, projects have got stuck due to various reasons.

The reason I am saying this is because these are independent of slowing down economy. Because if you have a power plant but don't have the coal, whether economy is doing 9 percent or 5 percent, you will have a problem. So, I am saying these are specific factors than the general macro factors.

To my mind both of them, things are stabilising. It is not that companies and businesses will bounce back immediately but the situation will not get worse.

Q: Will HDFC Bank cut its base rate in the near future?

A: The key determinant of a bank's base rate is the deposit rate; not all deposit rates, but the rate that is taken into account for calculation. Each bank has its own calculation. The formula does not change.

We last changed our base rate in December last year [2012] and we came down to 9.7 percent from 9.8 percent. Since then, we have not really seen any change in deposit rates. But some time in this quarter, we will again go through that calculation. If there is any change in deposit rates, there will be automatic transmission (to the base). In terms of trends of base rate, the only logical way that base rate can come down is when deposit rates come down.

Q: Are you seeing any re-pricing of deposit rates at your bank?

A: Not particularly. From where they were a year back deposit rates have come down by 0.5-1.0 percent. But if you look at the last few weeks, then I don't think you have seen any reduction. One positive for the system as a whole is that perhaps the premiums which were earlier being paid for large bulk deposits and so on have come off from what they were. I don't know whether this will happen again during March.

Q: What are the key challenges for HDFC Bank going forward, besides meeting market expectations?

A: The good part is on the market expectations bit because we don't have a policy on guidance and so we are not trying to keep pace with that. Honestly, if your question is what is the key challenge I would find it difficult to try and say one or two things which are key challenges or key risks. I don't think we bet the bank on any one or two things which can swing the bank. Obviously as bank we face multiple challenges and risks at any point of time and realistically if there are half a dozen things that can go wrong, one or two of them will go wrong and hopefully three or four will not.

When you look at the fact that we have significantly expanded our network, I think for us to be able to continue to deliver our service quality, our turnaround time, our entire product range to customers, is an important part of our challenge. Our ability to attract train, retain people and get the right culture is a key challenge. Managing people risk across geography and products is a challenge.

Managing within the portfolio the ups and down, managing asset quality across various products with increased competition are challenges.

Q: Are you open to inorganic growth?

A: Theoretically, we have always been open to inorganic growth. We have done two deals in the bank's life time and things have worked out well.

But when we refer to our target of growing faster than the banking system, we are not looking at inorganic growth to deliver that delta growth. That, we can do organically.
So, if there is an opportunity that comes into the market place, we will evaluate it and we would take a call. We don't chase deals unless we believe, it adds value or it is something that we could create value out of it.