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05 Aug 2013

HEADLINES

Poorly handling–Divestment erodes 50k cr off 7 PSUs' value

The government has raised nearly Rs 24,000 crore through divestment in 7 PSUs in FY 13. However, the manner in which it has gone about these selloffs "talking about them for several months and then bunching up several blue chip companies towards the end of the fiscal" has led to a loss in the market capitalization in these companies, erasing more than double of what the government has realized by cutting its stakes in these PSUs. The question remains- If FIIs are not willing to invest in public sector companies which were being sold at a deep discount to market prices, why would they invest in Indian equity market?

SHARES OFFLOADED IN FY 13				
			Market Cap (□ Cr)	
PSU	Stake sold (%)	Money Govt. raised (□ Cr)	Nov 23, 2012	Mar 28, 2013
Hind Copper	5.6	808	**24639**	**8734**
NMDC	10	5980	**66012**	**53206**
Oil India	10	3145	**27502**	**30595**
NTPC	9.5	11469	**1.31L**	**1.17L**
RCF	12.5	310	**2814**	**1964**
NALCO	6.1	629	**11623**	**8814**
SAIL	5.8	1512	**32218**	**25196**
Total	-	23853	**2.96L**	**2.46L**

Range of recommendations of FSLRC in Union Budget – Too wide to be effective

The recommendations of the Financial Sector Legislative Reforms Commission (FSLRC), which submitted its final report at the end of March,'2013, have provoked a substantial amount of public comment. It addresses 9 components– Consumer Protection, Micro-prudential regulation, Resolution, Capital Controls, Systemic risk, Development and redistribution, Monetary policy, Public debt management, Contracts, trading and market abuse. It also includes- Review of existing legislation including the RBI Act, the SEBI Act, the IRDA Act, the PFRDA Act, FCRA, SCRA, FEMA etc., which govern the financial sector .

Government eases FDI policy for multi- brand retail

The Cabinet Committee on Economic Affairs (CCEA) has given approval to waive off certain safeguards in FDI Policy. 30% mandatory sourcing from small domestic industries has been removed. Medium scale industries with total investment not exceeding $2 million would also be made eligible for sourcing of manufactured/processed to products. On the 30 % sourcing, the government expanded the definition of micro, small and medium enterprises (MSME), to include companies with a total investment of up to $ 2 million in plant and machinery will also be eligible for such sourcing of ' manufactured and processed' products. The 50% of the investment in back-end infra structure has been restricted to only the first tranche of $ 100 million.

JPMorgan to exit physical commodities biz

JPMorgan Chase & Co is exiting physical commodities trading, the bank said as Wall Street's role in the trading of raw materials comes under unprecedented political and regulatory pressure. The firm will explore "a sale, spinoff or strategic partnership" of the physical business. However, it will continue to trade in financial commodities such as derivatives and precious metals. Commodity decision's revenues last year were $2.4 billion (surpassing Goldman Sachs' and Morgan Stanley's combined). However, costs of running a huge logistical operation have reduced the profitability. Pressured by tougher regulation and rising capital levels, JPMorgan joins other banks such as Barclays and Deutsche Bank. This signifies an end of the period when investment banks across the world rushed to tap into volatile markets during a decade-long price boom.

Source: Wall Street Journal

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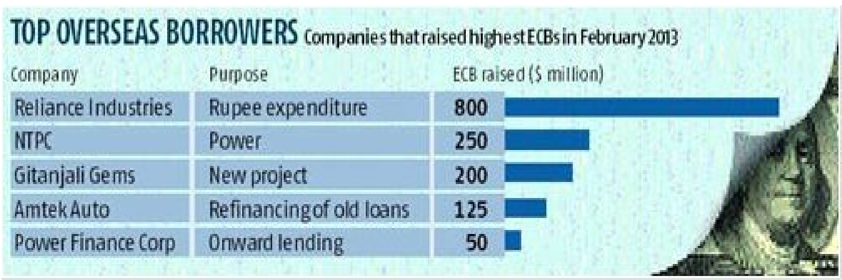
Easier and Bigger Borrowings made possible– The ECB Route !!

Government is planning to ease norms for raising funds through External Commercial Borrowings (ECB) specially for low-cost housing and infrastructure sectors like telecom and ports. This will be instrumental in financing of Current Account Deficit. ECB route allows borrowers to raise dollar loans from international banks, international capital markets, multilateral financial institutions like IFC and ADB, export credit agencies, suppliers of equipment, foreign collaborators and foreign equity holders. This would help as interest rates abroad are significantly lower. In January, Ministry had specified that ECBs up to $ 500 million can come in through the automatic route, provided the average maturity of the borrowing is over five years. Hitherto, ECBs only up to $ 50 million were permitted under the automatic route. Reporting mechanism for ECBs coming under automatic route will also be specified. An ECB window of $1 billion was made available for low-cost housing in December 2012.



TOP OVERSEAS BORROWERS Companies that raised highest ECBs in February 2013

Company	Purpose	ECB raised ($ million)
Reliance Industries	Rupee expenditure	800
NTPC	Power	250
Gitanjali Gems	New project	200
Amtek Auto	Refinancing of old loans	125
Power Finance Corp	Onward lending	50

Source: Economic Times

Unprecedented Jump in power tariffs— The Good and the Bad !!

Some of the recent UPA Government decisions, managed to create uproar in large communities.

These decisions include-

- Doubling the price of natural gas to $8.4 per million metric British thermal units (mmBtu),
- Allowing the additional cost incurred by companies on imported coal to be passed on to consumers
- Increasing domestic coal prices by an average 11 %

This would impact power companies, most of which are highly burdened with debt and are battling delayed payments by discoms. The decision will raise power tariffs by 15 paise per unit. This means an additional cost of Rs 13,680 crore for the consumers. Infrastructure Companies like GMR Infrastructure, GVK Power and Infrastructure, Reliance Power and state-owned NTPC will face the spillover effect. The revised generation cost of Rs 6.20 per unit for these companies is in stark contrast to the average cost of generation for coal-based power plants at Rs 3.50 per unit. However, even this price is soon going to go up. Finance minister P Chidambaram had indicated that power and fertilizer sectors would be insulated from the price increase, either by tweaking it or by having a separate input price for the sectors. Oil and gas explorer, including Reliance Industries and Cairn India, will be among the major gainers from the move.

The Industry body CII welcomed the change saying it would help upstream companies to invest in exploring more challenging frontiers to augment gas production for the country and also yield increased royalty and dividend to the Government. Also, the move is believed to bring much-needed investments in the hydrocarbon sector. Sector experts also believe that market determined pricing will attract long term investments and ultimately result in lower dependence on import of gas.

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Did You Know?

The total amount of all U.S. government liabilities, explicit and implicit (Social Security, Medicare, etc), stands at $57.7 trillion. That's around $180,000 owed by every man, woman and child in the U.S

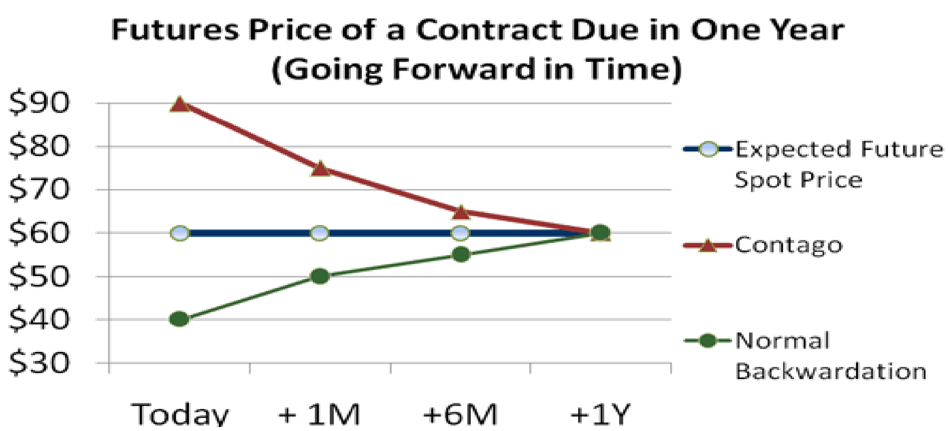
2008 was Berkshire & Hathaway's worst year in the 44 years that Buffett has been its Chairman. Net worth fell by $11.5 billion that year, a decline that reduced per-share book value by 9.6%. The only other year that saw a decline was 2001, when Berkshire's net worth fell by 6.2%.

October 13, 2008, saw the single-largest point gain in the Dow Jones Industrial Average. The index rose 936.4 points (11.1%). Just two days later, on October 15, the index posted its second largest point loss in history, falling 733.1 points (7.9%).

The Little Things

Backwardation- A term often used in commodities or futures markets to refer to markets where shorter-dated contracts trade at a higher price than longer-dated contracts. Plotting the prices of contracts against time, with time on the x-axis, shows the commodity price curve as sloping downwards as time increases.

Contango- It refers to a situation where the future spot price is below the current price, and people are willing to pay more for a commodity at some point in the future than the actual expected price of the commodity.



Hybrid Security- Any security that includes more than one component. For example, a hybrid security might be a fixed income note that includes a foreign exchange option or a commodity price option.

Knock-in Option- An option the existence of which is conditional upon a pre-set trigger price trading before the option's designated maturity. If the trigger is not touched before maturity, then the option is deemed not to exist.

Knock-out Option- An option the existence of which is conditional upon a pre-set trigger price trading before the option's designated maturity. The option is deemed to exist unless the trigger price is touched before maturity.

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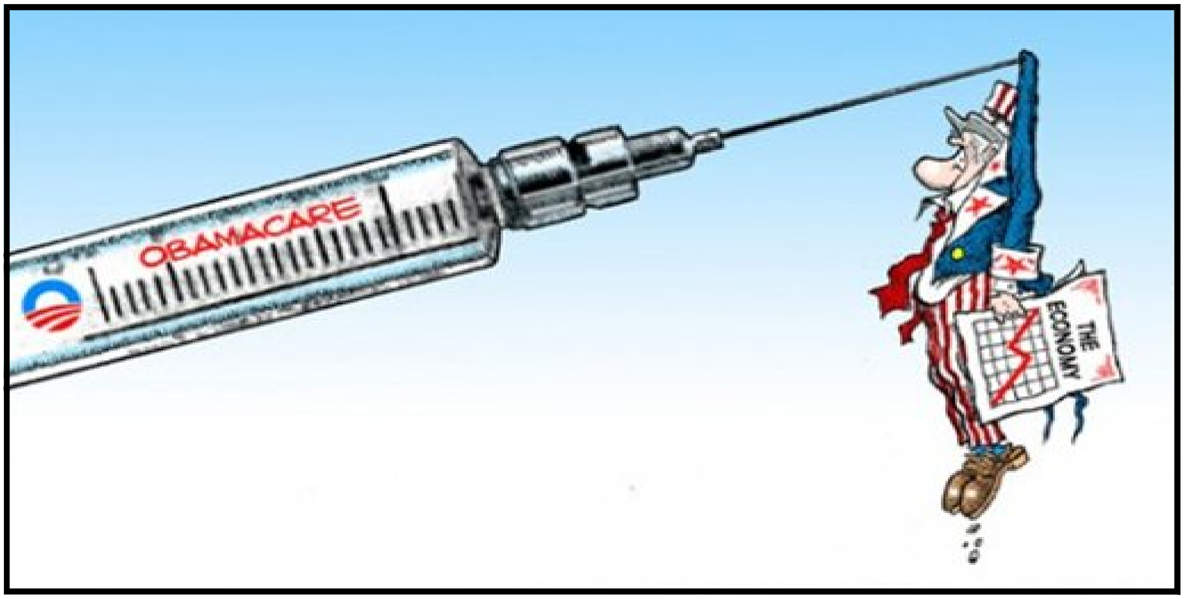
THE WRONG MEDICINE?



The Patent Protection and Affordable Care Act (PPACA), commonly called as Obamacare, is designed to increase the affordability and quality and rate of health insurance coverage for the Americans and at the same time reducing the overall cost of healthcare for its citizens and the government. PPACA funding is carried out via taxes and multiple offsets, major source include Medicare tax on incomes over $200,000, an annual fee from insurance providers and a 40% excise tax on "Cadillac insurance plan" policies. However, the sheer estimated size of the Obamacare is currently $2.6 trillion for the first decade according to one source, adding to the already $16 trillion of U.S. debt (approx) and estimated addition of $7 trillion of debt in U.S. economy in current decade, leading to increased taxation and hurting small businesses and individuals.

Beginning in 2014, more significant insurance reforms will be implemented. Insurers will be prohibited from denying coverage or setting rates based on health status, medical condition, claims experience, genetic information, evidence of domestic violence, or other health-related factors. A qualified health plan, to be offered through the new American Health Benefit Exchange, must provide essential health benefits which include cost sharing limits. No out-of-pocket requirements can exceed those in Health Savings Accounts, and deductibles in the small group market cannot exceed $2,000 for an individual and $4,000 for a family.

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NPA's and Bad Debts problems faced by Banks

A well developed financial system helps in smooth flow of savings and investment and thus supports economic growth. In India, banks and financial institutions play major roles in the financial system. To judge the efficiency of the banking sector, Non Performing Assets (NPA) is a very important basis. NPA's beyond a certain level are a cause for concern as credit plays a very important role in economic growth and NPA's affect the smooth flow of credit.

Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realisability of the dues:

- **Sub-standard assets**: A sub standard asset is one which has been classified as NPA for a period not exceeding 12 months
- **Doubtful Assets**: A doubtful asset is one which has remained NPA for a period exceeding 12 months.
- **Loss assets**: Loss assets are where loss has been identified by the bank, internal or external auditor or central bank inspectors but the amount has not been written off, wholly or partly.

Slack appraisal of projects, wrong projection of the demand of industrial sector, diversion of funds, willful default (or misappropriation of funds) by borrowers, political favors etc, have resulted in "Non Performing Assets" (NPA's). Adverse economic and market factors, ranging from recessionary conditions, regulatory changes and resource shortages to inefficient management and strained labour relations have impacted the health of businesses, and driven them to default on their loan repayments. Sometimes the banks themselves are responsible – delay in loan disbursement can throw a project off track, and have a cascading effect on its viability and capacity to repay. Banks have also been known to take comfort in collateral, and hence not follow up diligently enough on loan dues.

Companies had taken a lot of debt during India's boom several years ago, but are struggling to repay now that it is coming due. Kingfisher Airlines Ltd. defaulted on its debt last year, while companies like wind-turbine maker Suzlon Energy Ltd. and construction company HCC Ltd. have restructured their debt.

Ratings firm Crisil expects that the gross non-performing assets of all Indian banks would be 4% of total loans by end-March 2014 – the highest since 2005.

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The Great Indian Banking Divide

Public Sector banks have perennially had a much Higher NPAs that Private Sector Banks. Apart from higher rural lending by public sector banks, better risk management by Private Sector banks is cited to be another reason. Frequent changes in the top management of public banks also impact the decision-making. Going by 2011 data, Priority sector (lending to agriculture, small-scale industries, weaker sections, for housing (of less than Rs 25 lakh) and education) has accounted for close to three-fourths of incremental bad loans during the year ended March 2011. Although ratios of NPAs to advances to weaker sections have declined consistently from 5 per cent in 2008 to about 2.5 per cent in 2011, this has increased significantly in 2012, with strong implications for the financial inclusion exercise. Because of this, various banks tried including off-balance items in meeting priority sector credit targets. Off-balance sheet items include instruments like letter of credit (LC), bank guarantee (BG), derivative instruments (currency hedging) and others. They achieve their priority lending obligations by buying out loans from non-banking institutions or by investing in rural infrastructure development fund (RIDF) of the National Bank for Agriculture and Rural Development (Nabard) . ICICI Bank's rural loan book, in fact, declined by a little over Rs.2,000 crore in the last three years. The nation's largest lender, State Bank of India (SBI), more than doubled its farm loan book from 2009 to 2012.

Net non-performing assets of leading banks in 2012-13 in R crore

Bank	Mar '13	Mar '12	Change
SBI*	21,956	15,819	38.8%
BOB*	4,192	1,544	171.6%
Bank of India*	5,947	3,656	62.7%
PNB*	7,237	4,454	62.5%
Canara Bank*	5,278	3,386	55.9%
ICICI Bank	2,231	1,861	19.9%
Axis Bank	704	473	49.0%
HDFC Bank	469	352	33.1%
Kotak Mah Bank	311	237	31.2%
Indusind Bank	137	95	44.5%

*PUBLIC SECTOR BANKS.

The Financial Stability Report (FSR) released by the RBI blamed seasonality factors for the higher slippages in the March quarter of 2013, which traditionally sees higher bad loans.

Until now, RBI restructuring norms allowed banks to avoid applying the 'bad loan' tag on distressed accounts which were given additional time to tide over difficult circumstances . Classification of a loan as a bad loan forces the bank to set aside a large portion out of its earnings to make up for loss arising out of a potential default. However , the central bank has made exceptions for project delays in infrastructure and commercial real estate.

The Reserve Bank of India has said that from April 2015 banks will no longer have the leeway to relax repayment norms for troubled companies without classifying their loans as non-performing assets, which would lead to a surge in bad loans. RBI has also asked banks to increase provisions on loans restructured from June 2013 to 5% from the present requirement of 2.75%.

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Multitudes of Hazards

Under Basel III, higher NPAs would require higher provisioning, and therefore higher economic capital. For the public sector banks, this is going to pose additional challenges, given the fiscal situation. Also, if higher NPAs lead to higher write-offs, this will have negative effects on those who repay their loans promptly, and create a moral hazard problem. Among the banking groups, the deterioration is pronounced for public sector banks, followed by foreign banks. The capital adequacy ratio is disturbed and cost of capital goes up. The economic value addition (EVA) by banks gets upset because EVA is equal to the net operating profit minus cost of capital.

An important indicator of asset quality is Slippage ratio (addition of Gross NPAs during the year as a percentage of outstanding standard assets of the previous year). The slippage ratio of the banking system, which showed a declining trend during 2005-08, increased during 2008-12 .

Possible Solutions:

Banks must disclose the names of the accounts who have become NPAs. This will help other banks and financial Institutions be watchful of them. Banks can be asked to publish their action plan for NPA reduction. The proposal for a super regulatory body in the financial sector is being examined by the government. Banks should have adequate preventive measures, fixing presanctioning appraisal responsibility and having an effective post-disbursement supervision. A host of early warning signals used by different banks for identification of potential NPAs are-

Financial warning signals, such as Deterioration in liquidity/working capital position, Nonpayment of wages/power bills, Substantial increase in long term debts in relation to equity and Evidence of aged inventory/large level of inventory.

Management related warning signals- Change in management, ownership, or key personnel, Diversion of funds or Lack of co-operation from key personnel

Banking related signals- Sales transactions not routed through the account, Return of outward bills/dishonored cheques, or Frequent requests for loan.

Considering the importance of a healthy Banking system for the growth of an Economy, joint and prudential actions are necessary from Government and RBI, at the earliest.

As said by Nassim Nicholas Taleb, an essayist, scholar and statistician - "If you are in banking and lending, surprise outcomes are likely to be negative for you."

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