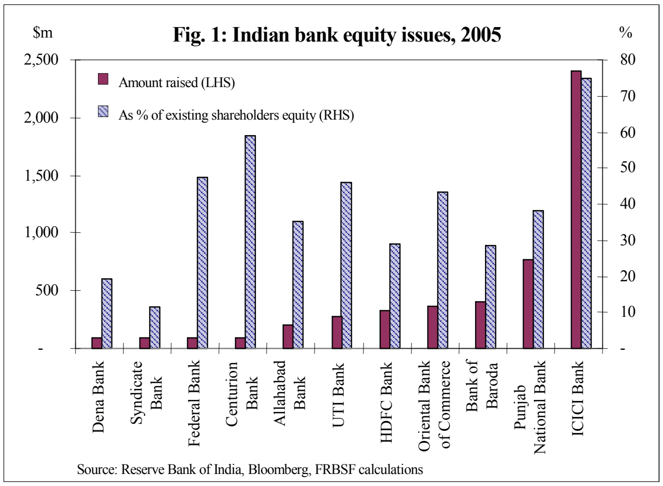
Asia Focus
COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO MARCH 2006

Indian Banks Tap Markets

While Chinese banks have garnered big headlines with mega-IPOs and strategic stake sales, Indian banks have quietly mounted a capital-raising campaign every bit as impressive. Buoyed by strong share prices, Indian banks have tapped local and offshore stock markets in unprecedented amounts over the past year. The remarkable wave of equity increases is strengthening balance sheets, supporting rapid growth in assets and reshaping industry structure. By some measures, Indian equity-raising exceeds Chinese levels, and India's market-friendly approach is allocating capital more efficiently and building a network of large, financially sound private banks.

EQUITY INCREASES WITHOUT PARALLEL

The number and amount of Indian bank equity increases the past year is without parallel in Asia. In 2005, sixteen banks announced new share issues, including 11 of the 18 banks in the Bombay Stock Exchange's index of leading bank stocks. The offerings increased shareholders equity of issuing banks by $4.7 billion, or 47 percent of March 2005 levels (Figure 1).



Banks accounted for a disproportionately large share of new equity issues in India last year. Whereas banks account for only 19 percent of Indian stock market capitalization as measured by the Morgan Stanley Capital International index series, local bank offerings equaled 30 percent of all the equity raised on India's two major stock exchanges. Including offshore sales, the bank totals equaled 46 percent of equity issues on the two exchanges. Although Chinese banks tapped markets for more than twice as much new equity as did Indian lenders last year, Indian banks issued much more capital relative to the size of the country's banking system. Indian equity offerings equaled 15.9 percent of local bank system equity and 0.9 percent of assets, against Chinese new issues equivalent to 10.6 percent of commercial bank equity and 0.4 percent of assets. No other Asian market came close to India for bank capital increases last year.

MOTIVATION

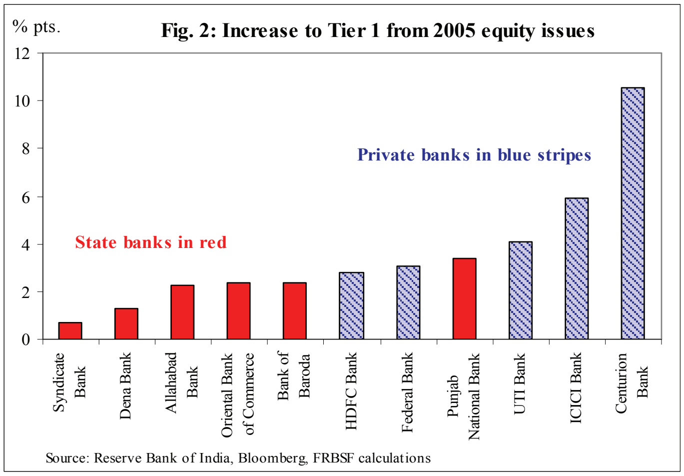
Necessity and opportunity are contributing equally to Indian banks' rush to raise equity. Regulatory issues clearly play an important role. The Reserve Bank of India is requiring lenders to comply with the Basel II standardized approach by March 2007, and banks for the first time must allocate capital for market and operational risk. Banks also need capital to support growth. System assets expanded 30 percent in the year through November 2005, and loan books will likely continue to grow rapidly this year. Savvy opportunism seems to have motivated some issuers. With share prices at all-time highs, even well-capitalized banks tapped markets, apparently to stockpile funds for times when markets might prove less generous. For all these reasons, Indian banks will almost certainly continue to raise capital this year, if market conditions permit.

RESHAPING THE INDUSTRY

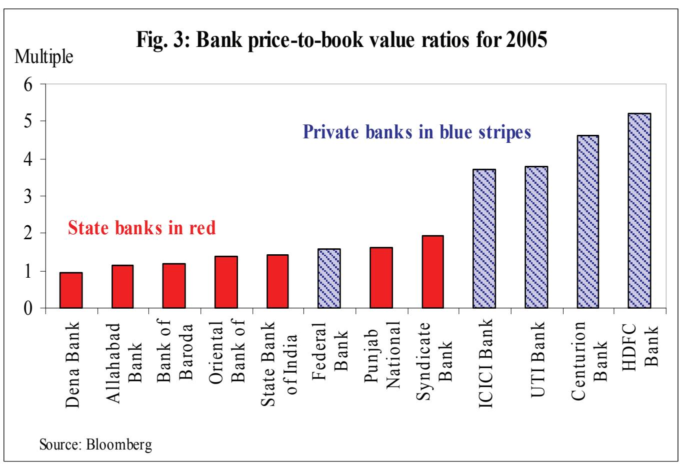
Capital increases are reshaping the Indian banking industry. For over a decade, a more commercial approach to lending has enabled private banks to increase assets faster than state banks. Now, superior access to external capital is providing private lenders an added boost. Despite having only one-quarter the assets of state banks, private banks raised 76 percent more equity last year. The difference has given private banks a sizeable capitalization advantage. Although it is impossible to determine the precise impact on BIS ratios given available public information, our calculations indicate that last year's equity sales raised private bank issuers' risk-based Tier 1 capital ratios by an aggregated 5.9 percentage points, or more than twice the 2.4 percentage point gain for state bank issuers (Figure 2). Bigger capital cushions will support faster growth at the private banks.

THE PRIVATE SECTOR ADVANTAGE

Private banks enjoy structural advantages in fundraising. Indian law requires state banks to maintain a minimum public ownership of 51 percent. With many large state banks already below 60 percent government ownership, few new



shares can be sold to the public. Even where state banks can accommodate additional private shareholders, markets offer more generous terms to private banks. Because investors perceive them as better-managed, private banks boast higher price-to-earnings and price-to-book value ratios than state institutions. HDFC Bank's earnings and book value ratios are more than twice those of the largest government bank, State Bank of India. Richer valuations translate to higher prices for new issues (Figure 3). Foreign investors give private banks an added edge. Whereas no state bank issuer raised money offshore last year, all but one of the private issuers sold shares in New York. Although requiring more burdensome disclosures than local offerings, U.S. listings fetch prices 10-20 percent above those of identical locally-listed bank shares. Offshore sales diversify private banks' investor bases and lower funding costs.

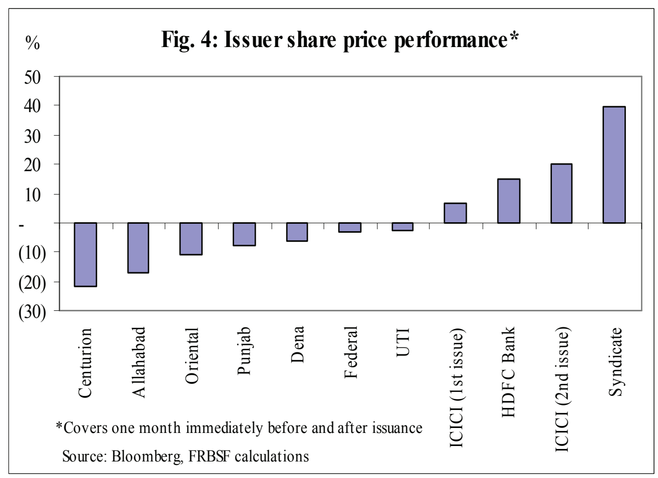


INDIA VS. CHINA

India has taken a starkly different approach to bank share sales from China. In China, where the government takes a greater role in setting economic priorities, the state allows only designated firms to sell new shares. In India, banks have been free to set their own issuance plans as long as they respect government ownership mandates. China, the world's foreign direct investment (FDI) champion, has sold numerous large bank stakes to foreign strategic investors. India, which discourages FDI with cumbersome legal constraints, has seen few foreign purchases of strategic bank stakes. The Chinese government has prioritized recapitalization of some of the most troubled banks – the Big Four – and a market-wide freeze on new issues has prevented smaller, oftentimes better-managed banks from tapping equity markets despite tight capital constraints. In India, markets are providing the greatest and cheapest funding to what markets rate the best-run institutions, the private banks. China's strategy is perpetuating the dominance of banks controlled by the central government. India's more laissez-faire approach is helping private lenders gain market share.

LENDING RISKS

Capital increases carry risks for Indian banks. If equity injections encourage unsound lending, bank financial health will suffer, not improve. It is worth recalling that almost all Thai banks raised equity in 1995-1996. While boosting Tier 1, the capital increases also supported the real estate lending boom that contributed to the Thai financial crisis in 1997. Indian banks must take care to manage their new capital prudently. Market reaction to Indian bank capital increases points to possible problems. Although locally-listed bank stocks in aggregate jumped 48 percent last year, the local stocks of most banks raising equity fell in the two-month span immediately before and after issuance (Figure 4). The market clearly likes the sector, but investors seem skeptical about how issuers will deploy their capital.



MARKET DISCIPLINE

But the benefits of Indian banks' increased reliance on markets appear to outweigh the risks. Indian banks are subjecting themselves to greater market scrutiny, and banks issuing in the demanding U.S. market are meeting especially high accounting, disclosure and corporate governance standards. Investors are alert to the risks rapid growth presents. They are funding most generously the banks with the cleanest balance sheets and the most sophisticated risk management procedures. Although capital increases might encourage excessive lending at some banks, in the long run market discipline should help create a stronger Indian financial system.

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