Global Equity Research

Indian Banks

Corporate governance– miles to go

- **Government banks are governed by parliamentary enactment** that accord minimal rights to non-governmental shareholders. These shareholders cannot adopt annual accounts, appoint auditors, or appoint or set the remuneration of executive directors. Until such provisions are amended, we believe it will be difficult to have corporate governance in government banks.

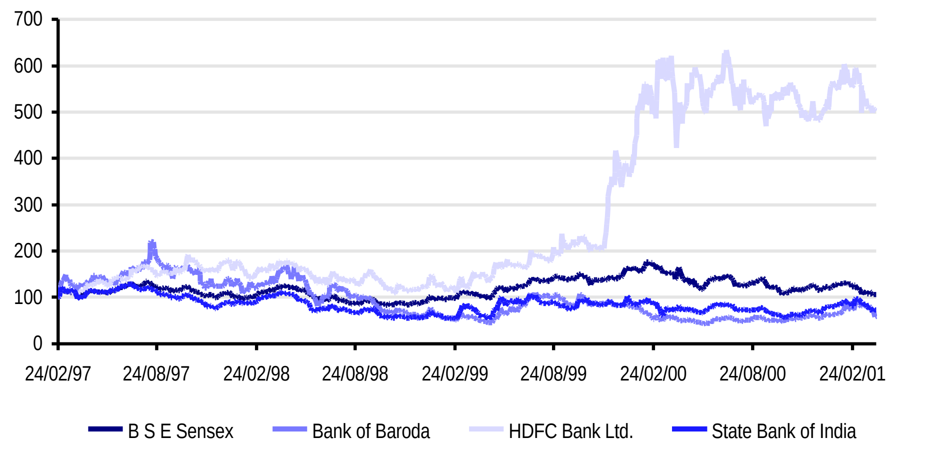
- **Private banks will be more responsible to minority shareholders,** following recent amendments to the Companies Act. We believe these legal safeguards, while reassuring in theory, can be illusionary in practice. Ultimately, it depends on whether the board of directors is actually able to supervise executives to any significant extent.

- **The absence of truly independent directors**—ie, directors who hold views that might be independent of those of the controlling shareholder or management—weakens the board of both government and private banks, in our view. We believe non-executive directors in both types of banks are chosen more for their compliant attitude rather than their independent views.

- **Our top picks are Bank of Baroda (BoB) and State Bank of India (SBI).** The recent affair surrounding co-operative banks following the collapse of Madhavpura Co-operative Bank has led to depressed share prices, particularly among bank shares. We believe this presents an opportunity to pick up SBI and BoB shares, the better-managed government banks, in our view.

- **We are reinitiating coverage on HDFC Bank with a Buy rating.** We believe it has digested the amalgamation with Times Bank and we view management's focus on growth and new products positively.

Select banks vs Sensex



Source: UBS Warburg

Sector Review

Hemindra Hazari
+9122-286 2059
hemindra.hazari@ubsw.com

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Hemindra Hazari
+9122-286 2059
hemindra.hazari@ubsw.com

Overview

Formal corporate governance code to be introduced in FY2001 annual reports

Compliance with the formal corporate governance code will be incorporated in FY2001 annual reports. However, it will take amendments to acts of parliament before the notion of corporate governance is taken on board in government-owned banks. The structure of corporate governance is being introduced for private banks by recent amendments to the Companies Act, which makes the board of directors more responsible and provides greater protection for minority shareholders. However, a word of caution: we believe that investors should not be dismayed by the lack of a corporate governance structure or conversely, lower their guard at elaborate corporate governance norms. Our report reveals that substance (eg, the importance of truly independent directors) is more important than form (compliance with the corporate governance code).

Table 1: Corporate governance structure checklist

	Government banks			Private banks		Institutions	
	SBI	BoB	Corporation Bank	ICICI Bank	HDFC Bank	ICICI	HDFC
Can shareholders adopt annual accounts?	No	No	No	Yes	Yes	Yes	Yes
One share one vote	No	No	No	No	No	Yes	Yes
Does the board appoint CEO and chairman?	No	No	No	Yes	Yes	Yes	Yes
Executive chairman	Yes	Yes	Yes	No	No	No	Yes
Does the CEO have five- year plus tenure?	No	Yes	Yes	Yes	Yes	Yes	Yes
Do shareholders appoint auditors?	No	No	No	Yes	Yes	Yes	Yes
Voluntary disclosure of executive directors' remuneration?	No	No	No	Yes	No	Yes	No
Audit committee of the board	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Nominations committee	No	No	No	Yes	No	Yes	No
US GAAP	No	No	Yes	Yes	No	Yes	No
Below-the-line deductions	No	No	Yes	No	No	No	Yes

Source: UBS Warburg

The lynchpin for corporate governance, independent directors, is missing

In both government and private banks, boards have not always exercised to any appreciable extent their oversight and supervisory powers over the executive. The missing element in both cases, we believe is the absence of truly independent directors, ie, directors who are both unrelated to management in any form and have the personal calibre to hold and air views independently of the controlling shareholder or management.

Our study demonstrates that minority shareholders have minimal rights in government banks, as the government has not amended relevant parliamentary acts, which are primarily concerned with safeguarding the interests of the government as the dominant shareholder. On the other hand, private banks, theoretically, accord full rights to shareholders as per the Companies Act. In practice however, executive directors and the dominant shareholder of private banks run their organisations unfettered by restraints that may be placed on them by non-executive directors who are usually silent partners.

We believe the depressed valuations of government banks reflect concerns that management is not responsible to minority shareholders that do not have meaningful rights. Conversely, we believe the market has not adequately recognised the efficient management at SBI and BoB, which is forcing these banks to better respond to market forces.

Madhavpura Bank collapses because of high risk lending to share brokers

Madhavpura Mercantile Co-operative Bank (Madhavpura), a Gujarat-based co-operative bank with a single but significant branch in Mumbai collapsed as a result of indiscriminate lending to share brokers and the collapse of share prices that were given as collateral. Madhavpura could not meet its obligations to other banks and its pay orders were not honoured. This dragged down the share prices of government banks that in accordance with market practice had discounted Madhavpura's pay orders. Newspapers report that Bank of India (BOI.BO, Rs11.00 NR) has been the worst hit, having lost almost Rs1.8bn while SBI has lost Rs410m.

Madhavpura Bank's problems adversely affects banks valuations

The fate of Madhavpura led to a run on other co-operative banks which had to be rescued by the Reserve Bank of India (RBI). In our opinion, investor confidence has been severely shaken and Madhavpura's fall has hit valuations of bank shares.

An opportunity to buy SBI and BoB

We believe the steep fall in the prices of bank shares presents an opportunity for bottom trawling. SBI and BoB have strong, responsible management with considerable skill and foresight in steering the banks' performance, in our opinion. We believe their promising prospects and attractive valuations should ensure them some weight in many portfolios.

Valuation

Sharp difference in valuation of government and select private banks

Table 2: Comparative valuations

		Share price	12-mth target price		FY2001E	
	Rec.	(Rs)	(Rs)	% upside	P/BV	P/ABV
State Bank of India	Buy	200	288	44%	0.8	1.2
Bank of Baroda	Strong Buy	44.00	80	81%	0.4	1.0
HDFC Bank	Buy	226	270	19%	6.1	5.9

Source: UBS Warburg

The valuation of the sector is sharply divided into two segments. The large government banks that dominate the sector such as SBI and BoB trade at low valuations and the private banks, for example, HDFC Bank, which command higher valuations.

The sharp difference in valuation has been attributed to many factors, including government ownership of banks. Such ownership is generally associated with inefficiency, a large work force, overextended branch networks, the inability to adapt to a changing environment, lack of technology and the large number of non-performing loans (NPLs).

Government banks could be re-rated if parliamentary acts are amended

While these factors partially explain the depressed valuations of government banks, we believe corporate governance concerns also play a major role. If the relevant parliamentary acts are amended, and recruitment, promotion and remuneration of management rationalised, we think there would be greater investor interest and the banks' shares might be re-rated. However, such amendments are unlikely to be introduced for another year, in our opinion.

From the reported book value we deduct 100% of net NPLs and add undisclosed reserves

In analysing banks, we believe reliance on reported book value can be misleading. This is due to the high amount of NPLs,[1] which is characteristic of the Indian banking system. Furthermore, some banks maintain 'secret reserves',[2] whereby they generally put away some profits in good years to boost profits in lean years. We estimate such reserves from tier-2 capital. Accordingly, when valuing an Indian bank, we adjust a bank's reported book value against both its net NPLs (ie, NPLs that have not been offset against profits) and secret reserves.

BoB a Strong Buy, SBI and HDFC Bank are Buys

We like SBI and BoB for their attractive valuations and their efforts at upgrading their technology. Their valuations have also come down sharply, following the problems at co-operative banks whose pay orders have been dishonoured following over-exposure to stock market speculative loans. We are also positive on HDFC Bank, although we believe that in the short term its large exposure to the capital markets needs to be monitored.

[1] An NPL is defined by the Reserve Bank of India as a loan where the borrower fails to pay loan instalments for 180 days. International best practice is 90 days.

[2] Indian banks are allowed to create secret reserves. These have all the characteristics of published reserves except that they are not disclosed in the annual accounts and are a component of Schedule 5 of the accounts in 'Other liabilities and provisions'. Banks are allowed to include secret reserves in tier-2 capital but not in tier-1 capital. If secret reserves are classified as general provisions then their inclusion in tier-2 capital is capped at 1.25% of risk weighted assets. International best practice does not recognise secret reserves. SBI, HDFC Bank, ICICI Bank and Corporation Bank maintain such reserves.

Categories of banks

Different categories of banks are governed by different acts

Different acts of parliament govern the diverse banks in India. All banks are governed by the Banking Regulation Act (BRA), 1949; the Reserve Bank of India Act, 1934; the Negotiable Instruments Act, 1881; and the Bankers' Books of Evidence Act, 1891.

Indian banks may be divided into five main categories:

SBI is governed by a separate act

- The first, SBI, a banking behemoth with 9,050 branches and Rs2,615bn in assets, is a category in itself. The largest bank in the world in terms of branches, the SBI is not a nationalised bank but is largely owned by the Reserve Bank of India and is governed by the SBI Act, 1955. SBI has seven subsidiaries that were formerly the state-run banks of seven erstwhile princely states. These subsidiaries are governed by the SBI (Subsidiary Banks) Act, 1959.

The Banking Companies Act governs nationalised banks

- The second category consists of 19 nationalised banks, which were nationalised in two waves of bank nationalisation, in 1969-70 and in 1979-80. These banks are governed by their respective acts of parliament which nationalised and acquired each bank, namely, The Banking Companies (Acquisition and Transfer of Undertaking) Acts of 1970 and 1980, and The Nationalised Banks (Management and Miscellaneous Provisions) Schemes.

- The third category consists of older private sector banks run by particular communities and which are strong in specific regions.

The new private banks, which were allowed in 1992-93, are governed by the Companies Act

- In the fourth category are new private sector banks that were established in 1992-93. Some were promoted by financial institutions, for example, ICICI Bank and HDFC Bank.

- The fifth category includes co-operative banks, which originate from co-operative societies, which are under the dual control of the RBI and the Registrar of Co-operative Societies of the state in which they are registered. The co-operative banks, (which have been severely shaken in the recent collapse of the Madhavpura Co-operative Bank) are outside the purview of this report.

The Companies Act regulates ICICI and HDFC

There are also financial institutions that are not banks such as ICICI and HDFC which are governed by the Companies Act, but are respectively regulated by RBI and the National Housing Bank (which is a 100%-owned subsidiary of RBI).

The third, fourth and fifth categories of banks are all companies incorporated under the Companies Act, 1956. These companies are licensed to operate as banks under the Banking Regulation Act, 1949. Their banking business is regulated by the Reserve Bank of India; as companies they are regulated by the Department of Company Affairs; and as listed companies they are regulated by SEBI and the stock exchange where their shares are listed.

Parliamentary acts need amending to provide boards with autonomy and responsibility

These statutes, especially those pertaining to the SBI, its subsidiaries and the nationalised banks have certain provisions that contradict many of the basic tenets of corporate governance. These parliamentary acts were conceived in an era where the government owned 100% or close to 100% of the banks. However, in the 1990s, when the government diluted its holdings, it amended only those sections diluting government ownership, leaving untouched the sections pertaining to government control. These acts therefore require amending to vest power and responsibility with the board of directors of individual banks, to grant them autonomy and make them responsible to the non-governmental shareholders.

What is corporate governance?

Accountability rests with the board of directors

Corporate governance has gained importance following the publication of the *Cadbury Report* in December 1992. The Committee was set up in the UK in the wake of the problems at Bank of Commercial and Credit International (BCCI), Maxwell, and the controversy over directors' pay.

The Cadbury Report defines corporate governance as: "The system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship." [3]

Markets and investors reward companies that have strong corporate governance with higher valuations. The belief is that boards with sufficient autonomy take decisions for improving performance within a system of accountability. The Securities Exchange Board of India-appointed *Kumar Mangalam Birla Committee on Corporate Governance* (January 2000) observes: "[Corporate governance] is the blood that fills the veins of transparent corporate disclosure and high-quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure. Without financial reporting premised on sound, honest numbers, capital markets will collapse upon themselves."

The regulator and the government are the interested parties in banks

Banks play a strategic role in any economy, especially where capital markets are evolving. Given their importance to the economy, banks are in a highly regulated industry with access to government safety nets. While in other companies, the responsibility for reviewing and reporting to the shareholders is with the directors, in banks it has to be broader to include stakeholders (depositors, employees, customers and the wider community) too. As the Basel Committee on Banking Supervision states: "Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders."[4]

The issue of corporate governance is gathering steam in India. The capital market regulator, Securities Exchange Board of India (SEBI), has recently issued a set of guidelines. These include the so-called "mandatory recommendations", whereby listed companies above a certain size are now required to disclose whether they conform with the mandatory recommendations in their forthcoming FY2001 annual reports.[5]

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[3] *The Financial Aspects of Corporate Governance*, 1 December 1992.

[4] *Enhancing Corporate Governance for Banking Organisations*, September 1999.

[5] The new clause in the Listing Agreement, namely clause 49, is available on the SEBI website. www.sebi.gov.in/circulars/2000/CIR102000.html.

Equitable treatment of all shareholders

Minority shareholder interests have to be protected

One of the basic principles of corporate governance is the equitable treatment to all shareholders. The *OECD Code on Corporate Governance* lays particular importance on the equitable treatment of all shareholders which is important in a system of dominant shareholders where the corporate governance issue is mainly the protection of minority rights. Minority shareholders' apprehensions over the misuse of their capital by dominant shareholders or executive directors need to be addressed. Minority shareholders' confidence can be enhanced if the legal system provides the means to quickly redress any violation of their rights. In India, this is extremely important in the case of government banks where the government owns over 56% of these banks. However, as we illustrate, the statutes that govern these banks discriminate against minority, ie, non-governmental, shareholders.

Non-governmental shareholders cannot approve the annual accounts

Shareholders of government banks at annual general meetings (AGMs) can "discuss" the balance sheet and the profit-and-loss account, but are forbidden from approving them.[6] Private banks that are governed by the Companies Act have to present audited accounts to their AGMs for the shareholders' approval. The government proposes to pass a bill in parliament which will enable shareholders present at the AGM to "discuss and adopt"[7] the balance sheet and profit-and-loss account of nationalised banks.

Restrictions on voting rights

In private sector banks shareholders owning 10% or more of a bank's outstanding equity can only vote on 10% of the outstanding shares.[8] Therefore, in ICICI Bank in which ICICI currently owns a 47% stake, it can only vote on 10%. In SBI, no shareholder other than RBI, which holds a 59.7% stake, is entitled to exercise voting rights in excess of 10% of the issued capital.[9] The situation is worse for the nationalised banks where no shareholder is entitled to exercise voting rights in excess of 1% of the total voting rights.[10]

Appointment of auditors

Shareholders generally appoint auditors at AGMs

The annual audit is a cornerstone of corporate governance. The directors are required to report on their performance through their annual reports and financial statements to shareholders. The audit and the auditors are critical components of the checks and balance system and comment on management's presentation of its performance. The appointment of the auditors should therefore vest not in the hands of the directors but in the general body of shareholders at the annual general meeting.

[6] Section 42 (2), SBI Act and Section 10A(2) of the Banking Companies Act.

[7] Section 6, The Banking Companies (Acquisitions and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Bill, 2000. Bill No. 195 of 2000, page 3.

[8] Section 12 (2), Banking Regulation Act.

[9] Section 11, SBI Act.

[10] Section 3 (2E), Banking Companies Act.

RBI appoints the auditors for government banks

However, according to the governing statutes of the nationalised banks and SBI the general body of shareholders has no role in the appointment and remuneration of auditors. In government banks, auditors are appointed and their remuneration set by the RBI in consultation with the central government.[11] In practice however, some latitude is provided. The Standing Committee on Bank Audit, representing the comptroller and auditor general (CAG), RBI and the central government, prepares a panel of eligible auditors. A short-list from this panel is provided to the board of directors from which the board makes its selection, and RBI then gives the necessary approvals. The minority shareholders, however, have no say in the approval of the auditors. The report of the auditors is addressed to the "President of India", while in private banks the auditor's report is addressed to the shareholders.

The role of the chairman

Critical role of the board chairman

The chairman of a bank's board of directors plays a crucial role in securing sound corporate governance, and the functioning of the board depends on the chairman. The chairman should be able to distance himself from the day-to-day running of the bank while ensuring that the board supervises the bank's management and ensures that the interests of shareholders and stakeholders are protected. The appointment of the chairman is therefore one of the most critical decisions which the board undertakes.

The board in government banks has no role in the appointment of the chairman

The posts of chairman and managing director are combined in one post in government banks. The chairman-cum-managing director (CMD) is appointed by the central government in consultation with the RBI.[12] The CMD's tenure, remuneration and termination of service are determined by the central government in consultation with RBI and not by the board.[13] Hence, while the board has to report to the bank's shareholders it is powerless in the vital decisions of appointing the chairman and determining his remuneration and removal.

The government appoints all executive directors of SBI

The situation in SBI is similar. The government can nominate a maximum of seven directors, the RBI nominates one and minority shareholders elect a maximum of four directors. Here again the appointment, remuneration and tenure of the chairman, vice-chairman and the two managing directors (ie, all the executive directors) are determined by the central government in consultation with the RBI.[14] Again, the board is powerless in these matters.

If the principles of corporate governance are to be followed in SBI and the nationalised banks, the respective statutes will have to be amended to make their boards accountable for their decisions. As the majority shareholder, the government has the right to appoint directors to look after its interest but having appointed directors it must repose confidence in them to take key decisions. The current system may have worked when the government had 100% ownership but now that non-governmental ownership has increased to 30% and the government is considering lowering its stake in nationalised banks to 33%, then authority and responsibility must rest with the board, in our opinion.

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[11] Section 41 (1) (2), SBI Act and Section 10, Banking Companies Act.

[12] Section 5 (1), Nationalised Banks Scheme.

[13] Section 8, Nationalised Banks Scheme.

[14] Sections 19-20, SBI Act.

HDFC Bank and ICICI Bank do not have chairmen

While government banks depend on the government to appoint their chairmen, private banks such as ICICI Bank and HDFC Bank depend on their boards of directors to elect their chairmen. However, ICICI Bank has been without a chairman for almost three years, while HDFC Bank has not had a chairman since 1 January 2001.

Separation of the posts of chairman and CEO

International best practice is veering to the view of separation of the posts of chairman and CEO

Anglo-American opinions on the corporate governance issue of keeping the role of chairman and chief executive officer (managing director) separate and distinct are divided. *The Cadbury Report*, recommends that, "Given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive." The *European Association of Securities Dealers (EASD)*, recommends that, "In one-tier board systems, the positions of chief executive officer and chairman of the board should preferably be distinct, subject to legal constraints; if not, the company should disclose and explain its decision."[15]

From across the Atlantic, the *Business Roundtable* (an association of CEOs committed to improving public policy), argues, "Most corporations will continue to choose, and be well served by, unifying the positions of chairman and CEO. Such a structure provides a single leader with a single vision for the company and most Business Roundtable members believe it results in more effective organisation."[16]

The roles of chairman and CEO are combined in Indian government banks

In nationalised banks in India, the posts of chairman of the board and the managing director (CEO) are unified and the post is the 'chairman and managing director'. Thus, power is consolidated in the hands of a single individual.

SBI chairman has all the powers of the board

The SBI Act provides for all powers of the board to vest in the chairman: "Subject to such general or special directions as the Central Board may give, [the chairman can] exercise all such powers and do all such acts and things as may be exercised or done by the State Bank."[17] The powers of SBI vice-chairman and managing director are restricted to the "duties delegated to him by the Central Board".[18]

Even though SBI has two managing directors, the roles of chairman and CEO are combined in the chairman's post. The chairman of SBI and the CMDs of nationalised banks are extremely powerful board members because they are executive chairmen.

HDFC has an executive chairman

HDFC effectively combines the roles of CEO and chairman in a single position. HDFC also has the post of managing director, which is subordinate to that of the chairman.

We believe a non-executive chairman who is independent, unrelated to the promoters, is not a business associate of the management or of a significant shareholder, is necessary to protect minority shareholder interests and to effectively supervise the executive.

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[15] *Corporate Governance Principles and Recommendations*, May 2000.

[16] *Statement of Corporate Governance*, September 1997.

[17] Section 27, SBI Act.

[18] Section 28(1) and 29 (1)(b), SBI Act.

Executive management

Clearly defined roles required for CMDs and EDs in government banks

In nationalised banks, the roles of CMD and the second-in-command, the executive director (ED), are not well defined. We believe that in the interests of corporate governance, these roles should either be clearly defined or modified. Either the powers of the ED should be delineated from those of the CMD or the post of ED abolished, or alternatively the ED becomes the CEO and another individual is appointed as the non-executive chairman.

Table 3: Executive directors at listed government banks

Bank	Designation	Career officer	Tenure
SBI	Chairman	SBI	2yrs
	MD	SBI	1yr 3mths
	MD	SBI	1yr 6mths
BoB	CMD	Bank of India	5yrs
	ED	BoB	5yrs
Bank of India	CMD	Central Bank of India	3yrs
	ED	BoB	5yrs
Oriental Bank of Commerce	CMD	Union Bank of India	5yrs
	ED	Central Bank of India	5yrs
Syndicate Bank	CMD	Syndicate Bank	2yrs
	ED	-	-
Dena Bank	CMD	Bank of Maharashtra	3yrs 7mths
	ED	Punjab and Sind Bank	3yrs
Corporation Bank	CMD	Bank of India	5yrs
	ED	Punjab National Bank	5yrs

Source: Banks, UBS Warburg

Executive management has no prior experience of working together

With the exception of SBI, the government usually follows the practice of appointing the CMD and ED from other banks. As a result, the CMD and ED are generally from different banks and have no prior experience of working with each other and with other members of management of the bank.

CEOs have limited tenure

Another important feature that Table 3 highlights, is the limited tenure of CEOs. With the exception of BoB, Oriental Bank (ORBC.BO Rs39, NR) and Corporation Bank (CRBK.BO Rs110 NR), all the other CEOs (CMDs) have tenures of less than four years. In our view the implication of the short tenure is that it prevents dynamic CMDs with ideas and leadership qualities from implementing their vision. We are concerned that these banks may consequently suffer from lack of a long-term strategy, continuity and focus.

Table 4: Executive directors at ICICI, HDFC, ICICI Bank and HDFC Bank

Institution	Designation	Career officer	Tenure
ICICI	Chairman emeritus	SBI, ICICI	-
	MD, CEO	ICICI	10yrs
	JtMD, COO	ICICI	5yrs
	Deputy MD	ICICI	5yrs
HDFC	Chairman	HDFC	9yrs
	MD	HDFC	5yrs
	ED	HDFC	3yrs
	ED	HDFC	3yrs
HDFC Bank	Chairman		-
	MD	Citibank	8yrs
ICICI Bank	Chairman		-
	MD, CEO	Union Bank of India	5yrs

Source: Institutions, banks and UBS Warburg

Executive directors in private banks have longer tenures

Table 4 indicates that executive directors at ICICI, HDFC, HDFC Bank and ICICI Bank are career officers with their respective institutions. At relatively new institutions such as HDFC Bank and ICICI Bank they have reasonably long tenures. Therefore, we perceive them as being closely tied to the performance of the organisations they head and they have a reasonable tenure within which can they implement their vision and strategy.

The role of independent directors

The success of corporate governance requires independent directors

According to SEBI, at least one-third of the board should consist of independent directors. Independent directors are defined as "directors who apart from receiving Directors' remuneration do not have any other material, pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect a director's independence of judgement."

However, one of the largest pension funds in the US, the California Public Employees Retirement System (CalPERS), lays down a more stringent definition of "independent director" that encompasses facets other than remuneration and pecuniary relationship.

CalPERS's definition of independence is more stringent than that of SEBI

According to CalPERS, an "independent director" is a director who:[19]

- "has not been employed by the Company in an executive capacity within the last five years;
- is not, and is not affiliated with a company that is, an adviser or consultant to the Company or a member of the Company's senior management;
- is not affiliated with a significant customer or supplier of the Company;

[19] *Corporate Governance Core Principles and Guidelines*, CalPERS, 13 April 1998.

- has no personal services contract(s) with the Company, or a member of the Company's senior management;

- is not affiliated with a not-for-profit entity that receives significant contributions from the Company;

Fewer non-executive directors will qualify as "independent directors" according to the CalPERS definition

- within the last five years, has not had any business relationship with the Company (other than service as a director) for which the Company has been required to make disclosure under Regulation S-K of the Securities and Exchange Commission;

- is not employed by a public company at which an executive officer of the Company serves as a director;

- has not had any of the relationships described above with any affiliate of the Company; and

- is not a member of the immediate family of any person described above."

As per the more rigorous CalPERS definition, fewer non-executive directors in India would meet this test of 'independent director'."

Table 5: Composition of board of directors

Company	Size of board	Executive directors	Non-executive other than nominees	Promoter nominees	Strategic partner nominees	Government nominees	Employee nominee	Officers' nominee	RBI nominee
SBI	16	3	5	0	0	5	1	1	1
BoB	8	2	3	0	0	1	0	1	1
Corporation Bank	10	2	4	0	0	1	1	1	1
HDFC Bank	10	1	4	3	2	0	0	0	0
ICICI Bank	8	1	5	2	0	0	0	0	0
HDFC	15	4	11	0	0	0	0	0	0
ICICI	15	3	8	2	0	2	0	0	0

Note: As at April 2001.
Source: Companies, UBS Warburg

Table 6: Directors and shareholding

(%)	ED/ total directors	Non-executive other than nominee directors/ total directors	Holding of single largest shareholder	Largest shareholder
SBI	18.8	31.3	59.7	RBI
BoB	25.0	37.5	66.2	Govt. of India
Corporation Bank	20.0	40.0	68.3	Govt. of India
HDFC Bank	10.0	40.0	28.0	HDFC
ICICI Bank	12.5	62.5	47.0	ICICI
HDFC	26.7	73.3	10.0	Standard Life
ICICI	20.0	53.3	11.1	Life Insurance Corp.

Source: Companies, UBS Warburg

Looking at the composition of the board of directors of select banks and institutions (Table 6), the category of "Non-executive other than nominees" varies from 73% in HDFC to 31% in SBI, which reflects the non-promoter, non-strategic shareholding interest, which in HDFC is 75.4% and 40% in SBI. In the case of private banks, directors representing promoters' interests on the board of private banks cannot exceed three persons.

Non-executive directors are rarely independent

According to a recent study sponsored by Queen Elizabeth House, Oxford University, *Corporate Governance and the Indian Private Sector* (January 2001),[20] "The most striking and commonly agreed feature of corporate governance practices in Indian private sector companies has been the widespread and widely perceived failure of boards. The board simply does not exist as an institution of governance in the private sector, except in a handful of companies…*truly independent directors are rare in Indian companies* [emphasis ours]."

Accounting issues

Accounting can be tricky

Accounting issues are extremely important in banking as the nature of the business makes it difficult for outsiders to determine the quality of loans and whether banks and financial institutions have 'secret reserves' or 'hidden losses'.[21] Furthermore, due to the practice of 'evergreening' (new loans disbursed to service instalments of earlier loans) and under-provisioning for bad debts, it is difficult to determine the actual quality of profits. Banking secrecy laws also prevent disclosure of clients' names and particulars. Banks can only disclose their client lists in cases of lawsuits filed against bad debt accounts. The shareholders, particularly the minority shareholders, are totally dependent on management's presentation of the accounts. We believe this problem could be lessened if 'independent directors' play a proactive role in the management and supervision of the board.

RBI has the authority to relax stringent accounting norms

The Banking Regulation Act does lay down some stringent accounting practices, for example:

- A bank is not allowed to declare a dividend unless all its capitalised expenses are written off.[22]
- The creation of a reserve fund is mandatory. Banks have to transfer a minimum of 20% of their profits to this reserve before any dividend is declared.[23]

However, the RBI can exempt banks from these requirements and the regulator has, unfortunately, been liberal in disbursing this privilege. For example, ICICI Bank declared a dividend in FY2000 even though it will amortise its ADR expenses over three years. Furthermore, government banks have recently been allowed to amortise their voluntary retirement scheme (VRS) expenses and still announce dividends.

[20] The study was conducted by Jairus Banaji and Gautam Mody with a research grant from the Department for International Development, UK.

[21] Loans not classified as non-performing or insufficient provisions for NPLs.

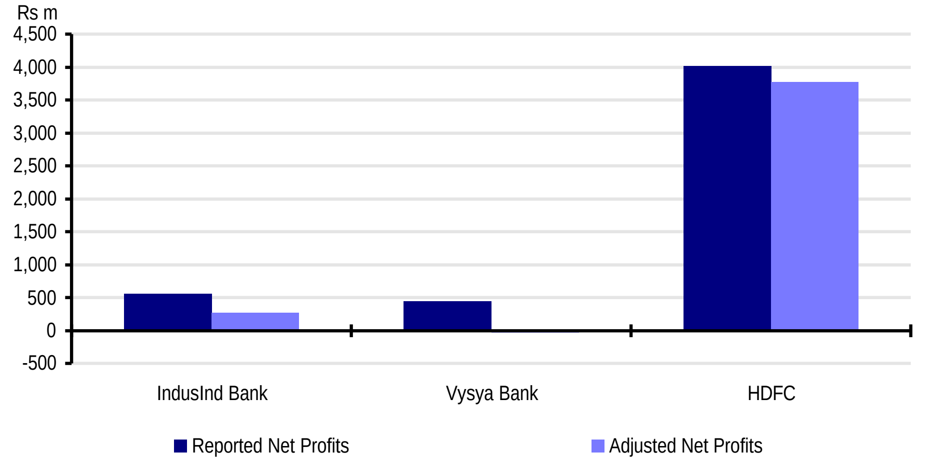
[22] Section 15(1), Banking Regulation Act.

[23] Section 17 (1), Banking Regulation Act.

Below-the-line deductions are permitted in Indian banks

A practice which RBI and NHB, unfortunately, tolerate is the utilisation of shareholder funds to report higher profits (below-the-line deductions). Private sector banks, IndusInd Bank (INBK.BO Rs13.70, NR) and Vysya Bank (VYSA.BO Rs108, NR) were allowed to overstate reported earnings in FY2000 by writing down their reserves. For HDFC this has been an annual feature since FY1997. HDFC's practice is not strictly comparable with the other two banks since the concerned reserve can be utilised for bad debt provisions. This is our view is not a prudent accounting practice.

Chart 1: Dipping into shareholder funds to report higher profits FY2000



Source: Annual reports, UBS Warburg

Consolidation of accounts

Banks present non-consolidated earnings

In India, companies report non-consolidated accounts and their subsidiaries' (where holdings exceed 51%) accounts are included in the annual report. For banks this will become mandatory in FY2001. While the majority of the listed government banks have only a few insignificant subsidiaries, SBI is a notable exception. SBI has eight commercial bank subsidiaries and these subsidiaries together constitute India's second largest bank in terms of deposits and credit after SBI. ICICI and HDFC are two of the few institutions to present consolidated accounts.

Disclosure and transparency

We believe a strong commitment to transparency and disclosure attracts capital and helps maintain confidence in the capital markets. International experience, particularly in countries with large and active stock markets, reveals that disclosure enhances shareholders' ability to exercise their voting rights and is an appropriate mechanism to supervise and monitor the performance of corporate management.

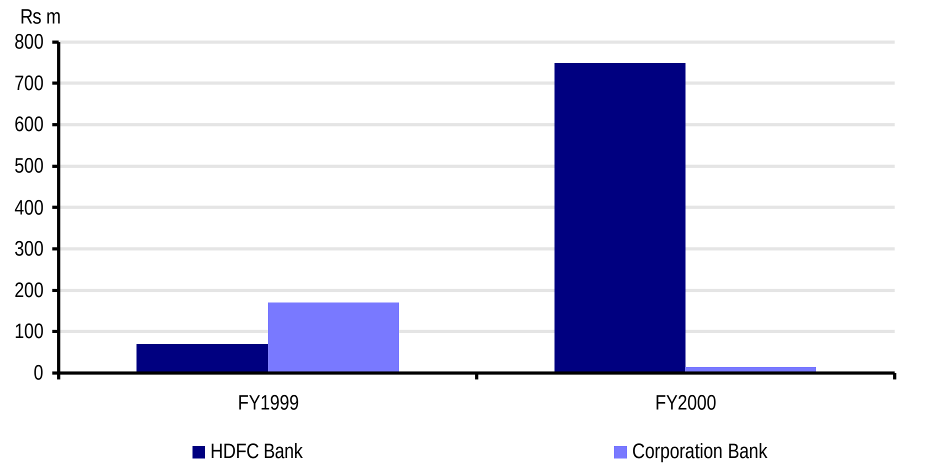
More disclosures required for analysis of bank performance to be meaningful

While the RBI has improved disclosure procedures in the annual reports of banks, we believe these are still inadequate. Greater disclosure by the banks is required in terms of the sector and maturity of NPLs, profitability of various divisions, average weekly/monthly balance sheet and more disclosure on interest income, interest expense, fee income and composition of capital adequacy. It is only with the wider dissemination of information that meaningful analysis can be done by shareholders, depositors and analysts. We believe that RBI ratings for banks should also be disclosed since there appears to be a discrepancy between the financial institutions' 'true and fair view' and that of RBI inspectors. It must be noted that banks and other financial institutions regulated by RBI have to conform finally to the RBI inspector's 'true and fair view' of the accounts.

Some banks resort to evening-out of earnings

The practice of evening-out earnings is often resorted to in banks given the existence of general provisions, which are not disclosed to shareholders. We believe profits can be inflated by utilising these general provisions and profits can be suppressed by adding to the general provisions. Such practices, however, are contrary to the principles of corporate governance. Corporation Bank wiped out the bulk of its general provisions in FY2000 to report profits in line with market expectations. HDFC Bank created a substantial general provision as a result of its merger with Times Bank in FY2000. Both banks did not disclose this vital information to shareholders in their directors' report.

Chart 2: General provisions: the hidden cushion



Source: Annual reports

ICICI the most transparent

We believe ICICI is far ahead of the other banks and financial institutions in its disclosure practices. Its annual report and quarterly reports contain disclosures that go beyond the minimum requirements. ICICI, ICICI Bank and Corporation Bank are among the few financial institutions that report their accounts in US Generally Accepted Accounting Principles (GAAP), which requires more disclosures than Indian GAAP.

Board remuneration

We believe shareholders have a right to know the amount of their directors' remuneration, both present and future, and the manner in which it has been determined. At the same time, executive remuneration should be sufficient to attract and retain members of the stature required by the company, in our opinion. International best practice is to establish a compensation committee of the board, generally composed of non-executive directors, to determine the remuneration packages of the executive directors.

Not all companies voluntarily disclose employee remuneration

In India, private banks, which are governed by the Companies Act, have to disclose in their annual reports the remuneration of all employees who are earning in excess of Rs600,000 per annum. Unfortunately, some companies such as HDFC and HDFC Bank did not voluntarily disclose this information in their annual reports and shareholders had to specifically ask for it. However, all companies are required to disclose the full remuneration details of their employees in their annual reports from FY2001.

As the government determines the salaries of the executive directors in government-owned banks, the issue of the board or the compensation committee evaluating salaries does not arise.

While government banks do not have to disclose this information, it is generally accepted that the salaries of their executive directors are significantly lower than in the private sector banks and financial institutions.

Government banks have not allotted stock options to their employees

Salaries and bonuses are only one part of the total compensation package that executives receive. A much larger compensation would be in the form of stock options and shares of the company. We believe these must also be disclosed to shareholders. ICICI, ICICI Bank, HDFC and HDFC Bank have been giving their employees shares and stock options as part of the overall remuneration package to retain and attract talent.

Declaring stock options allotted to executive directors will be mandatory in FY2001

Only ICICI voluntarily discloses stock options and shares awarded to individual executive directors in its annual reports. The practice of non-disclosure will change with the new corporate governance code, which comes into effect in FY2001 whereby individual employees, especially the executive directors, who are allotted share and stock options will have to be named.

Bank of Baroda (Reuters: BOB.BO)

Strong Buy

Price: Rs44.10 (12-month range: Rs75.40 - 34.25)

Price target: Rs80.00 (+81%)

Restructuring and a reduced labour force should, we believe, drive earnings in FY2002E. To sustain growth, the bank plans to transform itself into a technologically advanced institution to woo customers and investors.

Rsm	Net profit	UBSW EPS (Rs)	RoE	RoRWA	DPS (Rs)	P/E*	P/Op*	Yield*	Stated BVPS (Rs)	P/True BVPS*
03/99	4,212.60	14.33	17.1%	1.09%	3.00	3.1x	1.4x	6.8%	88.15	1.2x
03/00	5,027.70	17.10	18.2%	1.76%	4.00	2.6x	1.2x	9.1%	100.02	1.0x
03/01E	2,080.42	20.27	20.0%	1.84%	4.00	2.2x	1.1x	9.1%	102.73	1.0x
03/02E	8,171.04	27.76	24.3%	2.21%	4.00	1.6x	0.9x	9.1%	126.09	0.7x
03/03E	10,036.08	34.10	24.2%	2.35%	4.00	1.3x	0.7x	9.1%	155.80	0.5x

* Valuations based on share price of Rs44.10 on 10/04/01

Winds of change

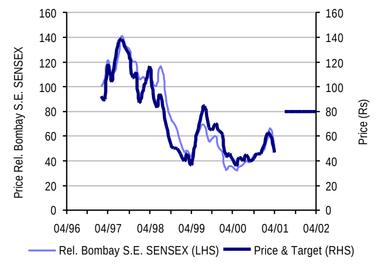
- **Boost to earnings.** We believe the downsizing, streamlining and reorienting being undertaken by the organisation will drive ROE to 24% in the short term.

- **Launch of new products with a technological initiative.** Networking of branches will commence by November 2001. With the technology roll out, BoB should have the capability to launch new products and sustain strong earnings growth.

- **Attractive valuation.** Our 12-month target price is Rs80.00 at 1.2x FY2002E adjusted NAV. After factoring in earnings growth and restructuring plans, we believe the valuation is attractive.

Hemindra Hazari
+9122-286 2059
hemindra.hazari@ubsw.com

Market capitalisation	Rs13,053.6m/US$280.4m
Tier 1 ratio	8.9%
Cost/income ratio	55.3%
4-year CAGR EPS (1999-2003E)	24.2%
Free float (Ord)	33.78%
Major Shareholder	Government of India (66.2%)
Company web address	www.bankofbaroda.com



Source: UBS Warburg

IT transformation

Implementing a comprehensive IT plan

BoB, India's second largest bank, plans to transform itself into a technologically savvy bank, which is capable of adapting itself to the ongoing changes in the financial sector. BoB has appointed Gartner, a global IT consultant, as adviser on its IT plans to roll out new products, such as retail lending, cash management services and capital market-related activities.

Networking of branches to commence from November 2001

BoB plans to invest Rs2.5bn in its IT initiative, and we expect a new business and IT plan to be announced by October 2001. BoB expects to network 500 of its key branches, which will account for approximately 50% of its business by April 2003. By October 2004, 1,000 metro, urban and quasi-urban branches should be networked. Once the key branches are connected to the central database, BoB plans to launch a series of products, such as Internet banking.

Table 7: Time frame for IT roll out and networking of branches

Gartner appointed as IT consultant	February 2001
Business strategy plan	July 2001E
IT strategy plan	October 2001E
500 metro/urban branches networked	April 2003E
500 urban/quasi-urban branches networked	October 2004E

Source: BoB

We believe the networking of branches is crucial for the success of new products, as customers have become more demanding. BoB should be able to leverage off its extensive branch network to penetrate the retail finance, cash management and capital market-related services segments, in our view.

Retail loans

Significant growth projected for retail loans

Retail loans (housing, consumer durables, automobiles, educational and personal) stood at 3% (Rs7.3bn) of total credit in FY2000. BoB is focusing on the retail segment, since the mid-sized corporate segment is considered high risk. We expect retail loans to be 5% (Rs14.1bn) of total credit by FY2001E and to grow to 7% (Rs22.7bn) by FY2002E.

BoB has 20m retail accounts

We believe the potential for retail finance is considerable. BoB has approximately 20m accounts. Assuming it manages to sell loans worth Rs500,000 to 1% (200,000 accounts) of its customer base, retail loans would total Rs100bn. More importantly, we believe BoB would not have to incur marketing costs to acquire new business, as customers are already in place. What BoB should do, in our opinion, is to identify and sell loan products to its customers, which should be possible once its technology backbone is in place and management is more proactive. In our opinion, such a customer base would be low risk.

Table 8: Impact of VRS on BoB's FY2001E net profits

Employees applying for VRS	6,763
Per employee cost (Rs m)	0.93
Gross cost of VRS (Rs m)	6,317
Savings on taxation (Rs m)	2,432
Net VRS cost (Rs m)	3,885

Source: BoB, UBS Warburg estimates

We believe operating profit in FY2002E should be boosted by savings of Rs1bn in BoB's wage bill as a result of the downsizing 6,763 employees.

Gujarat earthquake

Worst-case scenario of earthquake will reduce NPL-adjusted FY2001E NAV by 4% to Rs42.60

The epicentre of the 26 January 2001 earthquake was Kutch, Gujarat where BoB has 680 branches with deposits totalling Rs109.6bn and credit at Rs41.3bn as at 25 January 2001. None of BoB's corporate exposures in Gujarat have reported significant damage and we therefore do not foresee any problems there. Only in the Kutch region, which traditionally has had low credit off-take, could there be a problem, and we estimate BoB's credit exposure in the region to be Rs600m.

Table 9: Worst-case scenario of BoB's earthquake exposure

(Rs m)	FY2001E
Gross NPLs	41,310
Earthquake exposure	600
Gross stress loans	41,910
Less provisions	-24,204
Net stress loans	17,706
Net worth	30,233
Net stress loans	-17,706
Adjusted net worth	12,527
Number of shares (m)	294
Adjusted NAV (Rs)	42.6

Source: UBS Warburg estimates

No exposure to co-operative banks

We believe BoB has been prudent and maintained minimal exposure to co-operative banks and as a result has not faced any of the problems associated with the co-operative banks. BoB, like other government banks, also has insignificant exposure to loans against shares. We therefore do not foresee problems from these two areas affecting BoB.

Bank of Baroda

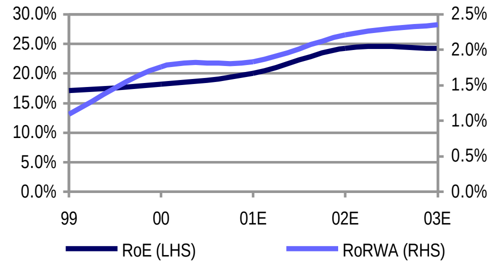
Per share (Rs)	**3/99**	**3/00**	**3/01E**	**3/02E**	**3/03E**
EPS (stated)	14.33	17.10	7.07	27.76	34.10
EPS (UBSW adjusted)	14.33	17.10	20.27	27.76	34.10
GOPS	32.14	35.73	40.50	49.28	59.21
DPS	3.00	4.00	4.00	4.00	4.00
BVPS (stated)	88.15	100.02	102.73	126.09	155.80
BVPS (adjusted)	36.33	44.66	44.60	65.28	92.20
Profit & Loss (Rsm)					
Net interest income	15,735	17,135	19,176	21,146	24,202
Other income	5,785	6,415	7,092	8,097	9,354
Total revenues	**21,520**	**23,550**	**26,267**	**29,243**	**33,556**
Expenses	(12,067)	(13,033)	(14,347)	(14,739)	(16,132)
Operating profit	9,453	10,517	11,920	14,504	17,424
Provisions and other items	(3,767)	(3,088)	(7,160)	(3,155)	(3,407)
Profit before tax	5,686	7,429	4,760	11,349	14,017
Pre-exceptional net income	4,214	5,028	5,965	8,171	10,036
Capital dynamics (Rsm)					
Risk-weighted assets	263,705	307,132	342,949	396,841	455,690
Tier one capital	23,969	27,206	25,022	31,206	39,133
Total capital	35,226	37,150	36,113	44,630	52,490
Tier one ratio	9.1%	8.9%	7.3%	7.9%	8.6%
Total capital ratio	13.4%	12.1%	10.5%	11.2%	11.5%
Net profit after tax	4,213	5,028	2,080	8,171	10,036
Tier 1 requirement					
Less: Working capital requiremen					
Less: Dividends	980	1,363	1,413	1,295	1,295
Surplus capital generated					
Surplus capital generation ratio					
Balance sheet (Rsm)					
Assets	522,322	586,052	640,968	739,790	850,842
Customer loans	210,915	243,930	281,579	323,816	372,389
Customer deposits	446,130	513,082	574,652	660,850	759,977
Funds under management					
Loans : assets	40.4%	41.6%	43.9%	43.8%	43.8%
Deposits : assets	85.4%	87.5%	89.7%	89.3%	89.3%
Loans : deposits	47.3%	47.5%	49.0%	49.0%	49.0%
Shareholders funds : assets	5.55%	5.02%	4.72%	5.02%	5.39%
Asset quality (Rsm)					
Non-performing assets	36,856	38,972	41,310	43,376	45,545
Total risk reserves	21,233	22,679	24,204	25,479	26,828
NPLs : loans	17.47%	15.98%	14.67%	13.40%	12.23%
NPL coverage	58%	58%	59%	59%	59%
Provision charge : average loans	2.01%	1.50%	1.25%	1.04%	0.98%
Net NPLs : shareholders' funds	53.9%	55.3%	56.6%	48.2%	40.8%
Profitability					
Net interest margin (avg assets)	3.40%	3.28%	3.31%	3.25%	3.23%
Provisions : operating profit	39.9%	29.4%	60.1%	21.8%	19.6%
RoE	17.1%	18.2%	20.0%	24.3%	24.2%
RoAdjE					
RoRWA	1.09%	1.76%	1.84%	2.21%	2.35%
RoA	0.86%	0.91%	0.98%	1.19%	1.27%
Productivity					
Cost : income ratio	56.1%	55.3%	54.6%	50.4%	48.1%
Costs : average assets	2.5%	2.4%	2.3%	2.1%	2.0%
Compensation expense ratio	47.2%	46.0%	45.3%	37.5%	35.1%
Momentum					
Revenue growth	+14.9%	+9.4%	+11.5%	+11.3%	+14.7%
Operating profit growth	+6.3%	+11.3%	+13.3%	+21.7%	+20.1%
Net profit growth	+110.7%	+19.3%	+18.6%	+37.0%	+22.8%
Dividend growth	+0.0%	+33.3%	+0.0%	+0.0%	+0.0%
Value*					
UBSW bank valuation	-	-	-	-	-
Leveraged P/E					
Risk tendency P/E					
Merger P/E					
Market capitalisation (Rsm)	21,581	18,541	13,580	13,054	13,054
Conventional valuation					
Market cap./Revenues	0.6x	0.6x	0.5x	0.4x	0.4x
Market cap./Operating profit	1.4x	1.2x	1.1x	0.9x	0.7x
P/E (stated)	3.1x	2.6x	6.2x	1.6x	1.3x
P/E (UBSW adjusted)	3.1x	2.6x	2.2x	1.6x	1.3x
Dividend yield (net)	6.80%	9.07%	9.07%	9.07%	9.07%
P/BV (stated)	0.5x	0.4x	0.4x	0.3x	0.3x
P/BV (adjusted)	1.2x	1.0x	1.0x	0.7x	0.5x

* Historical, current, & future valuations are based on a share price of Rs44.10 as at close on 10 Apr 2001

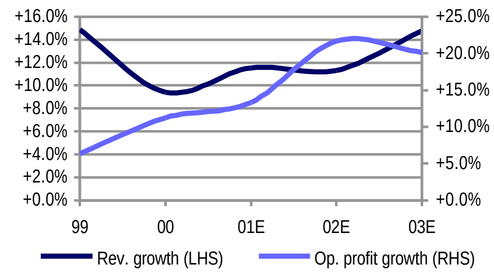
Source: Company data, UBS Warburg estimates

Bank of Baroda was founded on 20 July 1908. The bank along with 13 other private banks was nationalised by the Government of India on 19 July 1969. The bank had its IPO on December 1996 and was listed on the stock exchange in early 1997. At present, Bank of Baroda is India's second largest bank in terms of deposits (Rs513bn) and assets (Rs586bn). With 2,614 domestic branches, it has the second largest branch network in India. The Government of India is the single largest shareholder owning 66.2% of the shares outstanding and it directly appoints the chairman-cum-managing director and the executive director.

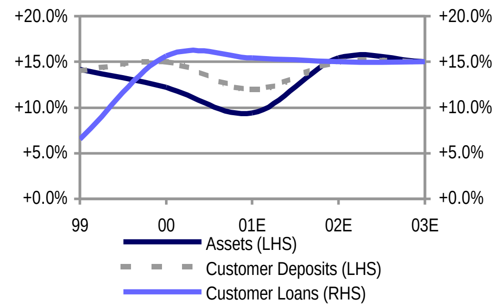
Profitability (RoE & RoRWA)



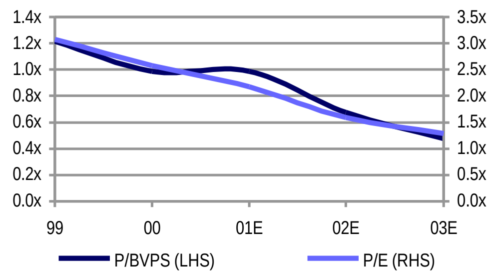
Momentum (Revenue & Operating profit growth)



Balance Sheet Growth



Value (P/Adj. BVPS & P/Adj. EPS)



State Bank of India (Reuters: SBI.BO)

Buy

Price: Rs200.45 (12-month range: Rs267.00 - 155.95)

Price target: Rs288.00 (+44%)

State Bank of India's share price has been punished on exaggerated concerns of the bullion affair and contagion from the co-operative banks, in our view. However, we believe the impact of these is minimal and expect SBI's strong fundamentals to easily weather the turbulence.

Rsm	Net profit	UBSW EPS (Rs)	RoE	RoRWA	DPS (Rs)	P/E*	P/Op*	Yield*	Stated BVPS (Rs)	P/True BVPS*
03/99	10,278.0	19.54	10.3%	1.21%	4.00	10.3x	3.1x	2.0%	197.65	1.6x
03/00	20,518.0	39.01	18.2%	1.90%	5.00	5.1x	2.5x	2.5%	230.81	1.3x
03/01E	8,853.0	43.70	18.5%	1.69%	5.00	4.6x	1.8x	2.5%	242.03	1.2x
03/02E	29,951.5	56.94	21.1%	1.91%	6.00	3.5x	1.5x	3.0%	298.05	0.9x
03/03E	35,021.5	66.58	20.1%	1.99%	6.00	3.0x	1.3x	3.0%	363.69	0.7x

* Valuations based on share price of Rs200.45 on 10/04/01

Down but not out

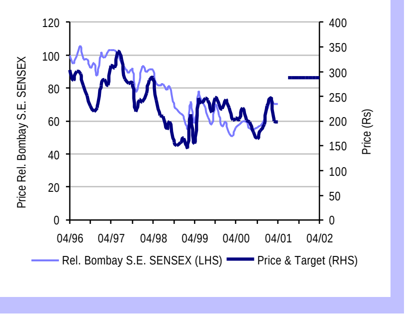
- SBI's share price has fallen 25% in the past month. We believe the valuation is extremely attractive and expect FY2002E earnings to be driven by Rs4.4bn (Rs8.4 per share) savings from lower employee costs.

- SBI is trading at 1.2x price-to-adjusted book value, which is at the low end of its historical band. We believe SBI is on a strong wicket as we expect earnings to increase by 30% in FY2002. Our 12-month price target of Rs288 is based on a PAVB of 1.3x FY2002E ABV.

- We believe SBI's bullion loss of Rs410m can be comfortably absorbed and that its exposure to the co-operative banks is insignificant. We do not expect any problems from these areas and we believe that the market has over reacted.

Hemindra Hazari
+9122-286 2059
hemindra.hazari@ubsw.com

Market capitalisation	Rs105.5bn/US$2.3bn
Tier 1 ratio	8.3%
Cost/income ratio	60%
4-year CAGR EPS (1999-2003E)	35.9%
Free float (Ord)	41%
Major Shareholder	RBI (59.7%)
Company web address	www.sbi.co.in



Source: UBS Warburg

Tenure of CEO extended

We expect the government to appoint the chairman with longer tenure

In October 2000, in a radical departure from past practice the government decided to breach the seniority principle and appointed a chairman who superseded six SBI officers. This was the first time in SBI's history that so many individuals had been superseded. The government decided to take this step because if it had continued with the earlier norm of appointments by seniority, SBI would have had eight CEOs over four years. After the present chairman retires we expect the government to extend the tenure to five years. We believe such a change will provide SBI with a long-term strategy, continuity and focus.

Pruning the steel exposure

The steel industry globally and in India has been going through a turbulent phase. Large steel companies announced major capacity expansion plans which banks and financial institutions liberally financed. Investors have been concerned over banks and financial institutions' exposure to steel.

SBI has been able to reduce its loans to the steel sector

SBI has reduced its loans to the steel industry. In FY1999, steel loans constituted 10% of SBI's loan portfolio, which by FY2000 had fallen to 8.5%. As at 31 March 2001, we expect the steel portfolio to have further reduced to 7% of loans.

We estimate SBI's loans to problem steel accounts to be approximately Rs7bn and believe that this has come down from Rs9bn in FY1999. If this exposure is classified as NPLs, SBI's FY2001 adjusted book value will fall by 3% to Rs151 from Rs165.

The reduction in its steel exposure highlights two important developments, in our view: First, the board realised that it needed to reduce its steel exposure to troubled groups. Second, it implemented the reduction. Despite being the largest bank in India, SBI has managed to reduce its loans to these problem accounts.

Consolidation of accounts

SBI has eight commercial bank subsidiaries. If these were to be merged into a single bank, the merged entity would constitute India's second largest bank after SBI. Moreover, SBI also has an investment bank, an asset management company and other smaller subsidiaries. In India, banks present non-consolidated accounts and the accounts of their subsidiaries are not disclosed in annual reports. From FY2001, however, banks will have to disclose such accounts.

We believe consolidation of accounts will have marginal impact on adjusted book value

Our estimates for SBI are shown on a non-consolidated basis because the investor relations department at SBI is unable to comment on the subsidiaries. However, for FY1999 and FY2000, we have consolidated net profits, book value and adjusted book value for SBI. While in FY2000E, consolidated EPS will increase 29% to Rs50.30 and book value increase by 25% to Rs288, adjusted book value will increase by only 2% to Rs159 since the subsidiaries have a high level of net NPLs compared with their net worth.

Table 10: Consolidated key historical indicators

(Rs m)	FY1999	FY2000
SBI net profit	10,278	20,518
Less dividend received from subsidiaries	-630	-457
Share of subsidiaries profits	4,982	6,382
Consolidated net profits	14,630	26,444
SBI EPS (Rs)	19.5	39.0
Consolidated SBI EPS (Rs)	27.8	50.3
SBI net worth	104,023	121,473
Share of subsidiaries net worth	24,321	29,963
Consolidated net worth	128,344	151,436
SBI NAV (Rs)	197.8	230.9
Consolidated SBI NAV (Rs)	244.0	287.9
SBI adjusted net worth	66,825	82,231
Share of subsidiaries adjusted net worth	-1,516	1,500
Consolidated SBI adjusted net worth	65,309	83,731
SBI adjusted NAV (Rs)	127.0	156.3
Consolidated SBI adjusted NAV (Rs)	124.2	159.2
No. of shares (m)	526	526

Source: Company data

SBI to reduce workforce by 9%

SBI's VRS cost estimated at Rs23bn for FY2001

SBI's workforce will be reduced by 9.1% (21,329 employees) and the gross VRS cost should be Rs23bn. We have written off the entire amount in FY2001 with the full tax benefit in our projections. We expect SBI to save approximately Rs4.4bn per annum in lower employee costs and we expect the cost-income ratio to fall to 49% in FY2002 from 55% in FY2001E.

Insignificant exposure to recent problems

Negligible exposure to troubled co-operative banks

SBI incurred a loss of Rs410m in the bullion pay order affair. However, we believe its FY2001E profits can easily absorb this amount. SBI maintains that currently it has no problems on exposure to the troubled co-operative banks. It also has minimal loans outstanding to the stock market. In our opinion, the fears about SBI are exaggerated, and the bank remains a solid, fundamentally sound bank.

Earnings driver

We expect SBI to report a three-year CAGR loan growth of 16%, with earnings growth driven by the lower salary cost because of the reduction in employees. This will, we believe, be a major factor in driving earning in FY2002E.

State Bank of India

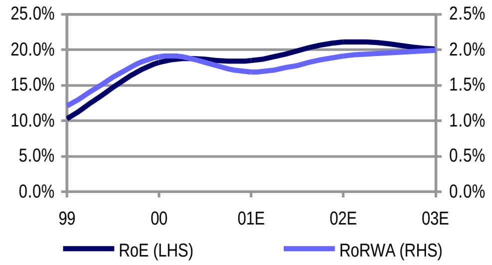
Per share (Rs)	**3/99**	**3/00**	**3/01E**	**3/02E**	**3/03E**
EPS (stated)	19.54	38.99	16.82	56.94	66.58
EPS (UBSW adjusted)	19.54	39.01	43.70	56.94	66.58
GOPS	65.57	79.85	108.90	131.94	154.98
DPS	4.00	5.00	5.00	6.00	6.00
BVPS (stated)	197.65	230.81	242.03	298.05	363.69
BVPS (adjusted)	126.97	156.24	165.05	218.57	281.74
Profit & Loss (Rsm)					
Net interest income	60,631	69,286	86,947	91,346	102,632
Other income	32,847	35,693	39,376	45,524	53,540
Total revenues	**93,478**	**104,979**	**126,323**	**136,869**	**156,172**
Expenses	(58,966)	(62,952)	(69,010)	(67,431)	(74,605)
Operating profit	34,512	42,027	57,313	69,438	81,568
Provisions and other items	(19,006)	(10,109)	(30,610)	(17,679)	(20,958)
Profit before tax	15,506	31,918	26,703	51,759	60,610
Pre-exceptional net income	10,278	20,518	22,998	29,951	35,022
Capital dynamics (Rsm)					
Risk-weighted assets	934,078	1,225,773	1,500,180	1,635,247	1,879,154
Tier one capital	87,430	101,494	102,682	128,781	159,421
Total capital	116,853	142,307	168,850	170,252	201,246
Tier one ratio	9.4%	8.3%	6.8%	7.9%	8.5%
Total capital ratio	12.5%	11.6%	11.3%	10.4%	10.7%
Net profit after tax	10,278	20,518	8,853	29,951	35,022
Tier 1 requirement					
Less: Working capital requiremen					
Less: Dividends	2,337	3,065	2,895	3,472	3,472
Surplus capital generated					
Surplus capital generation ratio					
Balance sheet (Rsm)					
Assets	2,225,090	2,615,047	2,988,288	3,444,566	3,969,939
Customer loans	823,598	981,020	1,154,355	1,327,508	1,526,635
Customer deposits	1,690,419	1,968,210	2,263,442	2,602,958	2,993,401
Funds under management					
Loans : assets	37.0%	37.5%	38.6%	38.5%	38.5%
Deposits : assets	76.0%	75.3%	75.7%	75.6%	75.4%
Loans : deposits	48.7%	49.8%	51.0%	51.0%	51.0%
Shareholders funds : assets	4.67%	4.65%	4.26%	4.55%	4.82%
Asset quality (Rsm)					
Non-performing assets	140,650	152,463	157,037	161,748	166,600
Total risk reserves	83,220	91,547	94,848	98,245	101,796
NPLs : loans	17.08%	15.54%	13.60%	12.18%	10.91%
NPL coverage	59%	60%	60%	61%	61%
Provision charge : average loans	1.83%	1.43%	1.27%	1.24%	1.26%
Net NPLs : shareholders' funds	55.2%	50.1%	48.8%	40.5%	33.9%
Profitability					
Net interest margin (avg assets)	3.29%	3.12%	3.42%	3.13%	3.04%
Provisions : operating profit	55.1%	24.1%	53.4%	25.5%	25.7%
RoE	10.3%	18.2%	18.5%	21.1%	20.1%
RoAdjE					
RoRWA	1.21%	1.90%	1.69%	1.91%	1.99%
RoA	0.51%	0.85%	0.82%	0.93%	0.94%
Productivity					
Cost : income ratio	63.1%	60.0%	54.6%	49.3%	47.8%
Costs : average assets	2.9%	2.6%	2.5%	2.1%	2.0%
Compensation expense ratio	54.6%	51.6%	45.8%	38.8%	37.0%
Momentum					
Revenue growth	+13.4%	+12.3%	+20.3%	+8.3%	+14.1%
Operating profit growth	-1.9%	+21.8%	+36.4%	+21.2%	+17.5%
Net profit growth	-45.2%	+99.6%	+12.1%	+30.2%	+16.9%
Dividend growth	+0.0%	+25.0%	+0.0%	+20.0%	+0.0%
Value*					
UBSW bank valuation	-	-	-	-	-
Leveraged P/E					
Risk tendency P/E					
Merger P/E					
Market capitalisation (Rsm)	104,323	121,248	107,808	105,497	105,497
Conventional valuation					
Market cap./Revenues	1.1x	1.0x	0.8x	0.8x	0.7x
Market cap./Operating profit	3.1x	2.5x	1.8x	1.5x	1.3x
P/E (stated)	10.3x	5.1x	11.9x	3.5x	3.0x
P/E (UBSW adjusted)	10.3x	5.1x	4.6x	3.5x	3.0x
Dividend yield (net)	2.00%	2.49%	2.49%	2.99%	2.99%
P/BV (stated)	1.0x	0.9x	0.8x	0.7x	0.6x
P/BV (adjusted)	1.6x	1.3x	1.2x	0.9x	0.7x

* Historical, current, & future valuations are based on a share price of Rs200.45 as at close on 10 Apr 2001

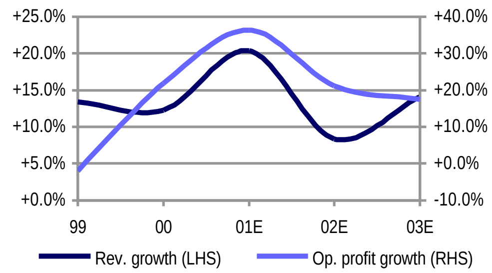
Source: Company data, UBS Warburg estimates

State Bank of India (SBI), formerly known as the Imperial Bank traces its origins to 1806. SBI was officially constituted through an act of parliament on 1 July 1955. It is India's largest commercial bank with a deposit market share of 18.6% and a credit market share of 20%. With 8,996 domestic branches, it has the largest branch network in India. The banking regulator, the Reserve Bank of India is the single largest shareholder owning 59.7% of the shares in issue. The Government of India directly appoints the chairman and the two managing directors.

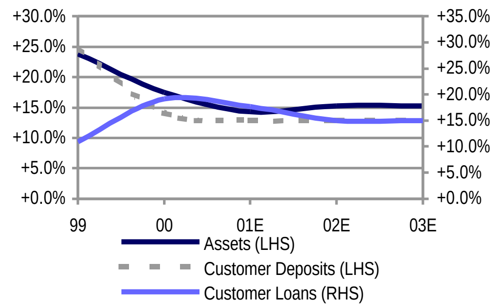
Profitability (RoE & RoRWA)



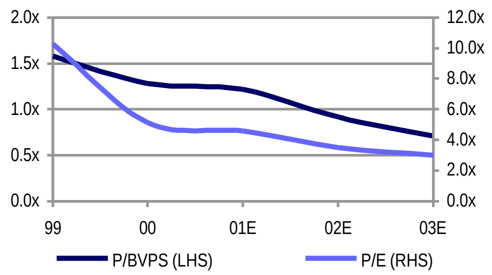
Momentum (Revenue & Operating profit growth)



Balance Sheet Growth



Value (P/Adj. BVPS & P/Adj. EPS)



HDFC Bank Ltd (Reuters: HDBK.BO)

Buy

Price: Rs226.00 (12-month range: Rs281.80 - 209.35)

Price target: Rs270.00 (+19%)

We believe HDFC Bank is poised for further growth after completing its merger with the erstwhile Times Bank. We think demanding valuations should not deter investors as we expect earnings growth to continue.

Rsm	Net profit	UBSW EPS (Rs)	RoE	RoRWA	DPS (Rs)	P/E*	P/Op*	Yield*	Stated BVPS (Rs)	P/True BVPS*
03/99	824.00	4.12	26.4%	2.42%	1.30	54.9x	35.8x	0.6%	16.95	13.6x
03/00	1,200.00	4.93	22.0%	2.02%	1.60	45.8x	21.2x	0.7%	30.89	7.0x
03/01E	2,049.18	8.42	24.8%	2.06%	2.00	26.8x	13.3x	0.9%	36.91	5.9x
03/02E	2,817.78	11.58	28.1%	2.08%	2.40	19.5x	10.5x	1.1%	45.62	4.9x
03/03E	3,575.58	14.70	31.0%	2.12%	2.40	15.4x	8.4x	1.1%	49.29	4.5x

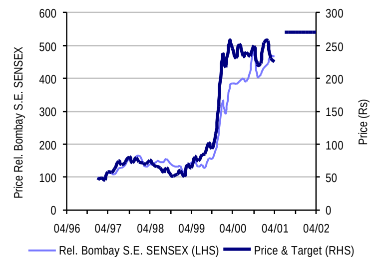
* Valuations based on share price of Rs226.00 on 10/04/01

Delivering on performance

- We expect HDFC Bank to report a 30% three-year CAGR growth in loans, which will sustain robust growth in earnings, in our view.
- Strong balance sheet. HDFC Bank is the only bank whose adjusted book value is higher than reported book value. This we believe should shield HDFC Bank from any downturn in the sector.
- The stock has outperformed the market by 53% last year because of its earnings growth, quality balance sheet and a proactive management. We believe this should continue to hold in future.
- Our 12-month price target of Rs270 is based on a PAVB of 5.8x FY2002E ABV.

Hemindra Hazari
+9122-286 2059
hemindra.hazari@ubsw.com

Market capitalisation	Rs45,200.0m/US$970.9m
Tier 1 ratio	9.6%
Cost/income ratio	39.8%
4-year CAGR EPS (1999-2003E)	37.4%
Free float (Ord)	58.6%
Major Shareholder	HDFC (28%)
Company web address	www.hdfcbank.com



Source: UBS Warburg

Emphasising retail

HDFC Bank is focusing on its retail loans such as automobile, consumer and individual loans for its future growth. The bank had earlier concentrated on loans against shares but due to the problems in the stock market, we believe the bank will be consolidating and reviewing this portfolio. HDFC Bank’s total retail loans increased from Rs2.96bn in FY1999 to Rs7bn in Q3 FY2001, while its retail accounts increased from 345,000 in FY1999 to 1m in Q3 FY2001. The growth in the retail loans was possible because of the thrust on branch expansion. HDFC Bank’s branches increased from 57 in FY1999 to 125 branches in Q3 FY2001. We expect HDFC Bank’s branches to increase by 25 branches a year over the next two years.

Leveraging off technology for marketing retail products

Conventionally, government banks have used their branches for deposits and have had minimum exposure to retail loans. However, the banks such as HDFC Bank have the technology for data warehousing and data mining and can therefore market retail loan products to their depositors.

Higher margins on retail lending

We believe retail loans with appropriate risk management systems can be highly profitable as these products have higher spreads while customer acquisition costs can be lower if the banks leverage off their depositor base. Moreover, with spreads on traditional lending to companies tightening, banks have to diversify their portfolios. Banks typically earn a yield of 11-11.5% on corporate loans while yield on retail loans is approximately 15.5%. Although the gross difference is 4%, after factoring in risk and customer acquisition costs, the actual difference is around 1%.

NPLs are not a concern

Adjusted NAV higher than reported NAV

Unlike many other Indian banks, HDFC Bank has been able to maintain its NPLs at extremely low levels, at 2.5% gross NPLs. We expect the gross NPLs to be 2.4% in FY2001. We believe low gross NPLs is a reflection on the bank’s strong risk management systems and its prudence in lending. The low NPLs and the substantial general provisions created in FY2000 have resulted in the bank’s adjusted book value being higher than its reported book value. This, in our opinion, reflects the strong fundamentals of HDFC Bank.

Table 11: HDFC Bank’s adjusted NAV

(Rs m)	FY1999	FY2000	FY2001E	FY2002E	FY2003E
Net worth	3,389	7,514	8,980	11,097	11,991
Net NPLs	-145	-369	-469	-539	-620
General provisions	70	749	749	749	749
Adjusted net worth	3,314	7,895	9,260	11,307	12,120
No of shares (m)	200	243	243	243	243
NAV (Rs)	16.95	30.89	36.91	45.62	49.29
Adjusted NAV (Rs)	16.57	32.45	38.07	46.48	49.82

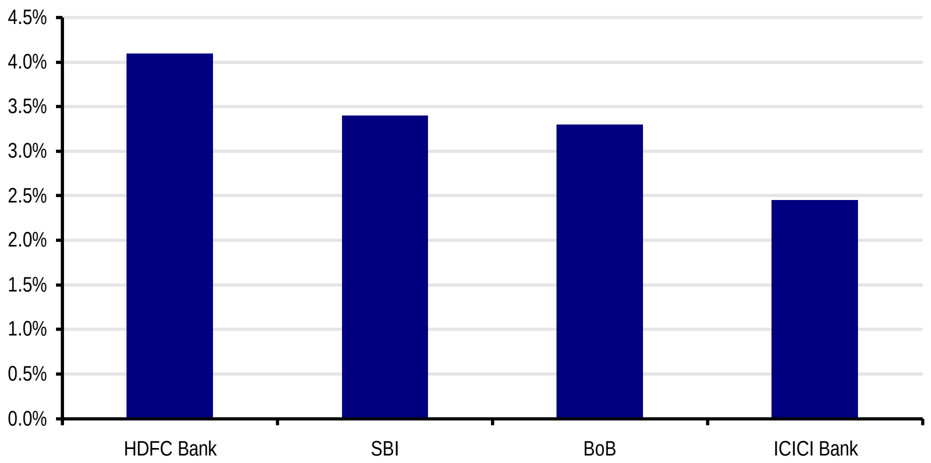
Source: UBS Warburg estimates

HDFC Bank has the highest net interest margin

Healthy net interest margin at 4.2%

The bank's net interest margin at 4.2% in FY2000 remains the highest compared with other banks in India. In future we expect the net interest margin to remain the highest among the banks although we expect it to decrease because of increasing competition and the large government banks becoming more proactive. HDFC Bank has been able to acquire low cost savings bank deposits as it is the market leader in the depository segment and also because it is the main banker to the stock exchanges and benefits from the float funds of the exchange.

Chart 3: Net interest margin, 2001E



Source: UBS Warburg

General provisions provide a cushion

Sufficient reserves to meet capital market exposure

HDFC Bank has significant exposure in loans and guarantees to stockbrokers and loans against shares, as it is the clearing bank of the Bombay Stock Exchange, National Stock Exchange, Calcutta Stock Exchange and other stock exchanges. Although its exposure to this segment is estimated at Rs9bn, to date only Rs30m in guarantees have devolved. According to HDFC Bank it has given guarantees of around Rs5bn of which approximately Rs2bn is towards foreign brokers in India, which are unlikely to devolve. HDFC Bank maintains that to date there have been no significant problems regarding its exposure to capital markets. HDFC Bank also maintains Rs749m in general provisions, which can be utilised for bad debts, and should be disclosed to shareholders if it is utilised.

ADR issue expected in FY2002

Equity issue likely in FY2002

We expect HDFC Bank to announce an equity issue during FY2002. This will most likely be an ADR issue of approximately US$100m. HDFC Bank would require additional capital if it continues to increase risk-weighted assets to 25% per annum. According to our estimates, HDFC Bank will require additional capital by FY2003.

Earnings driver

We expect the key earnings driver for HDFC Bank to be a 30% three-year CAGR loan growth that would sustain strong earning growth. We expect the net interest margin to decrease to 3.8% by FY2003. We do not expect any significant NPL problem to impede earnings growth.

HDFC Bank Ltd

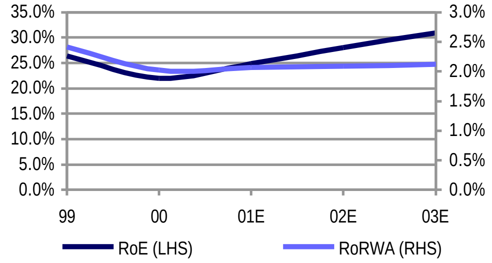
Per share (Rs)	**3/99**	**3/00**	**3/01E**	**3/02E**	**3/03E**
EPS (stated)	4.12	4.93	8.42	11.58	14.70
EPS (UBSW adjusted)	4.12	4.93	8.42	11.58	14.70
GOPS	6.31	10.67	17.05	21.57	26.99
DPS	1.30	1.60	2.00	2.40	2.40
BVPS (stated)	16.95	30.89	36.91	45.62	49.29
BVPS (adjusted)	16.57	32.45	38.07	46.48	49.82
Profit & Loss (Rsm)					
Net interest income	1,468	3,056	5,058	6,197	7,663
Other income	681	1,254	1,600	2,334	3,220
Total revenues	**2,149**	**4,310**	**6,658**	**8,531**	**10,883**
Expenses	(888)	(1,714)	(2,510)	(3,284)	(4,317)
Operating profit	1,261	2,596	4,148	5,247	6,566
Provisions and other items	(92)	(647)	(738)	(542)	(622)
Profit before tax	1,169	1,949	3,409	4,705	5,943
Pre-exceptional net income	824	1,200	2,049	2,818	3,576
Capital dynamics (Rsm)					
Risk-weighted assets	40,357	78,472	120,121	150,225	187,182
Tier one capital	3,367	7,503	8,980	11,097	11,991
Total capital	4,787	9,565	12,942	15,859	17,953
Tier one ratio	8.3%	9.6%	7.5%	7.4%	6.4%
Total capital ratio	11.9%	12.2%	10.8%	10.6%	9.6%
Net profit after tax	824	1,200	2,049	2,818	3,576
Tier 1 requirement					
Less: Working capital requiremen					
Less: Dividends	286	362	584	701	701
Surplus capital generated					
Surplus capital generation ratic					
Balance sheet (Rsm)					
Assets	43,502	116,561	150,202	191,575	243,318
Customer loans	14,006	33,622	54,780	71,214	92,578
Customer deposits	29,151	84,277	109,560	142,428	185,157
Funds under management					
Loans : assets	32.2%	28.8%	36.5%	37.2%	38.0%
Deposits : assets	67.0%	72.3%	72.9%	74.3%	76.1%
Loans : deposits	48.0%	39.9%	50.0%	50.0%	50.0%
Shareholders funds : assets	7.79%	6.45%	5.98%	5.79%	4.93%
Asset quality (Rsm)					
Non-performing assets	391	1,218	1,340	1,541	1,772
Total risk reserves	246	849	871	1,002	1,152
NPLs : loans	2.79%	3.62%	2.45%	2.16%	1.91%
NPL coverage	63%	70%	65%	65%	65%
Provision charge : average loans	0.68%	2.25%	1.05%	0.86%	0.76%
Net NPLs : shareholders' funds	4.3%	4.9%	5.2%	4.9%	5.2%
Profitability					
Net interest margin (avg assets)	4.62%	4.19%	4.12%	3.93%	3.82%
Provisions : operating profit	7.3%	24.9%	17.8%	10.3%	9.5%
RoE	26.4%	22.0%	24.8%	28.1%	31.0%
RoAdjE					
RoRWA	2.42%	2.02%	2.06%	2.08%	2.12%
RoA	2.30%	1.50%	1.54%	1.65%	1.64%
Productivity					
Cost : income ratio	41.3%	39.8%	37.7%	38.5%	39.7%
Costs : average assets	2.5%	2.1%	1.9%	1.9%	2.0%
Compensation expense ratic	14.9%	15.7%	11.8%	12.3%	12.9%
Momentum					
Revenue growth	+30.0%	+100.5%	+54.5%	+28.1%	+27.6%
Operating profit growth	+22.8%	+105.8%	+59.8%	+26.5%	+25.1%
Net profit growth	+30.4%	+45.6%	+70.8%	+37.5%	+26.9%
Dividend growth	+30.0%	+23.1%	+25.0%	+20.0%	+0.0%
Value*					
UBSW bank valuation	-	-	-	-	-
Leveraged P/E					
Risk tendency P/E					
Merger P/E					
Market capitalisation (Rsm)	12,284	25,230	48,071	45,200	45,200
Conventional valuation					
Market cap./Revenues	21.0x	10.5x	6.8x	5.3x	4.2x
Market cap./Operating profit	35.8x	17.4x	10.9x	8.6x	6.9x
P/E (stated)	54.9x	45.8x	26.8x	19.5x	15.4x
P/E (UBSW adjusted)	54.9x	45.8x	26.8x	19.5x	15.4x
Dividend yield (net)	0.58%	0.71%	0.88%	1.06%	1.06%
P/BV (stated)	13.3x	7.3x	6.1x	5.0x	4.6x
P/BV (adjusted)	13.6x	7.0x	5.9x	4.9x	4.5x

* Historical, current, & future valuations are based on a share price of Rs226.00 as at close on 10 Apr 2001

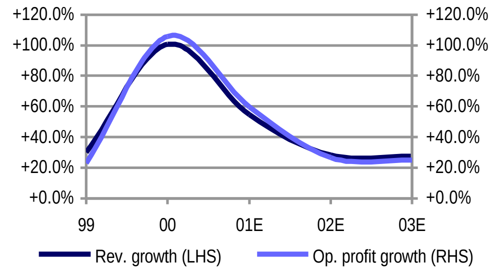
Source: Company data, UBS Warburg estimates

When the Reserve Bank of India announced in January 1993 guidelines for the establishment of banks in the private sector, HDFC Bank was one of the first to receive an 'In-principle' approval. The bank received its banking licence in January 1995. In FY2000, the bank merged with the erstwhile Times Bank and its branch network increased to 111. HDFC is the single largest shareholder holding 28% of the shares in issue and three directors on the board of HDFC Bank represent HDFC.

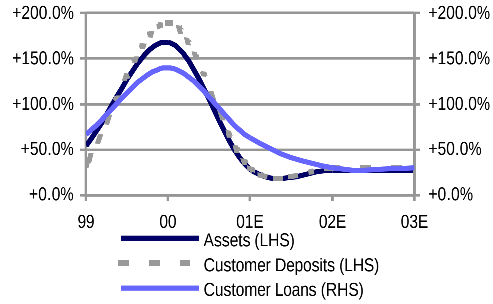
Profitability (RoE & RoRWA)



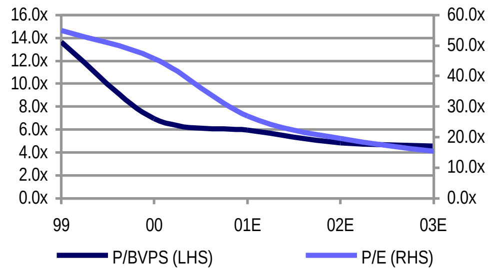
Momentum (Revenue & Operating profit growth)



Balance Sheet Growth



Value (P/Adj. BVPS & P/Adj. EPS)



Appendix

Chart 4: SBI: PABV chart

Source: UBS Warburg

Chart 5: SBI: PE chart

Source: UBS Warburg

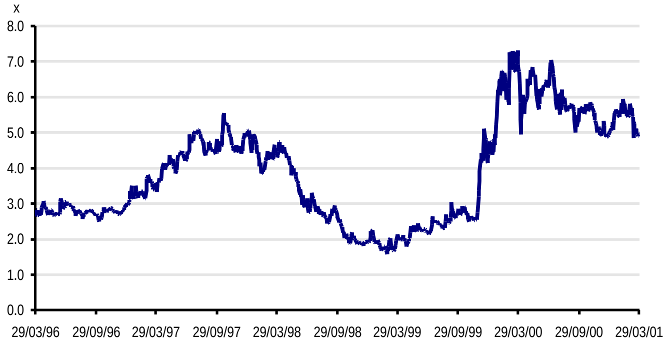
Chart 6: BoB: PABV chart

Source: UBS Warburg

Chart 7: BoB: PE chart

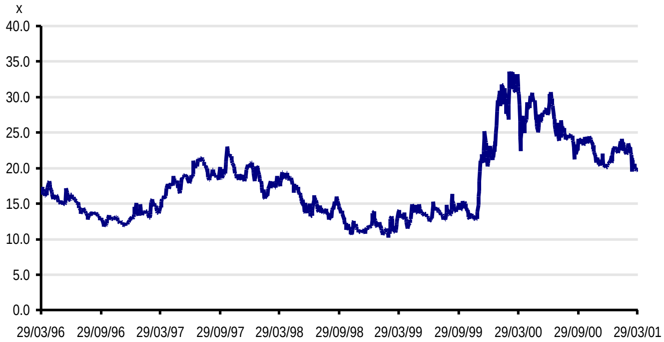
Source: UBS Warburg

Chart 8: HDFC Bank: PABV chart



Source: UBS Warburg

Chart 9: HDFC Bank: PE chart



Source: UBS Warburg

This report was produced by:
UBS Warburg Securities (India) Pvt. Ltd.

Street address:
2/F Hoechst House
Nariman Point
Mumbai 400 021
India
+91-22-281 4649

UBS Warburg
Head office:
1 Finsbury Avenue
London
EC2M 2PP
UK
+44-20-7567 8000

UBS Warburg Securities (India) Pvt. Ltd., 2/F Hoechst House, Nariman Point, Mumbai 400 021, India Phone: +91-22-281 4649

UBS Warburg, 1 Finsbury Avenue, London, EC2M 2PP, UK Phone: +44-20-7567 8000