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THE COMPASS

Provisioning relief to lift banks' profits

RBI asking banks to create investment reserve could weigh on financials

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The Reserve Bank of India (RBI) has lent a helping hand to the banking sector, especially public sector banks (PSBs), when it allowed them to spread the mark-to-market (MTM) provisioning burden for the October-December 2017 (Q3) and January-March 2018 (Q4) quarters equally over up to four quarters. The Street welcomed the move as the Nifty PSU Bank index, which has been under pressure, gained 1.65 per cent on Tuesday.

Owing to a sharp rise in yields (which are inversely related to bond prices) since September 2017, banks had to make additional provisions in Q3 for notional losses due to depreciation in the market value of government securities (G-sec). Banks have to provide for any loss in the market value of G-secs held in the AFS segment on a quarterly basis. Though bond yields have declined sharply in the last few days of FY18 as the government announced a lower-than-expected borrowing plan for April-September 2018, yields are still higher (7 basis points) in Q4 vis-a-vis Q3 (in last two quarters, yields are up 74 basis points).

RELIEF ON MTM PROVISIONS

In ₹ billion	Oct -Dec 2017		Estimates #	
	MTM provisions	MTM provisions as % of total provisions*	IFR At 2%	1/3rd of IFR as % of FY19 PPOP
State Bank of India	40.4	21.4	108	5.2
Punjab National Bank	10.8	24.1	17	3.4
Bank of India	9.1	18.5	10	3.2
Bank of Baroda	1.7	5.1	14	3.2
Canara Bank	8.7	32.7	9	2.6
Indian Bank	4.7	51.2	7	4.3
Union Bank of India	7.0	21.5	8	2.8

*Total provisioning (other than tax), MTM: Mark-to-market,
IFR: Investment fluctuation reserve, PPOP: Pre-provisioning operating profit,
#Motilal Oswal Securities Sources: Banks' presentation, BSE

The provision relaxation will benefit PSBs in Q4. "We believe banks that were badly hit owing to huge MTM provisions in Q3 will use this relaxation to write back a part of the cumulative MTM losses (Q3 and Q4) and apportion it over FY19," analysts at HDFC Securities said. While this should provide a cushion when banks may have to make higher provisions for bad loans due to the new NPA recognition rules, it is mere postponing the pain and thereby optically lifting profit.

The latest RBI circular also takes care of banks' future risk on account of MTM losses by asking them to create an investment fluctuation reserve (IFR) within three years, starting FY19. However, this comes at the cost of banks' distributable profit. Because, as the RBI says, banks should create IFR by transferring an amount equivalent to net profit on sale of investments during the year or net profit for the year after deducting mandatory appropriations, whichever is lower. Also, the minimum size of IFR should reach at least 2 per cent of their AFS and held-for-trading (or HFT) investment book.

"In a favourable interest rate scenario, PSB's earned significant income from trading in bond (AFS/HFT) portfolio and that may be missing in their profit & loss statement now till they create an IFR of 2 per cent of their respective AFS/HFT holding," said Asutosh Kumar Misra, analyst at Reliance Securities.

Additionally, banks' tier-1 capital ratio (ratio of common equity plus additional tier-1 instruments to risk weighted assets) would see some effect as distributable profits will be transferred to create an IFR and will not be part of net worth (thus impacting their book value). Banks can use this reserve to meet their CET1 (common equity tier-1)/tier-1 requirements, even if the IFR is below minimum size, but this too comes with limitations.

On the whole, creation of a new reserve is a long-term positive, but PSB stocks are likely to be driven by improvement in fundamentals, which may not happen soon. Thus, analysts believe any rallies could be used to book profits.