

Special Report

Market Risk for Indian Banks:
Profits Under Pressure but
Capital Should Stay Intact

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■ Outlook

The rapid and relatively substantial rise in rupee interest rates in recent months (the benchmark 10-year yield on government securities rose from 5.2% in May 2004 to 6.7% in less than 10 weeks, before settling at the current 6.1%) has brought into focus the market risk faced by Indian banks. Fitch Ratings had earlier pointed out the growing significance of market risk for Indian banks (see "*Asset Quality of Indian Banks: Road to Recovery*", May 2003). The spike in interest rates has affected the trading profits of banks; however, any mark-to-market (MTM) erosion on the government securities (G-secs) portfolio in a gradually increasing interest rate regime is unlikely to erode banks' equity, given the likely increase in net interest income, some residual unrealised gain on the portfolio (if any), and the recent forbearance by RBI (the central bank) permitting banks to hold a larger proportion of securities under the 'held-to-maturity' (HTM) category that need not be marked-to-market. Different banks, however, vary in their levels of vulnerability, with some 'new' private banks and government banks being less susceptible to rising market risk compared with most 'old' private banks. In the medium-term (two to three years), however, most banks are likely to need to increase their equity to meet the growing regulatory capital allocation for market risk.

■ Increased Market Risk

Indian banks are required by regulation to maintain a relatively large reserve portfolio (25% of net demand and time liabilities, referred to as the Statutory Liquidity Ratio or 'SLR') comprising primarily government securities. Thanks to the attractive trading opportunities offered by declining interest rates in recent years, most Indian banks (especially the government-owned ones) have built up fixed-income investments far in excess of the regulatory minimum (investments in debt securities are estimated at c.40% of total assets for the banking system as at end-FY04). The increase in G-secs helped boost trading profits, which comprised 23% of operating income in FY04 (20% in FY03). A large portion of such profits were either used to increase loan loss reserves or write-off some problematic assets, which resulted in a significant reduction in the NPL ratios of most banks.

With rising interest rates, however, Indian banks face the prospect of treasury profits being replaced by MTM provisioning for the diminution in the value of their investment portfolio. While government banks have been somewhat shielded from the recent spike in interest rates, thanks to the unrealised gains on their portfolios (as at end-March 2004 most government-owned banks had estimated that they could 'absorb' an interest rate rise of around 100-150 basis points without having to make MTM provisions), as a consequence of higher government bond yields since then, they are now exposed to market risk on the excess SLR portion of their investment portfolio.

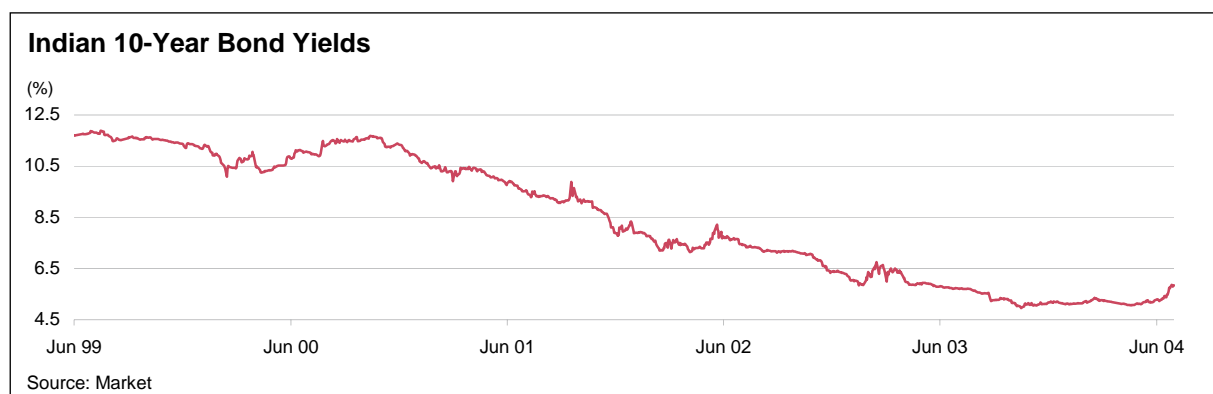
Indian banks were earlier permitted to classify a maximum of 25% of their investments portfolio as HTM, which is carried at book value and is not required to be valued on an MTM basis. Banks have to classify their investment securities into this category in the first quarter of the financial year and subsequent changes to the classification are not permitted during the year. In a special dispensation, RBI has recently permitted an additional, one-time transfer of G-secs, up to the minimum SLR limit, into the HTM category at market value during the current financial year. Any additional holdings of G-secs over and above the SLR limit would have to be classified under 'available for sale' or 'held for trading', and marked to market. This move will insulate banks from making MTM provisions arising out of investments made in pursuance of regulatory requirements. With the residual 'cushion' in the investments portfolio of government-owned banks down to 50 basis points or less as at end-August 2004, banks may have to incur a one-time hit while transferring securities to the HTM category, but will be 'protected' (from an accounting perspective) by future increase in interest rates on a large majority of their G-sec investments.

Going ahead, banks will now be exposed to market risk on their debt investment portfolio held in excess of regulatory requirement. Strategies to minimise this risk include reducing the excess investment portfolio (linked to pick-up in credit off-take), lowering the portfolio duration, and using interest-rate derivatives (a somewhat limited option at present, given the relatively thin market compared with the banks' portfolio size). Thanks to the above regulatory forbearance, Fitch estimates that most government banks would be able to 'absorb' a further three percentage points rise in interest rates before their pre-provision operating profits (excluding trading profits) in FY04 turned negative on account of the MTM provisions. Some of the 'new' private banks enjoy a slightly higher cushion on account of a lower duration and lower excess SLR portfolio, while a few of the 'old' private banks are significantly more vulnerable.

RBI had earlier advised banks to gradually build up an Investment Fluctuation Reserve (IFR) of up to 5% of their investment portfolio to help manage interest rate risks. As at end-March 2004, most banks are estimated to have built up an IFR of at least 3% of their investment portfolio. The IFR is treated as Tier 2 capital, and banks have approached RBI to permit use of the IFR directly to make MTM provisions (rather than route it through the income statement), so as to protect their reported RoAs. Although RBI has not communicated its views so far, the proposal, if approved, would directly shift the impact of MTM losses to the banks' equity and capital ratios.

■ Conclusion

The increase in interest rates has highlighted the inherent market risk that exists in the balance sheets of Indian banks. Fitch is of the view that interest rates are likely to rise gradually, and while it is possible that many banks' profits and earnings will be affected, the agency believes that the capital base of most banks will not be impaired. Indeed, higher earnings from the banks' lending activities may even substantially absorb or offset such MTM losses. Nevertheless, Fitch has commented in the past that the capital base of most Indian banks is relatively low, and in view of the increased regulatory capital allocation for market risk in future, most banks would need to shore up their capital position (incidentally, some banks have announced plans to raise equity in recent weeks). In addition, banks would also need to more actively manage their investment portfolio through better risk measuring and monitoring systems. The issue of 'market risk' has also drawn attention to the quality of earnings of Indian banks, even as they seek to replace their depleted trading profits with fund-based and non-fund-based income. At some stage of the cycle, the rising interest rates should reflect in higher net interest margins. Until then, profits of most Indian banks are likely to remain under pressure.



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