

Banking

BSE Sensex: 8,541

S&P CNX: 2,590

11 October 2005

RBI has allowed banks to treat IFR (Investment Fluctuation Reserve) as Tier I capital against the earlier treatment of the same as Tier II capital from March 2006. As of March 2005, IFR was almost 20-30% of Tier I capital for most of the state owned banks. Under the new norms, Tier I capital of most banks should go up by over 20%. This will lead to a smooth transition to Basel II norms, with limited equity dilution despite strong growth in loan book.

INCREASE IN TIER I CAPITAL DUE TO INCLUSION OF IFR (FY05 - RS M)

	EQUITY CAPITAL	RESERVES LESS REVAL. RES	IFR	TOTAL CAPITAL LESS IFR	% CHANGE IN TIER I	TIER I (%)	TIER I POST INCREASE
Bank of India	4,881	38,111	3,218	39,775	8.1	7.1	7.6
Corporation Bank	1,434	29,115	4,440	26,109	17.0	13.6	15.9
Andhra Bank	4,000	14,370	3,130	15,240	20.5	8.0	9.7
Union Bank	4,601	26,793	5,550	25,844	21.5	6.1	7.4
Bank of Baroda	2,945	53,332	10,425	45,852	22.7	8.2	10.1
Canara Bank	4,100	55,820	12,081	47,839	25.3	7.3	9.1
Syndicate Bank	4,720	15,279	4,191	15,807	26.5	6.1	7.7
Vijaya Bank	4,335	11,026	3,230	12,132	26.6	7.6	9.6
OBC	1,925	31,345	7,055	26,215	26.9	5.4	6.9
SBI	5,263	235,458	52,539	188,183	27.9	8.0	10.3
PNB	3,153	78,460	19,023	62,590	30.4	8.9	11.6
IOB	5,448	18,886	6,011	18,322	32.8	7.1	9.4
ICICI Bank	7,367	118,132	5,160	120,339	4.3	7.6	7.9
HDFC Bank	3,099	42,100	4,842	40,357	12.0	9.6	10.8
UTI Bank	2,781	21,344	2,928	21,197	13.8	8.9	10.1
Karnataka Bank	1,213	8,568	1,200	8,580	14.0	12.2	13.8

** Syndicate Bank and OBC already have had an equity dilution post March 2005.

Tier I ratio set to improve

Over the last couple of fiscals, banks have been building up the IFR which was required to be 5% of the AFS book, by appropriating it out of their profits. Even though IFR was a part of reserves, it was treated as Tier II capital. With the current change, banks can appropriate the IFR back to their core reserves, if they maintain CAR after providing for credit and market risk at 9% or more. Currently all the banks have CAR over 9% and are already providing for credit risk. However market risk on their AFS and trading portfolio might have a capital charge of 100-150bp by March 2006. While this would lower the overall capital adequacy by almost 100-150bp, the reclassification of IFR to Tier I will lead to a higher Tier I ratio. Infact, given the current IFR levels for most banks, Tier I ratio could increase by as much as 20-30% (125-225bp) for most of the state owned banks.

Thus, even as overall capital adequacy will still be lower by around 100-150bp (as Tier II will decline sharply), Tier I for banks will be higher enabling banks to maintain a healthy Tier I post-Basel II norms. Also, higher Tier I capital will allow banks to raise more Tier II capital through subordinated offerings.

Positive for Indian Banks

While banks like Vijaya Bank, Union Bank, IOB, BOB which would have required capital in the next 6-12 months, will be immediate beneficiaries as they need not rush for capital in order to maintain growth, larger banks like SBI, PNB and Canara Bank which hold substantial IFR on their books would see their Tier I ratio improve even after providing for credit and market risk by March 2006.

We rate this as a very positive development for banks and expect a re-rating of stocks as the estimates of dilution changes for banks. We believe that the core investment arguments of strong loan growth, stable net interest margins, high fee income, low operating expenses and 0-2% NPAs remain intact. Our top picks are **SBI, PNB, BOI, Syndicate Bank** and **Karnataka Bank**. We are also positive on **HDFC**.

N O T E S

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