

**INDIA****Banking sector****Caution on bond yields**

Reason for report: Sector update

Yields for 10-year government securities (G-Secs) have steadily risen to a 9-month high of 7.33% as on August 25, '09 (declining to 7.16% on August 26, '09). Yields have sharply moved up at the longer end of the curve owing to the large government borrowing programme for bridging the fiscal deficit. High balance sheet liquidity as well as the sluggish credit growth trend at present has reduced banks' appetite for government papers, resulting in further upward movement in yields. We expect yields to remain firm going forward; and, further increase in yields is likely to result in mark-to-market (MTM) losses on the AFS book of PSU banks. We estimate that potential losses would be the highest for Union Bank of India, Oriental Bank of Commerce and Canara Bank, given high percentage of securities in the AFS book.

- ▶ **Yields maintain upward momentum, banks reluctant to invest.** Long-tenor government securities have witnessed a marked upward movement in yields (Charts 2 & 3) compared with short-tenor securities. Most banks hold longer dated paper in the HTM portfolio. With the 25% limit of NDTL for HTM investments nearly exhausted, banks are reluctant to subscribe to long-dated paper as they will require classifying it as AFS investments. We expect this coupled with the already high government borrowing programme to maintain pressure on yields going forward. We believe 10-year G-Sec yields would remain firm, resulting in MTM losses in the AFS book going forward.
- ▶ **AFS portfolio could be nearing breakeven; likely to witness MTM losses.** We assume a weighted-average breakeven yield of 7.4% on the AFS portfolio, which was marked-to-market at 7.04% on June 30, '09. Given 10-year yields at a nine-month high of 7.33% as on August 25, '09, most of the notional gains on the AFS portfolios have been wiped out. In conjunction with our expectation of further firming up of 10-year yields, we expect PSU banks to witness notional losses on their AFS books. We estimate sensitivities of an increase in 10-year G-Secs from the breakeven yield (Table 1), and conclude that Union Bank of India, Oriental Bank of Commerce and Canara Bank will likely witness highest amount of stress (within the I-Sec PSU banks universe), given higher proportion of investments in the AFS book and higher duration.

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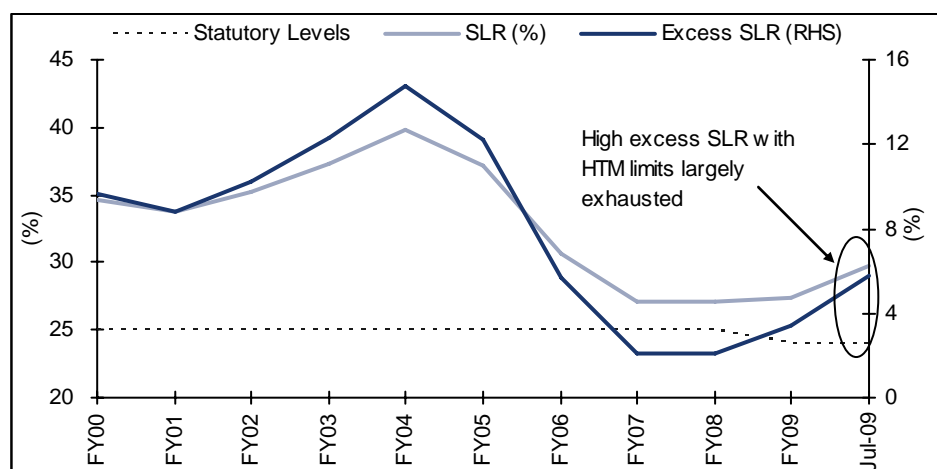
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**Table 1: Assessing impact of high yields on bottomline and network**

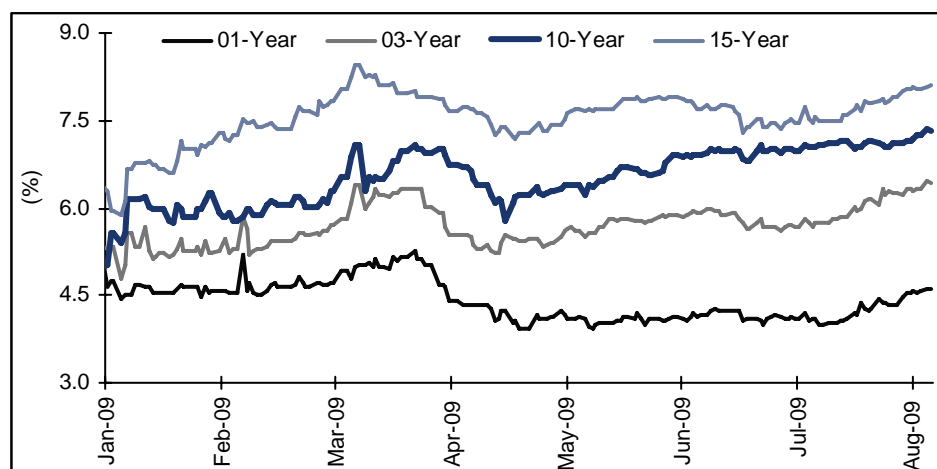
	7.5%			7.75%			8.0%		
	Unrealised gain/(loss) (Rs mn)	% of FY10E PBT	% of network	Unrealised gain/(loss) (Rs mn)	% of FY10E PBT	% of network	Unrealised gain/(loss) (Rs mn)	% of FY10E PBT	% of network
Bank of Baroda	(297)	0.83	0.23	(1,039)	2.89	0.82	(1,781)	4.96	1.40
Bank of India	(343)	0.77	0.24	(1,202)	2.71	0.84	(2,060)	4.65	1.43
Canara Bank	(380)	1.38	0.32	(1,331)	4.83	1.13	(2,282)	8.29	1.94
OBC	(239)	2.66	0.33	(837)	9.31	1.17	(1,434)	15.96	2.00
State Bank of India	(1,512)	1.04	0.26	(5,292)	3.66	0.91	(9,072)	6.27	1.57
Union Bank of India	(436)	1.67	0.51	(1,525)	5.84	1.77	(2,614)	10.02	3.04

Note: Deviations from assumed portfolio weighted average breakeven yield of 7.4%

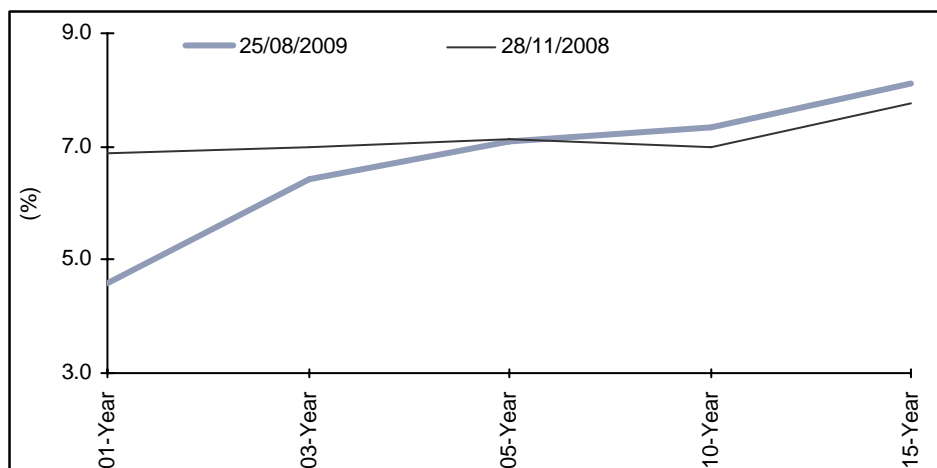
Source: Company data, I-Sec Research

**Chart 1: High excess SLR a deterrent to purchase of long-dated G-Secs**

Source: Company data, I-Sec Research

**Chart 2: Yields rise in higher tenor securities**

Source: RBI, I-Sec Research

**Chart 3: Yields on shorter-maturity paper have declined**

Source: RBI, I-Sec Research

*I-Sec investment ratings (all ratings relative to Sensex over next 12 months)*

**BUY:** +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

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