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SLR flexibility to be RBI's new tool

A proposed cut in the SLR would be positive for banks in the long-term

The Union Cabinet on January 11, 2007 approved the promulgation of an ordinance to amend the statutory liquidity ratio (SLR) for banks to ensure greater credit flow to the industry. To achieve this, the government intends to empower the Reserve Bank of India (RBI) to set lower SLR floors from the existing 25% on the net demand and time liabilities ie deposits. The move would give more operational flexibility to the RBI in the conduct of monetary policy and also reduce the stipulated bank lending to the government. Consequently, there will be more credit for the industry and the lending rates may ease while the banks stand to gain from the change in the following ways.

Positive for banks in the long run

- The average yield on the advances for public sector undertaking (PSU) banks is above 9% after the prime lending rate (PLR) hike while the current yield on investments is in the range of 7.2-7.5%. For private banks the average yield on the advances is in the vicinity of 10% while the average yield on investments is below 7%. This provides a significant opportunity for the banks in the longer term to improve their earnings based on a small realignment of their balance sheet composition as we don't expect the RBI to cut the SLR at this point of time.
- Our calculation suggests that the valuation upside for the banks will be between 6% and 8% based on the improvement in their price-to-book value multiple considering a 4% increase in the return on assets due to the proposed changes with the other things remaining constant.
- The banks would have more flexibility in their asset liability management as they can maintain shorter duration on the asset side and match it with a similar duration on the liability side.
- The 10-year yield may firm up due to the RBI's decision to reduce SLR holdings of the banks. This would indirectly influence higher marked-to-market provisions but since the SLR holdings are expected to go down and the provisions on the marked-to-market investment portfolio not required to be charged to the profit and loss account from FY2008 onwards, we feel the earnings of the banks would be less volatile and will get a significant boost as and when the RBI decides to lower the SLR floor of 25%.
- The liquidity in the market would increase driving down the lending rates which would further help in sustaining the corporate earnings growth.

Negatives not a major concern

- The banks need to set aside a certain portion of the incremental funds channeled into the advances in the form of higher provisions. However the net effect would still be very positive for the banks.

Sensitivity table for banks' earnings and valuation upside based on SLR cut of

SLR cut	Change in PAT (%)	Valuation upside (%)
3	3.5	6.6
2	2.3	4.4
1	1.2	2.2

We have based our calculations on a 9% yield on the advances, a 7.5% yield on the investments and a 4% cost of the funds. As the banks cut the SLR, the advances exposure increases while the investments decline keeping the total funds available constant but we start earning a bit higher due to the difference in the yields on the advances and the investments. The benefit translates into a growth in earnings, which helps in improving the return on assets (RoA). Assuming the equity (Tier I) remains constant at 7% the RoE improves helping in improving the implied price to book value, which is the primary determining factor for the valuation of the banks.

Banks with higher SLR holdings to gain

Our preliminary calculations show that the banks which have a higher SLR holding like SBI, Canara Bank and Bank of Baroda stand to gain more than their peers. Our calculations assume that the mentioned banks bring down their SLR holdings to the current threshold level of 25%. However, large banks like SBI, PNB, Canara Bank and Bank of Baroda prefer to have some cushion in their SLR holdings to meet unforeseen sudden statutory requirements.

This is a significant positive for the private banks since they get a much higher spread on their advances than investments, but due to the already low SLR holdings the incremental profit potential remains limited.

Our preliminary calculation on the banks under our coverage is based on the following assumptions.

- All the banks bring down their SLR holdings from the current level to 25%.
- The average yield on the advances for the PSU banks is 9% while the average yield on the investments is at 7.5%. The provisioning required on the incremental funds is 0.15% of such funds.
- The average yield on the advances for the private banks is 10% while the average yield on the investments is at 7%. The provisioning required on the incremental funds is 0.25% of such funds.
- Private banks having SLR holdings at 27%.

Based on the above assumptions for FY2008E the profit after tax (PAT) is expected to improve in the range of 0.8% to 3.1% for the banks under our coverage.

HDFC and HDFC Bank merger possibilities increase

The country's premier housing finance company HDFC can now re-consider its strategy of not merging its banking subsidiary with itself after the latest possibilities of a cut in the SLR requirement. HDFC has been saying that a merger would not be beneficial as the SLR requirement would be applicable on its deposits too and that would significantly reduce the funds available for disbursements. Any development on the merger front of the two premier financial institutions would provide significant valuation upside. HDFC's core housing finance business trades at a much lower price to book value multiple than what its banking subsidiary commands and if the merger happens then the multiples would converge. Hence, the valuation would improve more for HDFC while HDFC Bank would continue to trade at rich valuations.

SLR cut would help reflect true 10-year yields

We feel the current 10-year yield at 7.52% (December 11, 2006) which firmed up by 22 basis points to close at 7.74% does not reflect the true yields as the huge demand for government securities from all the entities mentioned in the table below have brought down the yields. In the absence of a large supply of new government paper in the market the demand-supply mismatch has currently become more pronounced.

The improved fiscal performance of the government and higher tax collections should keep the government's borrowing programme restricted. Hence in the absence of large fresh supplies it becomes imperative that the banks' SLR holdings be brought down since the government would not require such support anymore from the banks and even if required the other entities have bridged the gap. If we look at the ratio of the incremental government securities to the incremental system deposits we see that the same stood at 41% in FY2004 and 18% in FY2005. The ratio has come down significantly as the banks preferred to liquidate their investments in favour of the advances.

Break-up of G-Sec holdings

Rs crore	Outstanding Government securities				Change over previous year		
	2002	2003	2004	2005	2003	2004	2005
RBI	40900	52900	41000	60500	12000	-11900	19500
SCB	388200	472700	563600	610100	84500	90900	46500
SBI	143100	173500	192000	209000	30400	18500	17000
Nationalized banks	178800	220400	264500	293300	41600	44100	28800
Others	66200	78800	107100	107700	12600	28300	600
LIC	125500	156200	195200	238700	30700	39000	43500
EPFS	17500	21400	27800	36100	3900	6400	8300
PD	7100	9800	9700	2300	2700	-100	-7400
Others	61200	94300	167900	217100	33100	73600	49200
Total	640,400	807,300	1,005,200	1,164,800	166,900	197900	159600
Deposits		1355654	1578450	1836987		222796	258537
Incremental Gsec / Deposit ratio for banks						41%	18%

Source: RBI

RBI may prefer to wait and watch

The system deposits stood at Rs2,349,392 crore as on December 22, 2006. A cut of 1% in the SLR is expected to release almost Rs25,000 crore into the system. This would mean that the banks would have more funds to lend as advances. The current hike in the cash reserve ratio (CRR) by 50 basis points to 5.5% to absorb the excess liquidity is not in sync with a proposed SLR cut and the increasing liquidity in the system. We feel that the ordinance would only increase the RBI's flexibility to manage monetary operations in the economy and the RBI would take appropriate measures as and when the situation demands.

Impact of possible SLR cut

Banks	Sep-06 Deposits	SLR holding (%)	Funds released*	Change in NII	Change in PAT	As a % of FY08EPAT
Allahabad Bank	54006	28.0	1620.2	24.3	15.3	1.8
Andhra Bank	32513	26.5	487.7	7.3	4.6	0.8
BOB	107681	29.0	4307.3	64.6	40.7	3.1
BOI	103294	26.0	1032.9	15.5	9.8	0.8
Canara Bank	122121	29.0	4884.8	73.3	46.2	2.7
Corporation Bank	38017	27.0	760.3	11.4	7.2	1.2
Punjab National Bank	82340	29.0	3293.6	49.4	31.1	1.5
State Bank of India	288840	31.0	17330.4	260.0	163.8	2.7
Union Bank of India	61444	26.5	921.7	13.8	8.7	0.8
HDFC Bank	63447	27.0	1268.9	38.1	24.4	1.6
ICICI Bank	155403	27.0	3108.1	93.2	59.8	1.5
UTI Bank	29121	27.0	582.4	17.5	11.2	1.4

* amount of funds that can be deployed in advances, which are currently invested in SLR securities based on the assumption that banks bring down their SLR holdings to the current threshold level of 25% from the existing levels as on September 2006.

Source: Company, Sharekhan Research

The author doesn't hold any investment in any of the companies mentioned in the article.