MOTILAL OSWAL

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Update

Financials

RBI releases discussion paper on dynamic provisioning framework

Proposals to strengthen balance sheets, but could impact near-term earnings

- **RBI's discussion paper on dynamic provisioning framework highlights the requirement of counter-cyclical provisioning to reduce volatility in banks' earnings.**
- **While dynamic provisioning will make banks' balance sheets structurally strong, some of the norms that RBI has proposed will adversely impact their earnings and put strain on their capital in the near term.**
- **Banks with superior technology that are already planning to move to IRB (internal rating based) approach might come out with estimated loss assumption based on portfolio mix. Thus, 1.37% cannot be strictly taken as a benchmark for all banks.**
- **Higher provisions will directly impact RoA (by 10-15bp) and RoE (by 100-200bp) of banks in the short-to-medium term.**

RBI has released a discussion paper on **dynamic provisioning (DP)**, where it has highlighted the requirement of counter-cyclical provisioning to reduce volatility in banks' earnings. It has requested views from industry participants by 15 May 2012, post which it will release draft guidelines.

Key highlights of discussion paper

- **Introduction of DP to strengthen balance sheets and smoothen earnings:** The discussion paper emphasizes that it would be prudent for all banks to create a counter-cyclical buffer during good times, which could be utilized when asset quality pressure emanates during an economic downturn, thus reduce earnings volatility. Initial DP would be outstanding provisions made on standard asset and floating provision. However, it has an in built assumption that banks have reached 70% PCR. Incrementally RBI has suggested credit cost of 1.37%. If actual **specific provisions (SP)** is lower than 1.37% excess provisions will be transferred to DP and vice-a-versa subject to certain conditions.
- **Proforma credit cost estimated at 1.37%, but may vary from bank to bank:** Based on weighted average **estimated loss (EL)** of nine individual banks, RBI has arrived at a system-level **loss given default (LGD)** of 1.37% of loans during a downturn (a more conservative approach which RBI has recommended) and at an LGD of 0.84% of loans during normal times. For the purpose of calculation, model portfolio with corporate loans, retail loans, housing loans and other loans was taken as 49%, 17%, 6% and 28%, respectively. Thereby actual requirement would vary from bank to bank. Further banks might come out with estimated loss assumption based on their internal rating method. Thus, 1.37% cannot be strictly taken as a benchmark for all banks.
- **Treatment of DP:** The suggested framework for Indian banks is conservative (as credit cost suggested is based on downturn LGD) and the DP framework will include an element of general and specific provisions. RBI has suggested that till the level of normal LGD (0.84%), DP provisions should be considered as specific provisions and can be utilized to arrive at net NPA. Above normal LGD to actual levels (1.37%-0.84%), DP provisions should be considered as general provisions, and thus would be consider for tier-II capital.

To strengthen bank balance sheets but transition to impact near-term earnings

The suggested framework will strengthen the balance sheet of the banks and smoothen the earnings which is positive. However initially, banks would have to shore up their provision coverage ratio (PCR) to 70%, which may impact their profitability, especially in case of state-owned banks, wherein the PCR has declined significantly in the past one year. Further incrementally higher provision requirement could cumulatively impact banks PBT by 3-35% over FY13/14.

However, over the cycle, DP will considerably reduce earnings volatility and will also make earnings comparable among the banks. Higher provisions will directly impact RoA (10-15bp) and RoE (100-200bp) of banks in the short-to-medium term. These provisions will need some enhancement in NIMs to ensure that profitability remains intact. Banks with strong risk management systems would gain over the rest, once they convince RBI to lower provisioning norms for them.

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Suggested DP framework: Aim is to create a buffer in times of uncertainty

The DP framework is based on the premise of average losses; average SP is equal to EL over the cycle. Under this framework, in addition to SP (as per regulation), banks are required to make provisions to extent of EL and the difference between EL and SP is transferred to an account called DP. A positive difference between EL and SP will increase DP and a negative value will lead to drawdown from DP (subject to certain conditions). Thus, it will ensure that charge to P&L on account of credit cost will remain the same irrespective of the cycle.

Outstanding standard asset and floating provisions to form initial DP

While shifting to the DP framework, in the beginning, total provision outstanding on the balance sheet should be the addition of outstanding standard assets, floating provisions and specific provisions (at least 70% of NPA). In the other words, the DP initial balance will be the aggregation of standard and floating balance outstanding on the balance sheet. RBI has also ensured that the balance in the DP account should not go below 1/3rd of EL and has prescribed the floor limit below which banks cannot draw down from the DP account. Under the framework, RBI has suggested that banks take charge of 1/4th of the annual DP on a quarterly basis.

Incremental provision requirement in case of DP would be $\alpha Ct - \triangle SP$

Where α = average estimate of credit loss (1.37% of gross loans as calculated by a sample of 9 banks),

Ct = outstanding loan portfolio, and

$\triangle$SP = specific provisions made during the year.

Average credit cost over FY05-12 varies from 0.7% to 1.8%; whereas RBI recommends credit cost of 1.37%

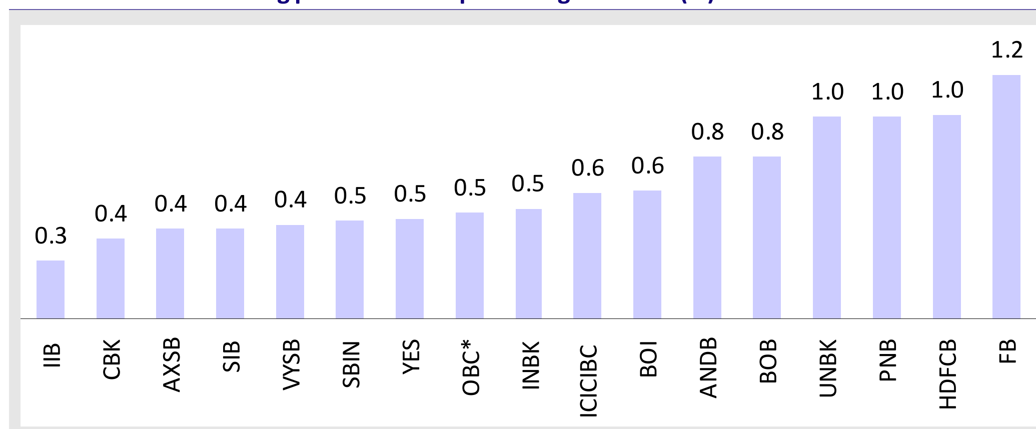
Credit cost (including standard asset provisioning, %)

	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	AvgFY05-12E
Public Sector Banks									
SBIN	0.84	0.27	0.77	0.76	0.65	0.87	1.49	1.63	0.91
PNB	0.60	0.15	1.01	0.53	0.74	0.68	1.21	1.14	0.76
CBK	1.76	1.30	0.83	0.90	0.84	1.10	0.70	0.68	1.01
BOB	1.29	0.81	0.67	0.65	0.32	0.70	0.72	0.80	0.75
BOI	0.83	1.12	1.14	1.02	0.63	1.25	0.71	0.85	0.94
UNBK	0.82	0.64	0.87	1.07	0.84	0.75	1.12	1.24	0.92
OBC*	0.77	0.02	-0.35	-0.30	0.40	0.82	1.16	0.97	0.44
INBK	1.49	0.72	0.73	1.53	0.17	0.78	1.18	0.70	0.91
ANDB	0.20	0.46	0.38	0.42	0.53	0.94	1.00	1.36	0.66
Private Banks									
ICICIBC	-0.19	0.87	1.48	1.38	1.66	2.00	1.09	0.64	1.12
HDFCB	0.99	1.88	2.46	2.59	2.72	1.96	0.61	0.93	1.77
AXSB	0.17	1.10	0.89	1.35	1.51	1.73	1.09	0.98	1.10
YES		0.96	1.06	0.32	0.89	1.02	0.41	0.23	0.70
IIB	0.92	1.15	0.71	0.62	1.03	1.09	0.95	0.75	0.90
VYSB	0.76	0.77	0.98	0.43	0.83	1.37	0.93	0.42	0.81
SIB	1.01	1.52	1.53	0.36	0.21	0.37	0.31	0.28	0.70
FB	1.80	1.76	1.04	1.44	1.83	1.85	1.87	1.20	1.60
JKBK	0.41	0.93	0.79	0.32	0.37	0.72	0.56	0.32	0.55

*OBC standard asset provisioning is available from FY06 Source: Company/MOSL

Initial DP under current guidelines to be 30-120bp for the banks under our coverage

Standard assets + floating provisions as a percentage of loans (%)



Source: Company/MOSL

Calculation of 'α' (average estimated credit cost)

Based on a sample of 9 banks, the discussion paper estimates credit cost at 137bp

While according to the discussion paper, 'α' needs to be calibrated on the basis of credit histories of individual banks, due to lack of data for all the banks and for the system as a whole, it is calculated based on a sample of 9 banks comprising of 32.5% of gross loans of scheduled commercial banks as at March 2010. The estimated value of 'α' for individual segments is significantly different from the value of 'α' for the total loan portfolio. Fixing a single 'α' at the level of total loan portfolio will neither be appropriate nor prudent. For the calculation of 'α', the relative proportion of corporate loans, retail loans, housing loans and other loans was taken as 49%, 17%, 6% and 28%, respectively.

The paper gives banks that have adequate data history the liberty to set up their own framework for the calculation of 'α', i.e. estimated credit loss based on their experience. Banks with superior technology that are already planning to move to IRB (internal rating based) approach might come out with estimated loss assumption based on portfolio mix. Thus, 1.37% cannot be strictly taken as a benchmark for all banks.

RBI more in favor of downturn LGD which is a more conservative approach

Segment-wise calculation of estimated loss (%)

	Based on normal LGD	Based on downturn LGD
Corporate Loans	0.28	0.62
Retail Loans	1.21	2.67
Housing Loans	0.11	0.27
All other Loans	1.67	2.26
Total Loans	**0.84**	**1.37**

Source: Company/MOSL

Utilization of DP to provide cushion during downturn

While implementing the Dynamic Provisioning Approach (DPA) for the first time, the RBI has assumed that the banks would have adequate specific provisions to cover its NPAs. Incrementally, as the banks adopt this approach, a positive value of $\alpha Ct - \Delta SP$ will increase the DP balance, while a negative value will represent a drawdown from the DP balance. This would ensure that the charge to P&L every year on account of

specific provisions and DP is maintained at a level of αCt. RBI has further defined the floor and the ceiling for the DP. The DP is subject to a floor of 0.33αCt. The floor limit would ensure that during downturns, the drawdown from the DP would not exceed 33% of the expected loss and in such a scenario banks will have to make additional provisions to restore the DP balance.

Floor of DP = 0.33% of estimated loss * outstanding loans

Utilization of DP (INR)

	Year	1	2	3	4	5	6
A	Loans O/S (Ct)	1,000	1,200	1,500	1,600	1,750	1,950
B	Specific prov during the year	5.0	10.0	25.0	37.0	29.0	25.0
C	EL (1.5% of A)	15.0	18.0	22.5	24.0	26.3	29.3
D	Incremental DP (C-B)	10.0	8.0	-2.5	-7.5*	0.8	4.3
E	Floor of DP (0.33% of C)	5.0	6.0	7.5	8.0	8.8	9.8
F	Stock of DP (Fpy+Dcy)	10.0	18.0	15.5	8.0	8.8	13.0
G	Charge to P&L						
	On account of SP	5.0	10.0	25.0	24.0	26.3	25.0
	Addition/reduction from DP	10.0	8.0	-2.5	-7.5*	0.8	4.3
	Prov as Floor DP is reached				5.5	2.8	

Source: Company/MOSL

Explanation of the working

- In this example, the dynamic provision is created in the first and second year, as the expected loss (αCt) is higher than the specific provisions. Thus, the positive value of αCt-$\triangle$SP will add to the stock of dynamic provisions.
- In the third year, when the specific provisions exceed the expected loss, the bank can draw down from the stock of dynamic provisions. Hence, the specific provisions requirement would be lower and dynamic provision reserve would deplete.
- However, drawdown is restricted to the floor for DP account. In the fourth year, specific provisions would be higher than αCt. With the DP account already hitting the floor, no further drawdown would be permitted and the excess amount (of INR5.5) would be charged to P&L account.

Treatment of DP on capital and NPA movement

Provision made on normal LGD bases to be netted from GNPA to arrive at NNPA above which to be treated as general provisions and thus be considered for tier-II capital

The suggested framework for Indian banks is conservative (as credit cost suggested is based on downturn LGD) and the DP framework will include an element of general and specific provisions. RBI has suggested that till the level of normal LGD (0.84%), DP provisions should be considered as specific provisions and should be used for arriving at net NPA. Above normal LGD to actual levels (1.37%-0.84%), DP provisions should be considered as general provisions, and thus, as tier-II capital.

RBI has suggested that two DP accounts be kept in the balance sheet: (a) DP account based on normal LGD – at the end of every quarter, the balance in normal LGD should be treated as SP, and (b) DP account based on downturn LGD – which could be treated as general provision and could be treated as capital.

To strengthen banks' balance sheets, but to impact RoA in near-term

The discussion paper appears to suggest that at the time of implementation of the DP framework, banks would have already seen the worst of the credit cycle and would have room to create DP in their balance sheets in the following years. Initially, banks would have to shore up their provision coverage ratio (PCR) to 70%, which may impact their profitability, especially in case of state-owned banks, wherein the PCR has declined significantly in the past one year. However, in our view, even if the framework is set up in the existing form, RBI would allow banks adequate time to reach the stipulated PCR. Ambiguity in terms of whether technical write-off is included remains; if disallowed, the impact could be higher.

Assuming amortization of 8 quarters and technical write-offs to be allowed while calculating 70% PCR, the impact on banks' PBT could be 0-10% over FY13/14 (see Table 1). Banks with superior technology and already planning to move to IRB (internal rating based) approach might come out with estimated loss assumption based on portfolio mix. Thus, 1.37% cannot be strictly taken as a benchmark for all banks. Currently, we model credit cost of 60-140bp for FY13-14. If the DP framework based on current suggested structure is implemented (at 1.37%), it will impact PBT by 3-30% for FY13/14 (see Table 2).

If the DP framework is adopted as suggested in the discussion paper, overall it will impact PBT (see Table 3) by 10-40% for FY13/14. However, over the cycle, DP will considerably reduce earnings volatility and will also make earnings comparable among the banks. Higher provisions will impact RoA (10-15bp) and RoE (100-200bp) of banks in the short-to-medium term. These provisions will need some enhancement in NIMs to ensure that profitability remains intact. Banks with strong risk management systems would gain over the rest, once they convince RBI to lower provisioning norms for them.

With private banks PCR already above 70%, there would be no impact

Table 1: Impact of increase in PCR to 70% for PSU banks to be 0-11%

	Provision (incl tech w/off)				Impact on PBT (%)	
	to retain 70% (a)	at end of 3QFY12 (b)	shortfall/ (excess) (a-b)	Assuming 8 quarters ammortisation (impact per year)	FY13	FY14
SBIN	351,180	313,654	37,526	18,7635	8.9	7.1
PNB	67,721	67,731	-10	-5	0.0	0.0
CBK	71,209	69,072	2,136	1,068	2.2	1.9
BOB	47,598	54,745	-7,147	-3,573	-4.8	-4.1
BOI	73,222	63,671	9,550	4,775	11.3	9.2
UNBK	54,673	49,315	5,358	2,679	7.4	6.4
OBC*	39,279	35,497	3,782	1,891	9.1	8.2
INBK	20,711	22,635	-1,923	-962	-3.1	-2.7
CRPBK*	16,695	14,996	1,698	849	4.3	3.7
ANDB	19,078	17,822	1,256	628	3.1	2.7

Source: Company/MOSL

Incrementally higher provisions will need some enhancement in NIMs to ensure that profitability remains intact, or else PBT to be impacted by 3-33%

Table 2: Provisioning requirement of 137bp to impact FY13/14 earnings by 3-33% (INR m)

	Provisions assuming 1.37% on opening loans		Current estimates of provisions		Shortfall/ (Excess)		Impact on (%) PBT	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Public Sector Banks								
SBIN	122,331	141,904	122,867	110,934	-536	30,970	-0.3	11.6
PNB	38,476	45,401	29,545	32,477	8,931	12,924	10.8	12.6
CBK	33,474	38,495	19,272	24,474	14,202	14,021	29.7	24.8
BOB	37,908	44,731	27,869	33,171	10,038	11,560	13.5	13.3
BOI	34,157	39,622	26,628	28,343	7,530	11,279	17.8	21.8
OBC	15,636	17,981	12,412	16,078	3,224	1,903	15.6	8.3
CRPBK	13,921	16,427	9,039	10,666	4,883	5,761	24.6	25.2
ANDB	11,548	13,396	10,278	10,763	1,271	2,633	6.2	11.5
Private Sector Banks								
ICICIBC	35,288	41,357	25,447	30,771	9,840	10,587	10.2	9.8
HDFCB	27,419	33,451	17,982	23,043	9,437	10,408	10.0	9.2
AXSB	23,022	27,626	18,980	22,919	4,041	4,707	5.8	5.8
YES	5,367	6,440	2,253	3,023	3,114	3,418	18.0	16.4
IIB	4,660	5,825	3,402	4,491	1,259	1,334	8.2	6.9
VYSB	3,945	4,734	1,814	2,367	2,131	2,367	28.5	26.7
SIB	3,593	4,455	1,427	1,951	2,166	2,504	33.5	32.8
FB	5,034	5,840	4,659	5,405	375	435	2.9	2.9
JKBK	4,342	5,254	2,017	2,865	2,325	2,389	20.3	18.6

*Please note the provisioning assumption under RBI norms has been taken on standard 137bp and it may vary with respect to change in portfolio mix of different banks Source: Company/MOSL

Double whammy of increasing PCR and higher credit cost to impact state-owned banks

Despite strong risk management practices, higher provisioning requirement on an incremental basis would impact private banks' profitability

Table 3: Overall DP framework could impact profitability by 3-33% (INR m)

	Excess Provision Required if DP comes in current form		Impact on PBT (%)	
	FY13	FY14	FY13	FY14
Public Sector Bank				
SBIN	18,227	49,733	8.6	18.7
PNB	8,926	12,920	10.7	12.6
CBK	15,270	15,089	31.9	26.7
BOB	6,465	7,987	8.7	9.2
BOI	12,305	16,054	29.1	31.1
UNBK	8,201	8,701	22.7	20.7
OBC	5,115	3,794	24.7	16.6
INBK	3,450	3,480	11.0	9.8
CRPBK	5,732	6,611	28.9	28.9
ANDB	1,899	3,261	9.3	14.2
Private Sector Bank				
ICICIBC	9,840	10,587	10.2	9.8
HDFCB	9,437	10,408	10.0	9.2
AXSB	4,041	4,707	5.8	5.8
YES	3,114	3,418	18.0	16.4
IIB	1,259	1,334	8.2	6.9
VYSB	2,131	2,367	28.5	26.7
SIB	2,166	2,504	33.5	32.8
FB	375	435	2.9	2.9
JKBK	2,325	2,389	20.3	18.6

Source: Company/MOSL

Financials: Valuation Matrix

	Rating	CMP (INR)	Mcap (USDb)	EPS (INR)		P/E (x)		P/BV (x)		RoA (%)		RoE (%)	
				FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
ICICIBC*	Buy	908	21.3	55	65	12.4	10.2	1.7	1.5	1.5	1.5	13.8	14.9
HDFCB	Neutral	530	25.3	22	29	24.0	18.6	4.2	3.6	1.6	1.7	18.9	20.9
AXSB	Buy	1,173	10.2	96	111	12.2	10.6	2.2	1.9	1.5	1.5	19.7	19.4
KMB	Neutral	557	8.4	24	28	23.1	19.8	3.2	2.8	1.8	1.6	14.2	14.1
YES	Buy	374	2.6	28	34	13.4	11.1	2.8	2.3	1.5	1.4	23.1	22.8
IIB	Buy	328	3.1	17	22	19.2	14.7	3.4	2.9	1.6	1.6	19.3	21.3
VYSB	Buy	366	1.1	30	34	12.2	10.9	1.4	1.3	1.0	1.0	14.0	12.3
FB	Buy	443	1.5	43	51	10.2	8.8	1.4	1.2	1.3	1.3	13.8	14.6
J&KBK	Buy	908	0.9	162	180	5.6	5.1	1.1	0.9	1.4	1.4	20.8	19.7
SIB	Buy	25	0.3	3	4	7.3	6.6	1.4	1.2	1.1	1.0	20.7	19.8
Private Aggregate			**74.7**			**25.1**	**19.9**	**3.2**	**2.8**				
SBIN (cons)*	Buy	2,171	29.7	208	255	10.0	8.1	1.4	1.2	0.8	0.9	15.1	15.7
PNB	Buy	931	6.6	135	161	6.9	5.8	1.2	1.0	1.1	1.1	20.0	19.2
BOI	Neutral	366	4.5	39	49	9.3	7.4	1.1	1.0	0.6	0.7	13.2	14.0
BOB	Neutral	804	6.8	116	123	6.9	6.6	1.3	1.1	1.2	1.1	21.1	18.4
CBK	Buy	472	4.3	74	85	6.4	5.5	1.0	0.9	0.9	0.9	16.9	17.0
UNBK	Buy	238	2.7	25	42	9.4	5.7	1.0	0.9	0.6	0.8	11.7	16.8
IOB	Neutral	96	1.2	11	19	8.4	5.0	0.7	0.6	0.4	0.5	8.4	13.1
OBC	Buy	255	1.5	41	48	6.2	5.3	0.7	0.6	0.7	0.7	11.3	12.0
INBK	Buy	237	2.1	44	48	5.3	4.9	1.1	0.9	1.4	1.3	21.6	20.0
CRPBK	Neutral	431	1.3	106	120	4.1	3.6	0.8	0.7	1.0	1.0	20.2	19.8
ANDB	Buy	121	1.4	23	25	5.3	4.8	0.9	0.8	1.1	1.1	18.3	18.0
IDBI *	Neutral	106	2.1	17	21	6.3	5.1	0.8	0.7	0.6	0.7	12.6	14.0
DBNK	Buy	93	0.6	22	26	4.3	3.6	0.8	0.6	0.9	1.0	19.3	19.5
Public Aggregate			**64.8**			**10.0**	**8.8**	**1.6**	**1.4**				
HDFC*	Neutral	688	20.6	27	32	18.1	15.0	5.0	4.5	2.8	2.9	26.7	29.2
LICHF	Buy	268	2.8	18	26	14.9	10.4	2.4	2.0	1.6	1.8	18.4	21.1
DEWH	Buy	241	0.6	26	36	9.2	6.6	1.6	1.3	1.3	1.4	17.1	18.0
IDFC	Buy	138	4.3	11	11	13.1	12.1	1.4	1.2	3.0	2.7	13.9	13.2
RECL	Buy	224	4.5	29	34	7.8	6.6	1.5	1.3	3.1	3.1	20.9	21.8
POWF	Buy	195	5.2	23	27	8.6	7.2	1.2	1.1	2.6	2.6	16.5	16.0
SHTF	Buy	603	2.8	57	65	10.6	9.2	2.3	1.9	3.0	3.0	23.6	22.2
MMFS	Neutral	682	1.4	55	68	12.5	10.0	2.4	2.0	3.8	3.7	20.8	22.1
NBFC Aggregate			**42.2**			**14.3**	**15.8**	**2.8**	**3.4**				

*Multiples adj. for value of key ventures/Investments; For ICICI Bank, HDFC Ltd BV is adjusted for investments in subsidiaries

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3. Broking relationship with company covered	None
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