Financials

Networth accretion across banks

	AFS Reserve Accretion (INR b)	NW Accretion (INR b)	% of FY24 NW
HDFCB	-	1.3	0%
ICICIBC	20.6	32.1	1%
AXSB	0.0	14.6	1%
KMB	NA	29.1	3%
IIB	NA	1.7	0%
FB	NA	3.4	1%
BANDHAN	0.7	1.1	0%
SBIN	38.7	25.4	1%
BOB	NA	30.2	3%
CBK	0.6	18.1	2%
UNBK	0.2	17.2	2%
INBK	2.1	0.0	0%
PNB	0.3	21.3	2%
BOM	2.0	2.0	1%
CBOI	2.5	-10.0	-3%
UCO	0.4	7.9	3%
IOB	0.2	0.2	0%
PJSB	0.2	-42.3	-37%
BOI	NA	1.3	0%
IDBI	4.0	14.9	3%

Assessing the impact of new investment guidelines

Net worth of PSBs increases by average ~2%; investment yields rise 15-40bp

The RBI in Sep'23 released new master directions regarding the classification of an investment portfolio. Previously, banks classified and valued their investment portfolios based on the 2021 regulations, which were primarily founded on a framework introduced in Oct'2000. The revised regulations align investment classification with global standards and incorporate international best practices. With the 1Q earnings season almost over, we revisit the impact of these regulations on major banks under our coverage. In this note, we have analyzed the impact for all of our coverage banks and note that the networth of our coverage public sector banks (PSBs) has improved by average ~2% (highest for BOB at ~3%), while their investment yields improved by around 15-40bp. Among private banks, KMB saw the highest networth accretion at 3%, while the increase for other banks was limited to 1%. We expect volatility in trading gains to subside, while the direct pass-through of unrealized gains (losses) to reserves would support capital ratios when interest rates moderate. Our preferred picks are ICICIBC, HDFCB, SBIN and FB.

Key changes in investment regulations – A quick recap

Following are some of the key changes between the old and new investment regulations. For details, please refer to Exhibit 11.

- **Investment Classification**:
  - **Old**: Investments were classified under HTM, AFS and HFT buckets.
  - **New**: Investments are classified as HTM, AFS and FVTPL (HFT is a separate category under FVTPL), with separate categories for JVs, subsidiaries, and associates.
- **Reclassification Rules:**
  - **Old**: Annual reclassification allowed with Board approval.
  - **New**: Reclassification only in exceptional cases with Board and RBI approval.
- **Gains/Losses on AFS Securities:**
  - **Old**: Gains/losses taken to P&L; net losses provided in P&L; net appreciation ignored.
  - **New**: Net gains/losses are credited/debited to the AFS reserve.
- **HTM Investment Ceiling:**
  - **Old**: HTM investments capped at 25% of total investments.
  - **New**: No limit on HTM investments.
- **Holding Period for HFT/FVTPL:**
  - **Old**: HFT investments to be sold within 90 days.
  - **New**: No sale period stipulated for FVTPL or HFT.
- **Sale of HTM Investments:**
  - **Old**: Disclosure of HTM investments' market value if sale/transfer exceeds 5% of book value.
  - **New**: HTM sale exceeding 5% needs RBI approval.
- **Acquisition of Investments at Discount/Premium:**
  - **Old**: Recognized as one-time gains/losses in P&L.
  - **New**: Discount/premium on HTM and AFS securities amortized over the instrument's life.

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Accretion in CET-1 across banks

	CET-1 – 1QFY25	Change in CET-1 QoQ (bp)
KMB	21.3%	210
AU SFB	19.5%	70
HDFCB	16.8%	50
IIB	16.2%	33
AXSB	14.1%	32
IDFCB	13.3%	-2
ICICIBC	15.2%	-36
FB	14.2%	-44
RBK	13.9%	-53
BANDHAN	14.1%	-310
BOB	13.1%	54
IOB	15.0%	52
CBK	12.1%	47
UCO	14.4%	22
UNBK	13.8%	16
IDBI	20.3%	15
PJSB	14.8%	6
PNB	11.0%	-9
INBK	13.4%	-10
SBIN	10.3%	-11
BOM	12.2%	-30

AFS and general reserve accretion led to increase in networth

The new investment regulations specify that unrealized gains on AFS securities need to be routed to the AFS reserve account, which was ignored hitherto. From 1QFY25 results, we note that the networth of most banks increased by around 1-2%, with KMB and BoB witnessing the highest growth of ~3%. We note that the AFS reserve accretion as a proportion of total investments was the highest for ICICIBC owing to its active trading and treasury, benefitting from the IPO. KMB stands out among its peers due to the highest percentage of its portfolio in the AFS book, leading to higher gains. Additionally, BOB witnessed higher gains among peer PSBs, resulting in a healthy networth accretion.

Capital ratios improve for banks; PSBs witness up to 54bp boost in CET-1

Unrealized gains on AFS securities need to be routed to the newly formed AFS reserve account and they will be considered under CET-1 capital. With bond yields correcting in 1Q, most banks benefitted from the increase in the value of AFS securities and thus reported a slight accretion in their CET-1 ratios. PSBs reported a CET-1 accretion of around **-11bp to +54bp**, while it ranged from **-53bp to +70bp** for private banks (excluding Bandhan and KMB). Among the outliers, KMB reported a healthy accretion in CET-1 by 2.1%, aided by stake sale in Kotak General insurance subsidiary, while Bandhan reported a sharp 3.1% decline in CET-1, affected by the increase in risk-weight in its EEB portfolio.

New norms drive an uptick in investment yields; PSBs see 15-40bp gain

Investment yields for most banks have increased as they earlier used to shift their high-yielding securities from HTM to AFS in order to book profits. However, new regulations restrict this practice, causing high-yielding assets to remain on the book. Additionally, revised norms now require amortizing discounts and premium over the security's term, contributing to the uptick in investment yields. This change means that investment yields will now follow a normalized trajectory and prevent any abrupt volatility. While many private banks do not disclose investment yield movements, PSBs have reported 3bp to 27bp improvement in investment yields. This has actually helped margins for PSBs as most of them reported a controlled NIM decline despite a continued rise in deposit costs, while the yield on advances also moderated for select PSBs.

Volatility in trading gains to moderate

PSBs historically have reported high volatility in trading profits depending on the interest rate environment. However, the new regulations are expected to limit this volatility in treasury gains, while banks' reserves/net worth will directly reflect the MTM movement on the AFS portfolio. We believe that banks will now actively manage their FVTPL portfolio to improve their overall treasury performance. This becomes even more critical as the reclassification of investments has been made more stringent and needs prior board/RBI approval.

Valuation and sector view

Although the overall guidelines has supported investment yields, capital ratios for banks and aligns investment classification to best practices, we remain watchful of growth outlook and performance on key metrics (margins, credit cost, LCR regulations etc.). During 1QFY25 earnings, we have moderated growth estimates across many banks and estimate ~13% loan growth cagr over FY24-26E. This has resulted in a ~2-3% cut in Private Banks sector earnings growth to low double digit run-rate during FY25E while PSBs are likely to fare better here. However, robust balance sheets, strong contingency buffers and reasonable sector valuations keeps us positive on the sector, though return outlook remains modest. **Our preferred picks** are ICICIBC, HDFCB, SBIN and FB.

Among private banks, KMB saw the maximum increase in net worth by 3%, led by reserve accretion of INR29b.

Punjab Sind Bank and Central Bank reported a decline in general reserves due to a change in valuation methodology related to the treatment of zero coupon bonds.

Exhibit 1: AFS + General reserve accretion across key private banks & PSBs during 1QFY25

	AFS Reserve Accretion (INR b)	% of FY24 NW	% of total invest-ments	General Reserve Accretion (INR b)	% of FY24 NW	% of total invest-ments	NW Accretion (INR b)	% of FY24 NW	% of total invest-ments
HDFCB	NA	NA	NA	1.3	0.0%	0.0%	1.3	0.0%	0.0%
ICICIBC	20.6	0.9%	0.4%	11.6	0.5%	0.2%	32.1	1.3%	0.7%
AXSB	0.0	0.0%	0.0%	14.6	1.0%	0.5%	14.6	1.0%	0.5%
KMB	NA	NA	NA	NA	NA	NA	29.1	3.0%	1.8%
IIB	NA	NA	0.0%	1.7	0.3%	0.2%	1.7	0.3%	0.2%
FB	NA	NA	NA	NA	NA	NA	3.4	1.2%	0.5%
BANDHAN	0.7	0.3%	0.2%	0.3	0.2%	0.1%	1.1	0.5%	0.3%
SBIN	38.7	1.0%	0.2%	-13.3	-0.4%	-0.1%	25.4	0.7%	0.2%
BOB	NA	NA	NA	NA	NA	NA	30.2	2.7%	0.8%
CBK	0.6	0.1%	0.0%	17.5	2.0%	0.5%	18.1	2.1%	0.5%
UNBK	0.2	0.0%	0.0%	17.0	1.8%	0.5%	17.2	1.8%	0.5%
INBK	2.1	0.4%	0.1%	-2.1	-0.4%	-0.1%	0.0	0.0%	0.0%
PNB	0.3	0.0%	0.0%	21.0	2.0%	0.5%	21.3	2.0%	0.5%
BOM	2.0	0.9%	0.3%	NA	NA	NA	2.0	0.9%	0.3%
CBOI	2.5	0.8%	0.2%	-12.4	-3.8%	-0.9%	-10.0	-3.1%	-0.7%
UCO	0.4	0.1%	0.0%	7.5	2.7%	0.4%	7.9	2.9%	0.4%
IOB	0.2	0.1%	0.0%	NA	NA	NA	0.2	0.1%	0.0%
PJSB	0.2	0.2%	0.0%	-42.5	-37.3%	-9.5%	-42.3	-37.1%	-9.5%
BOI	NA	NA	NA	NA	NA	NA	1.3	0.2%	0.1%
IDBI	4.0	0.8%	0.3%	10.9	2.0%	0.9%	14.9	2.8%	1.3%

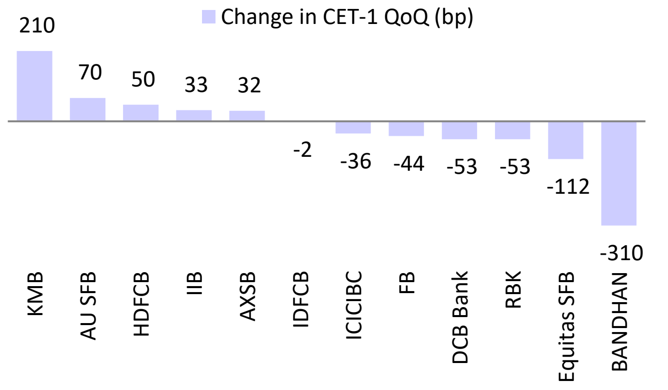
Source: MOFSL, Company

Exhibit 2: Capital ratios improve for most banks; PSBs witness CET-1 boost of up to 54bp

Banks	NW accretion (INR b)	% of NW	CET 1 -1QFY25	QoQ Change (bp)	CRAR - 1QFY25
Private*					
HDFCB	1.3	0%	16.8%	50	19.3%
ICICIBC	32.1	1%	15.2%	-36	16.0%
AXSB	14.6	1%	14.1%	32	16.7%
KMB	29.1	3%	21.3%	210	22.4%
IIB	1.7	0%	16.2%	33	17.6%
FB	3.4	1%	14.2%	-44	15.6%
BANDHAN	1.1	0%	14.1%	-310	15.7%
IDFCB	5.3	2%	13.3%	-2	15.9%
RBK	0.8	1%	13.9%	-53	15.6%
Public					
SBIN	25.4	1%	10.3%	-11	13.9%
BOB	30.2	3%	13.1%	54	16.8%
CBK	18.1	2%	12.1%	47	16.4%
UNBK	17.2	2%	13.8%	16	17.0%
INBK	0.0	0%	13.4%	-10	16.5%
PNB	21.3	2%	11.0%	-9	15.8%
BOM	2.0	1%	12.2%	-30	17.0%
UCO	7.9	3%	14.4%	22	17.1%
PJSB	-42.3	-37%	14.8%	6	17.3%
IDBI	14.9	3%	20.3%	15	22.4%

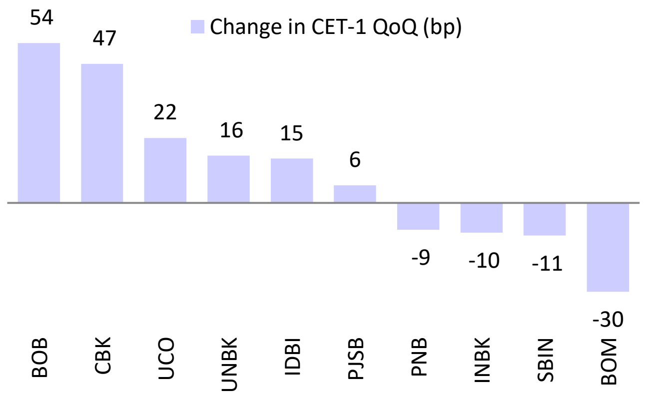
Source: MOFSL, Company; *Investment book break-up for private bank is as on FY24

Exhibit 3: Accretion in CET-1 ratio across private banks



Source: MOFSL, Company

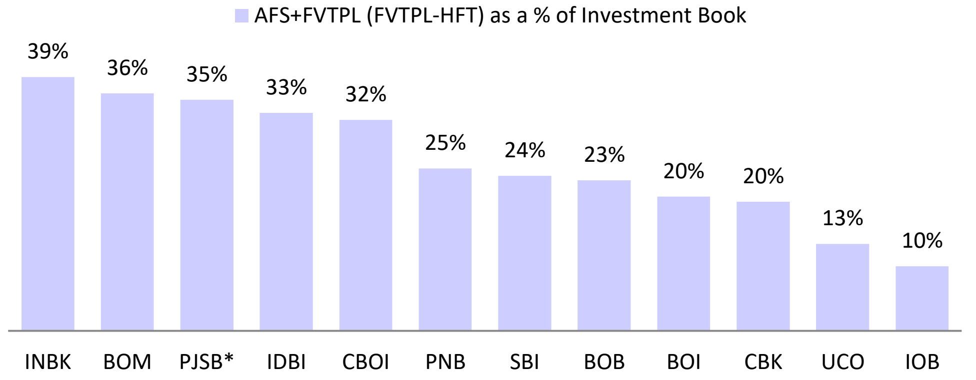
Exhibit 4: Accretion in CET-1 ratio across PSBs



Source: MOFSL, Company

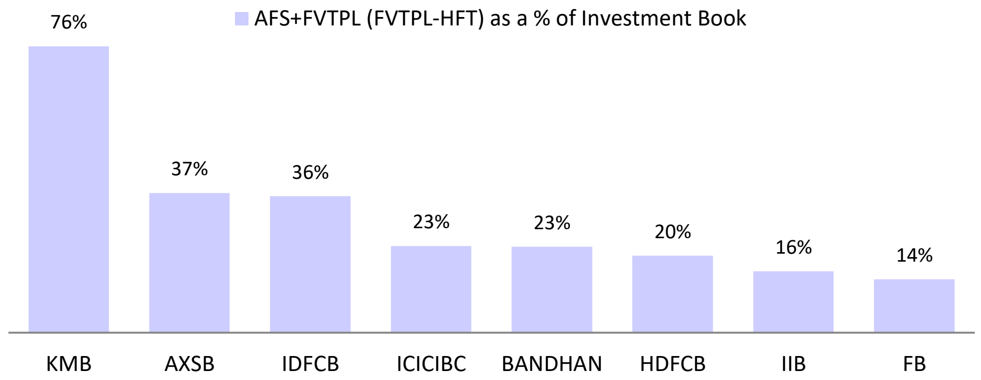
Most PSBs reported a rise in the mix of AFS + FVTPL (inc. FVTPL-HFT) book during 1QFY25.

Exhibit 5: PSBs have 20-40% of their investments classified under AFS+FVTPL (including FVTPL-HFT)



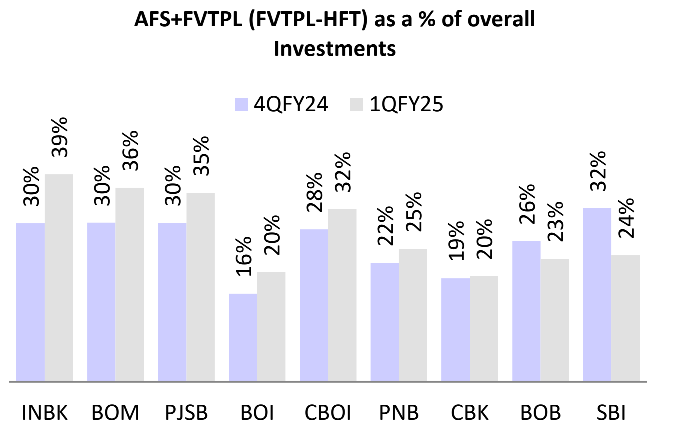
* Data for AFS book only, Source: MOFSL, Company

Exhibit 6: Most private banks have 15-40% of their investment book in AFS+FVTPL (inc. FVTPL-HFT) category



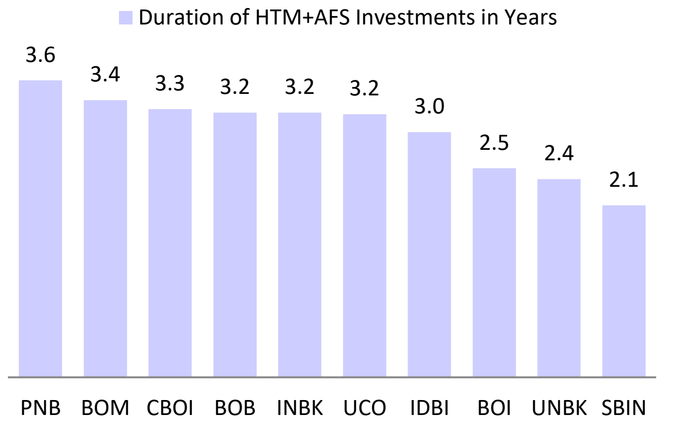
Note: Data as on FY24 , Source: MOFSL, Company

Exhibit 7: Mix of AFS + FVTPL (inc. FVTPL-HFT) investments increased for several PSBs during 1QFY25



Source: MOFSL, Company

Exhibit 8: Duration of AFS+HFT investment book among PSBs stands at >2 years



Source: MOFSL, Company

Yield on advances declined for PSBs, while the cost of deposits saw a steady rise.

Exhibit 9: Advances yield moderated for most PSBs while funding cost inched up

	Yield on Advances (%)	QoQ Change, bp	Cost of Deposits (%)	QoQ Change, bp
SBIN	8.8%	-8	5.0%	19
BOB	9.0%	-26	5.1%	2
CBK	8.7%	-5	5.7%	20
UNBK	8.7%	-15	5.4%	-5
INBK	8.7%	-12	5.1%	4
PNB	8.3%	-11	5.1%	1
BOM	9.0%	-18	4.5%	-8
CBOI	8.7%	-19	4.7%	-7
UCO	8.8%	-30	4.8%	-3
PJSB	8.7%	3	5.6%	-7
BOI	8.6%	13	4.8%	11

Source: MOFSL, Company

Sharp improvements in investment yield limited any major compression in margins even as funding cost remains tight while YoA moderated across many banks.

Exhibit 10: …however sharp improvement in investment yield limit margin decline

	Yield on Investments (%)	QoQ Change, bp	NIMs (%)	QoQ Change, bp
SBIN	7.20%	20	3.2%	-6
BOB	7.07%	16	3.3%	-15
CBK	6.94%	3	2.9%	-15
UNBK	NA	NA	3.1%	-4
INBK	7.15%	27	3.4%	0
PNB	7.06%	24	3.1%	-3
BOM	6.99%	41	4.0%	0
CBOI	6.86%	6	3.6%	-1
UCO	6.77%	33	3.3%	5
PJSB	7.05%	23	2.7%	37
BOI	7.13%	32	3.1%	15

Source: MOFSL, Company

Exhibit 11: Key changes in revised Investment Regulations vs previous methodology

New 2023 Regulations	Old 2021 regulations
1. Classification of investments	
❖ Bank should classify their entire investment portfolio (except investments in their own subsidiaries, joint ventures and associates) under three categories - Held to Maturity (HTM), Available for Sale (AFS) and Fair Value through Profit and Loss (FVTPL)	❖ Banks used to classify their entire investment portfolio (including SLR securities and non-SLR securities) under three categories, viz., Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT)
❖ All Investments in own subsidiaries, joint ventures and associates would be held in a distinct category - which is separate from other investment categories (i.e., HTM, AFS and FVTPL)	❖ Investment in equity of subsidiaries and joint ventures would be eligible for inclusion in HTM category.
2. Reclassification between investment categories	
❖ Reclassification after transitioning would be permitted only in exceptional circumstances. Such reclassification would require a prior approval of the Board of Directors and the department of supervision of RBI	❖ Reclassification were permitted freely between different categories once in a year with prior approval of the Board.
3. Gains/ Losses on AFS securities	
❖ The valuation gains and losses held under AFS need to be aggregated and the net appreciation or depreciation should directly get credited or debited to a reserve named 'AFS reserve' without routing through the Profit and Loss Account Any discount or premium on the acquisition of debt securities under AFS needs to be amortized over the remaining life of the instrument	❖ Profit or loss on sale of investments in the AFS category is required to be taken to the Profit and Loss Account. Net depreciation on AFS investments is currently required to be provided in P&L account and net appreciation is to be ignored.
4. Ceiling of Investments in the HTM category	
❖ There is no limit on the investments that can be made under the HTM category.	❖ Investments under the HTM category should not exceed 25% of a bank's total investments.
5. Holding period for the HFT/ FVTPL category	
❖ The FVTPL category or the HFT sub-category do not stipulate a period within which investments in that category need to be sold	❖ Investments classified under HFT should be sold within 90 days.
6. Sale of Investments in the HTM category	
❖ Investments under HTM category should not exceed 5%, any excess sale of 5% would require prior approval from the RBI.	❖ Banks needs to disclose the market value of the investments held in the HTM category if the sales/ transfers exceeds 5% of the book value
7. Acquisition of Investments at discount/ premium	
❖ For HTM, Any discount or premium on securities under HTM should be amortized over the remaining life of the instrument For AFS, Any discount or premium on the acquisition of debt securities under AFS needs to be amortized over the remaining life of the instrument	❖ The discount or premium would be recognized as a one-time gains or losses in the P&L account.

Source: MOFSL, RBI

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Investment Rating	**Expected return (over 12-month)**
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SELL	< - 10%
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