India Banks: Undoing Financial Repression – Structural Reset of Economics

3 September, 2014

Undoing Financial Repression – Structural Reset of Economics

Fiscal profligacy by the GoI since FY09 resulted in ~35% of the banking sector's incremental deposit mobilization over this period funding Govt.'s borrowing requirements (vis-a-vis ~15% over FY02-07) due to which the banking sector currently has 28% of NDTL as SLR holdings against the mandated minimum of 22%. Bond yields rose from close to 5% in late 2008 to ~9% in late 2013 resulting in bond losses apart from impacting CD ratio and NIMs. In this note, we study the potential structural changes to the banking sector's economics over the ensuing 4-5 years due to a combination of a Govt. committed on fiscal consolidation and a RBI keen to reduce SLR requirements.

We conclude that a possible sub-3% fiscal deficit scenario in 4-5 years can incentivize RBI to cut SLR requirement to sub-18% and bring about ~200bps correction to bond yields resulting in non-linear improvement to loan growth, CD ratios, NIMs, treasury gains and absorption of credit costs heralding a new-normal scenario of accepted RoA trajectory for banks. For most Pvt banks, the gains in the overall SLR book (including HTM book) can offset the credit costs and result in RoA expansion. However, for PSU banks, gains on the bond book - even assuming a decline in bond yields to 6% can offset only 25%-40% of current levels of stressed assets (net NPAs and restructured assets). Our polarized view on the banking sector gets further strengthened post this analysis.

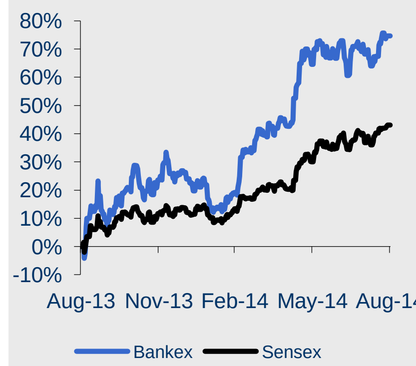
We draw comparison to a similar phase between 1999 and 2007, when fiscal deficit corrected from more than 6% to close to 2.5% of GDP. In that phase, bond yields fell from more than 12% to less than 6% and systemic SLR holdings fell from 40% of NDTL to 30% leading to a) CD ratios expanding from 45% to 69%, b) banking system NIMs moving from 3.1% to 3.6% and c) sizable bond market gains helping banks absorb almost the entire credit costs.

From a AFS book and modified duration perspective, KMB, YES, IIB, AXSB and KVB are better positioned amongst private peers while INBK, CBK, PNB and IOB stand to benefit in the PSU pack.

Key takeaways:

- **RBI to continue to cut SLR.** We estimate India's fiscal deficit to gradually narrow to 2.8% of GDP by FY20 led by higher tax revenue and lower subsidy burden (refer slide 16). As a result, net market borrowings to fall to 2.4% of GDP by FY20E from 4% of GDP in FY14, limiting supply of G-secs allowing RBI to further cut SLR for banks.
- **NIMs to improve.** Likely cut in SLR requirements to 18% of NDTL to propel systemic CD ratios to ~82% from 77% at present. This uptick in CD ratios should result in systemic NIMs expanding by ~20bps and RoA by ~10bps even without accounting for any change in spreads because of a potential drop in the cost of liabilities.
- **Bond yields to decline.** Despite SLR being cut to 18%, we estimate systemic SLR holdings to remain higher at ~22%, with the differential on account of the liquidity coverage ratio. We foresee the systemic demand supply equation changing in favor of supply from FY15, despite SLR holdings falling from 28% at present to 22% by FY19 (slide 6). Accordingly we believe bond yields are set to fall ~200bps over the ensuing 4-5 year period.

Date	Sep 3, 2014



Performance (%)

	1m	3m	12m
Bankex	5%	6%	81%
Sensex	3%	11%	46%

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"Our banks have a number of obligations that pre-empt lending, and allow what is called 'lazy banking'.

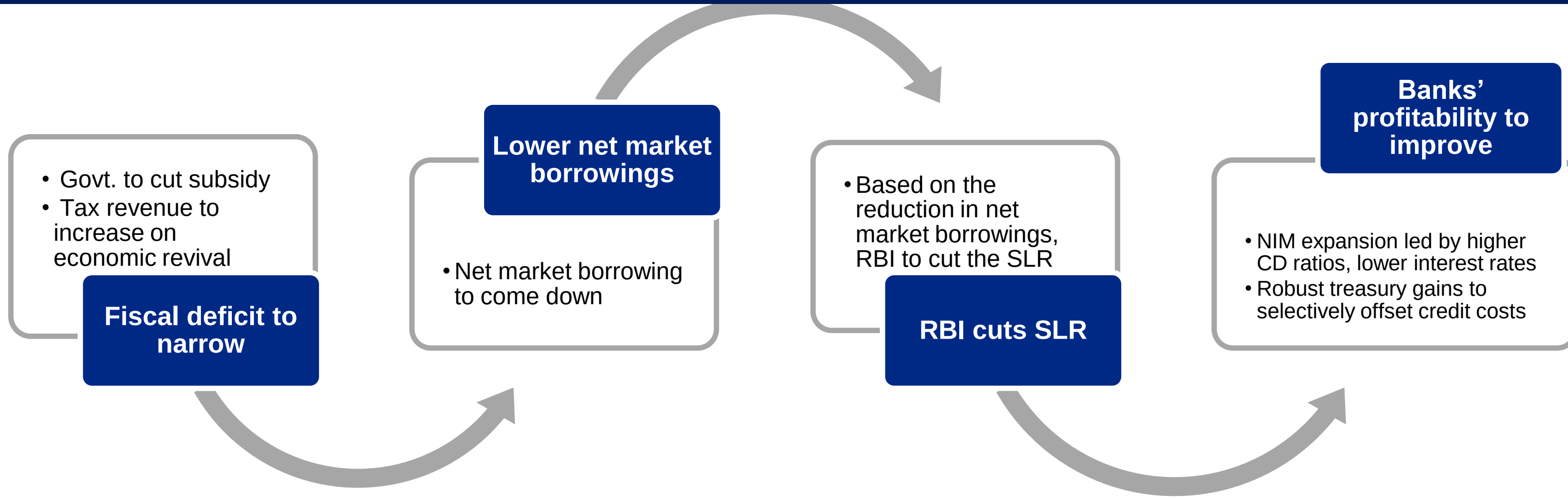
In this context, we need to reduce the requirement for banks to invest in government securities in a calibrated way, to what is strictly needed from a prudential perspective.

As government finances improve, the scope for such reduction will increase."

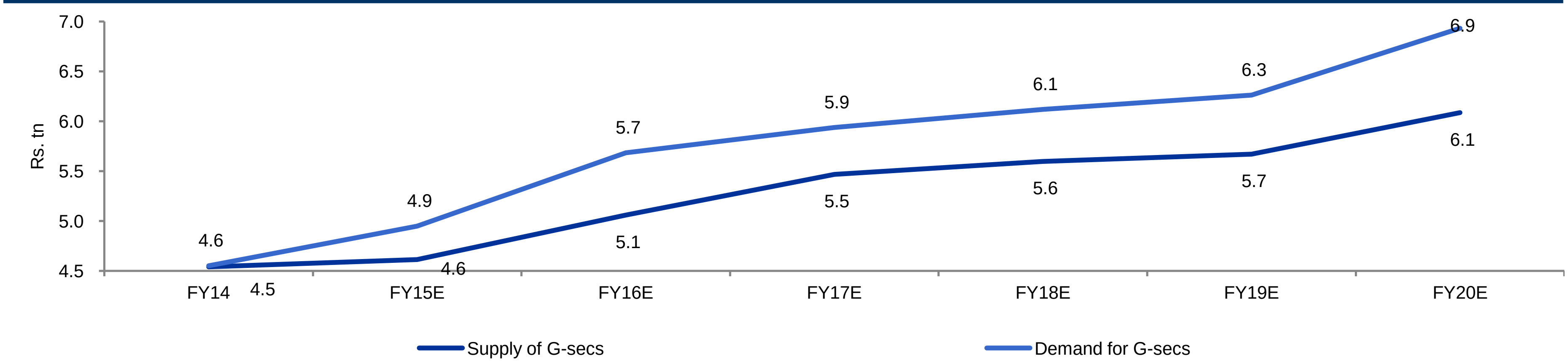
Financial repression *refers to a set of governmental policies that regulate or manipulate a captive audience – majorly banks- into investing in government debt. This results in cheap funding and is a prime tool used by governments in indebted economies.*

RBI to cut SLR based on the pace of reduction in fiscal deficit and net market borrowings

RBI to cut SLR in a phased manner depending on the pace of fiscal consolidation



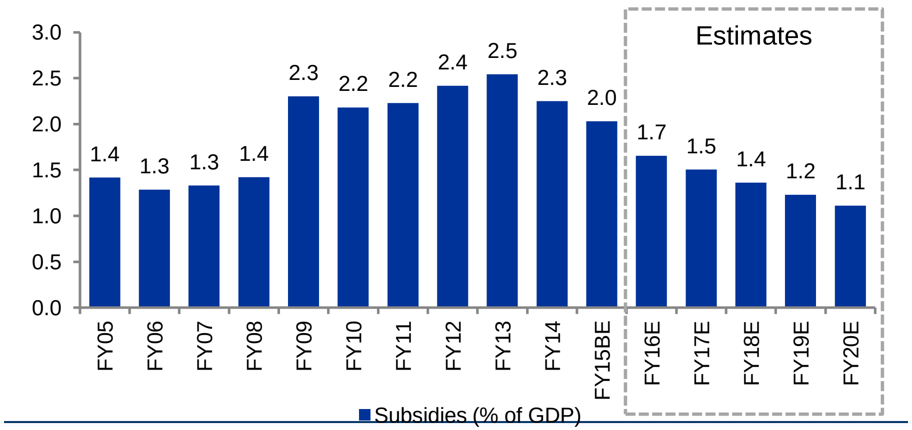
Demand for bonds to be higher than supply, despite SLR cuts due to pick up in financial savings. This realignment is set to drive yields lower.



Source: India Budget, Spark Capital Research

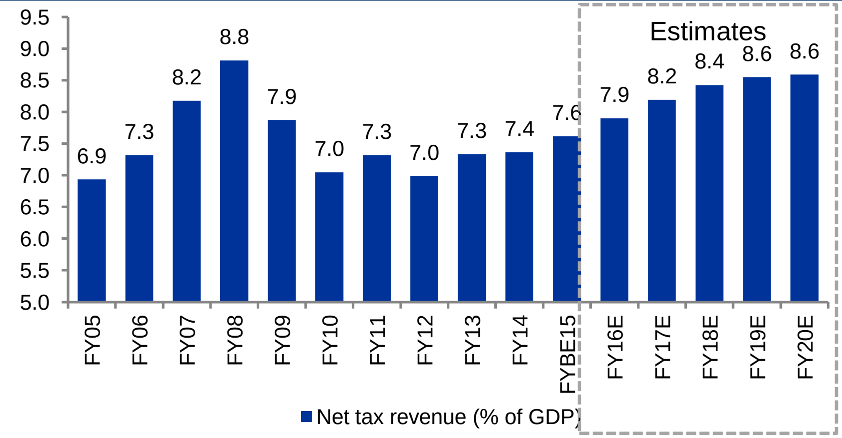
Fiscal deficit to narrow to 2.8% of GDP owing to lower expenditure and higher tax revenue

#1. Subsidies to continue to taper



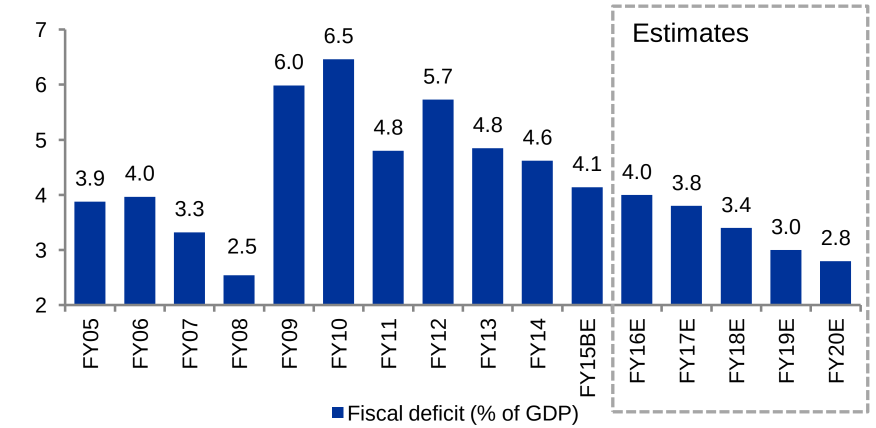
Source: India Budget, Spark Capital Research

#2. Tax revenue to start increasing on economic recovery



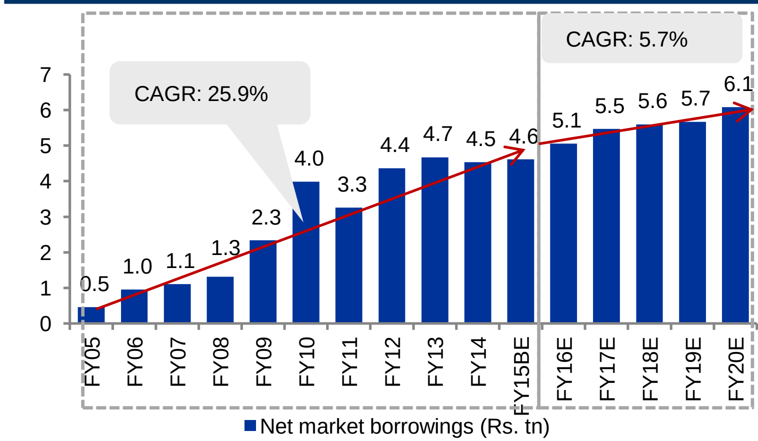
Source: India Budget, Spark Capital Research

Leading to gradual reduction in fiscal deficit



Source: India Budget, Spark Capital Research

Net market borrowings to remain contained



Source: India Budget, Spark Capital Research

Demand and supply equation indicates lower bond yields despite SLR cuts

RBI can cut the SLR to 18% of NDTL by FY19 as lower fiscal deficit leads to lower net market borrowing

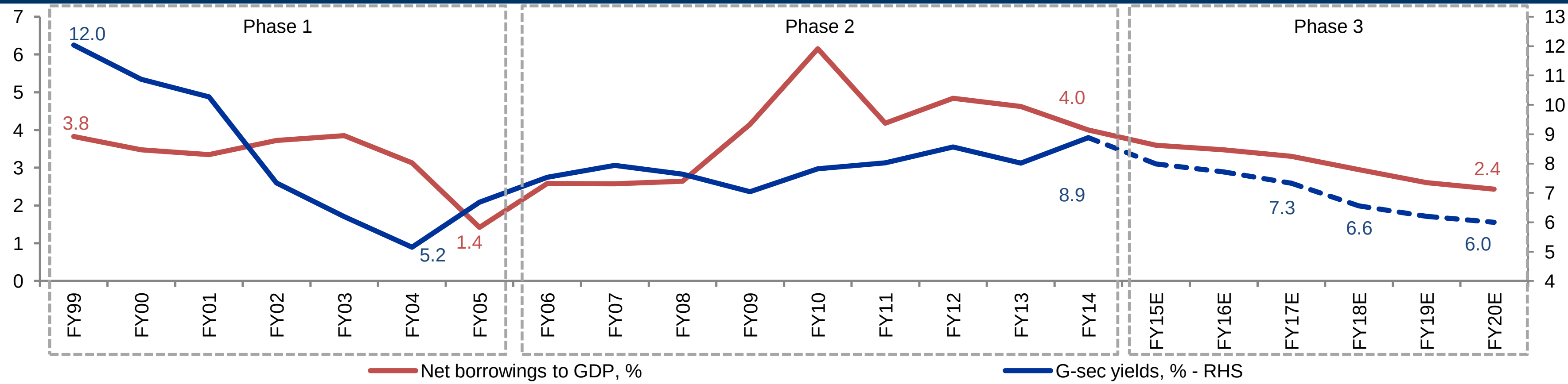
Demand and supply of G-secs

	(Rs. bn)	FY14	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E
Supply	Fiscal deficit	5,245	5,312	5,825	6,298	6,446	6,530	7,009
	Fiscal deficit (% of GDP)	4.6	4.1	4.0	3.8	3.4	3.0	2.8
	Total supply of G-secs or Net borrowings	**4,539**	**4,612**	**5,058**	**5,468**	**5,597**	**5,670**	**6,085**
	Demand model for banks							
	Deposits	77,394	89,003	103,243	119,762	138,326	157,691	178,191
	Deposits growth	14.6	15.0	16.0	16.0	15.5	14.0	13.0
Actual SLR investments	Systemic SLR (% of DTL)	28.7	27.3	26.0	24.5	23.0	22.0	22.0
	Systemic SLR	22,216	24,298	26,843	29,342	31,815	34,692	38,489
	Systemic SLR investment (Incremental)	2,155	2,081	2,545	2,498	2,473	2,877	3,797
Mandated SLR investments	Mandated SLR by RBI (% of NDTL)	22.5	22.0	21.5	21.0	20.0	19.0	18.0
	Mandated SLR by RBI	17,414	19,581	22,197	25,150	27,665	29,961	32,074
	Mandated SLR investment (Incremental)	2,056	2,167	2,617	2,953	2,515	2,296	2,113
Total Demand	**Institution-wise demand of bonds**							
	Banks	2,155	2,081	2,545	2,498	2,473	2,877	3,797
	Insurance	1,250	1,813	1,903	1,998	2,158	2,309	2,439
	Pension funds	450	495	550	622	659	719	775
	MFs	200	260	338	423	490	211	67
	FIIs	(25)	300	345	397	337	145	(145)
	RBI's OMO	520	-	-	-	-	-	-
	Total demand	**4,550**	**4,949**	**5,682**	**5,938**	**6,118**	**6,261**	**6,933**
	Demand -Supply	**11**	**337**	**624**	**470**	**521**	**591**	**848**

Bank deposits account for ~55% of household financial savings. We expect financial savings to pick up in next 4-5 years, leading to a sharp increase in the Banks Deposit base – from Rs. 77tn to Rs. 158tn in next five years. Hence, as the deposit base increases, demand for bonds from banks would increase despite SLR cuts.

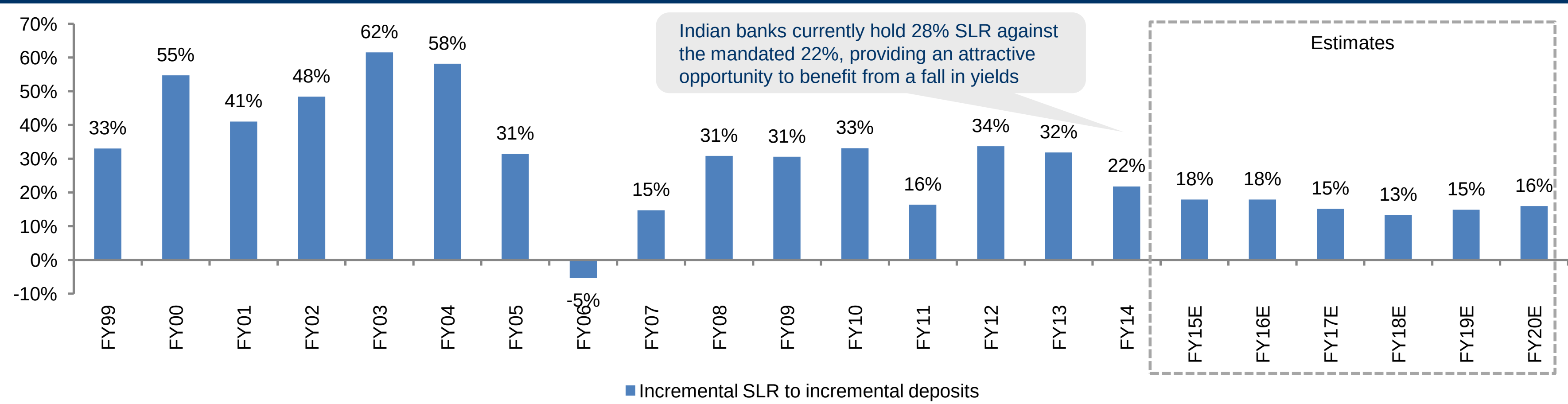
Bond yields to decline towards 6% in next 4-5 years

Fall in net market borrowings to result in decline in 10Y Gsec yields to ~6% by FY20



Source: RBI, Spark Research

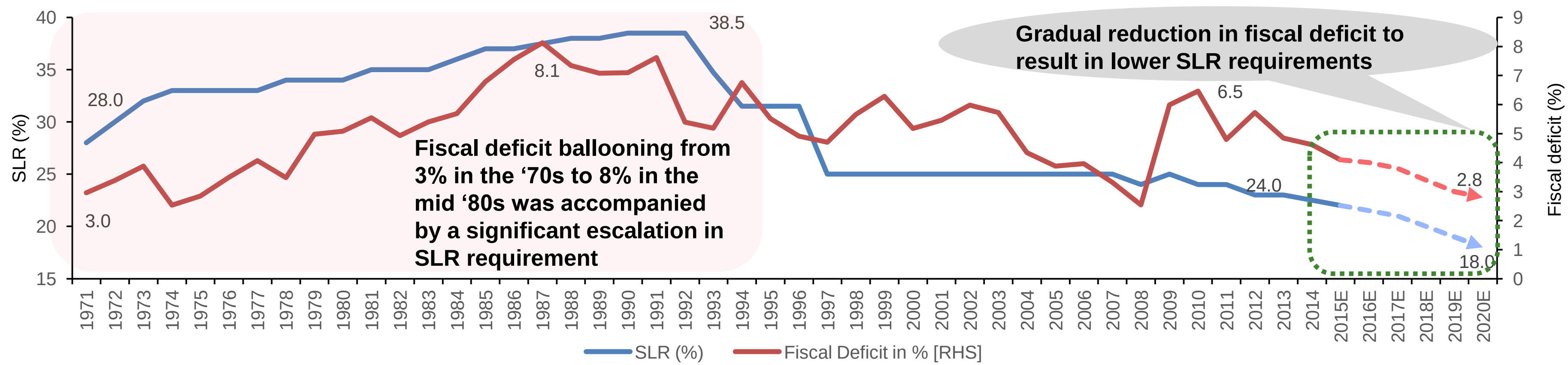
Banks would be able to cut SLR from the current 28% as funding Govt.'s borrowing requirements to come down on lower net borrowings



Source: Spark Capital Research

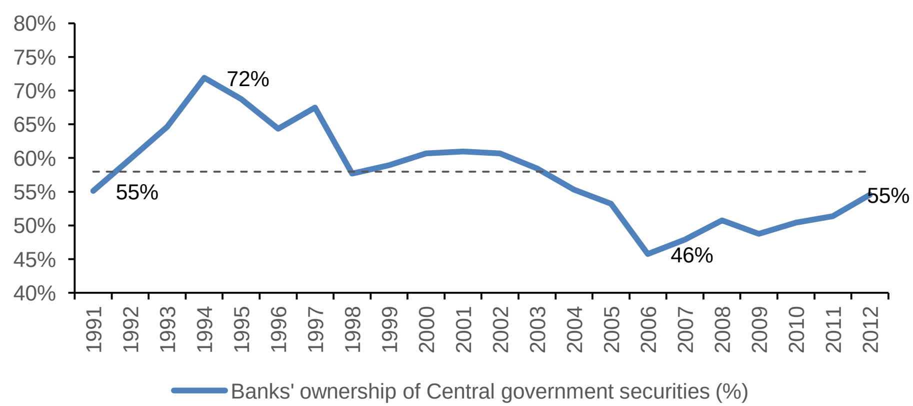
Indian banks have historically funded >50% of government borrowings

Strong correlation between fiscal profligacy and mandated SLR requirement...



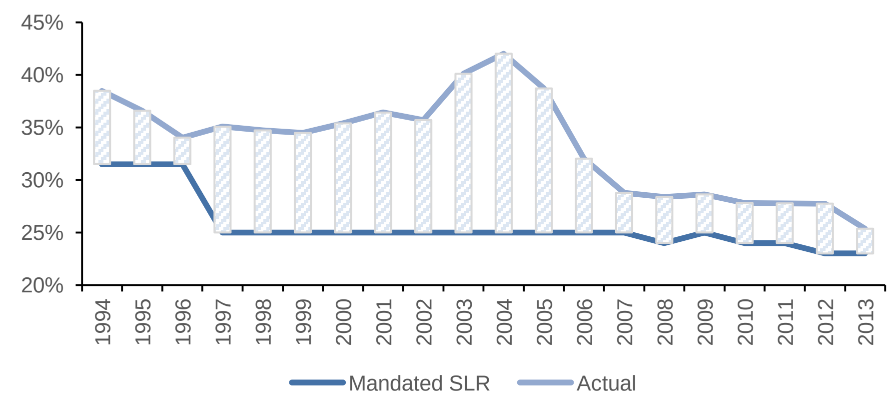
Source: RBI, Spark Research

... resulting in a captive market for government debt with Indian banks consistently holding >50%



Source: RBI,Spark Research

Indian banks have historically maintained ~4-7% excess SLR. Excess SLR is a function of credit demand, bond yields and liquidity.

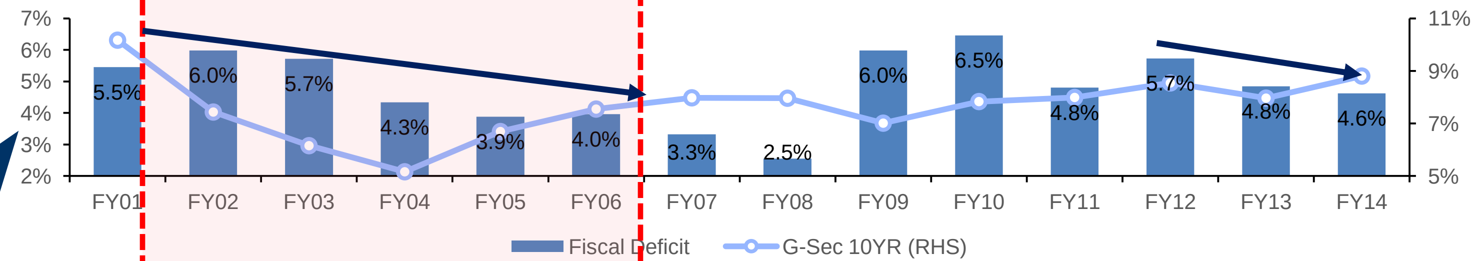


Source: RBI, Spark Research

Lower fiscal deficit, higher CD ratios – impact on SBI's NIM

Between FY02-FY06, SBI's CD ratio went from 45% to 69%, driving NIMs from 3.1% to 3.6%.

FY02-FY06 witnessed a reduction in fiscal deficit and flat market borrowings. Over this period incremental demand for bonds outstripped supply driving yields lower



	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Net Borrowings (Rs. Bn)	729	877	976	889	460	954	1104	1318	2336	3984	3254	4362	4674	4539
Incremental SLR investment (Rs. Bn)	612	681	1093	1300	616	-217	741	1802	1947	2183	1169	2362	2683	2155

Source: Spark Research

Balance sheet	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Networth	4%	4%	5%	5%	5%	6%	6%	7%	6%	6%	5%	6%	6%	7%
Total Deposits	77%	78%	79%	78%	80%	77%	77%	74%	77%	76%	76%	78%	77%	78%
Total Borrowings	3%	3%	2%	3%	4%	6%	7%	7%	6%	7%	7%	7%	11%	10%
Other Liabilities	15%	15%	14%	14%	11%	11%	11%	12%	11%	10%	12%	9%	6%	5%
Total Networth and Liabilities	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Cash & Balance with RBI	6%	6%	3%	5%	4%	4%	5%	7%	6%	6%	8%	4%	4%	5%
Bal with banks	13%	12%	9%	6%	5%	5%	4%	2%	5%	2%	2%	3%	3%	3%
Investments	39%	42%	46%	46%	43%	33%	26%	26%	29%	28%	24%	23%	22%	22%
Advances	36%	35%	37%	39%	44%	53%	60%	58%	56%	60%	62%	65%	67%	68%
Fixed & Other assets	6%	5%	6%	5%	5%	5%	5%	7%	4%	4%	4%	4%	4%	3%
Total Assets	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
CD Ratio	47%	45%	47%	50%	55%	69%	77%	78%	73%	79%	81%	83%	87%	87%
ID Ratio	51%	54%	58%	58%	54%	43%	34%	35%	37%	37%	32%	30%	29%	29%
Spread	2.5%	2.5%	2.4%	2.6%	3.1%	3.2%	3.1%	2.7%	2.4%	2.3%	3.0%	3.6%	3.1%	3.1%
NIM	3.0%	3.1%	3.1%	3.1%	3.5%	3.6%	3.4%	2.9%	2.8%	2.6%	3.2%	3.8%	3.3%	3.2%
RoA	0.5%	0.7%	0.9%	0.9%	1.0%	0.9%	0.9%	1.0%	1.1%	0.9%	0.7%	0.9%	1.0%	0.6%

If SLR is cut to 18%, what would the impact on systemic CD ratios & NIMs be?

We estimate a 20bps uptick in systemic NIMs and ~10bps improvement in RoAs if SLR was cut to 18%

	As is	Scenarios							
SLR % (Mandated)	22%	30%	24%	20%	18%	16%	14%	12%	10%
SLR % (actual)	26%	34%	28%	24%	22%	20%	18%	16%	14%
SLR differential for LCR requirement	4%	4%	4%	4%	4%	4%	4%	4%	4%
CD ratio%	77%	69%	75%	79%	81%	84%	86%	88%	90%
NIM %	3.17%	2.94%	3.11%	3.22%	3.28%	3.33%	3.39%	3.44%	3.50%
RoA%	0.72%	0.59%	0.69%	0.75%	0.78%	0.81%	0.84%	0.88%	0.91%
B/S									
Networth	7	7	7	7	7	7	7	7	7
Deposits	86	86	86	86	86	86	86	86	86
Borrowings	4	4	4	4	4	4	4	4	4
Other Liabilities	3	3	3	3	3	3	3	3	3
Networth and Liabilities	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Cash & balance with RBI	5	5	5	5	5	5	5	5	5
Bal with banks	3	3	3	3	3	3	3	3	3
Investments	23	31	25	22	20	18	16	14	13
Advances	66	59	65	68	70	72	74	75	77
Fixed & Other Assets	2	2	2	2	2	2	2	2	2
Assets	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
P&L									
Interest earned	9.0	8.8	8.9	9.0	9.1	9.1	9.2	9.2	9.3
Interest expended	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
NII	**2.7**	**2.5**	**2.6**	**2.7**	**2.8**	**2.8**	**2.9**	**2.9**	**3.0**
Other Income	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Total income	3.7	3.5	3.6	3.7	3.8	3.8	3.9	3.9	4.0
Operating expenses	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
PPOP	**1.9**	**1.7**	**1.8**	**1.9**	**2.0**	**2.0**	**2.1**	**2.1**	**2.2**
Provisions	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
PBT	1.1	0.9	1.0	1.1	1.2	1.2	1.3	1.3	1.4
Tax	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
PAT	**0.72**	**0.59**	**0.69**	**0.75**	**0.78**	**0.81**	**0.84**	**0.88**	**0.91**

*** YoA- Yield on Advances, YoI: Yield on Investments, CoD: Cost of Deposits, OI: Other income**

Key Assumptions

Despite the RBI cutting SLR to 18% we estimate actual SLR holdings to remain higher by ~400bps, given the implementation of the liquidity coverage ratio

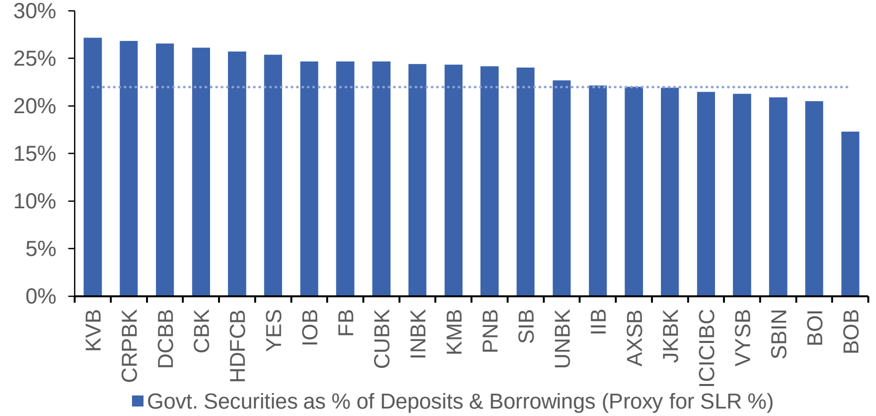
Systemic CD ratios can move from 77% at present to ~81% assuming a mandatory SLR requirement of 18%, driving NIMs and RoAs upwards by 20 and 10bos respectively

Assumptions*

YoA : 10.6%
YoI : 8.0%
CoD : 6.9%
OI: 1% of assets
Opex : 1.8% of assets
Non-tax provisions: 0.8% of assets
Tax rate: 33%

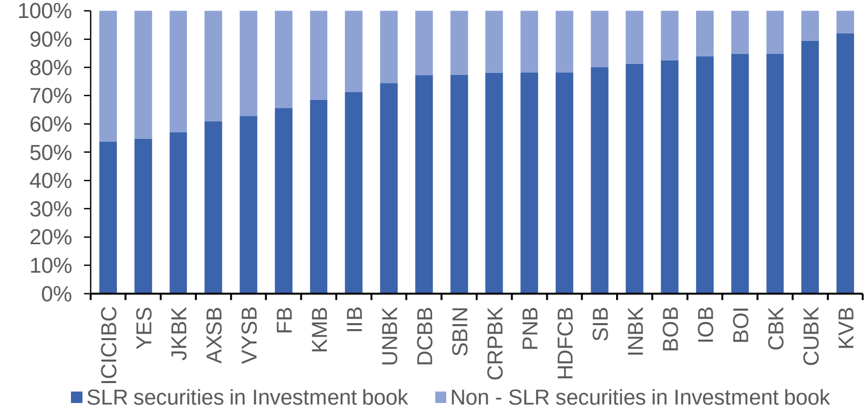
Banks' investment books attractively poised to benefit from a fall in yields

Indian banks continue to hold ~25% of DTL in g-secs…



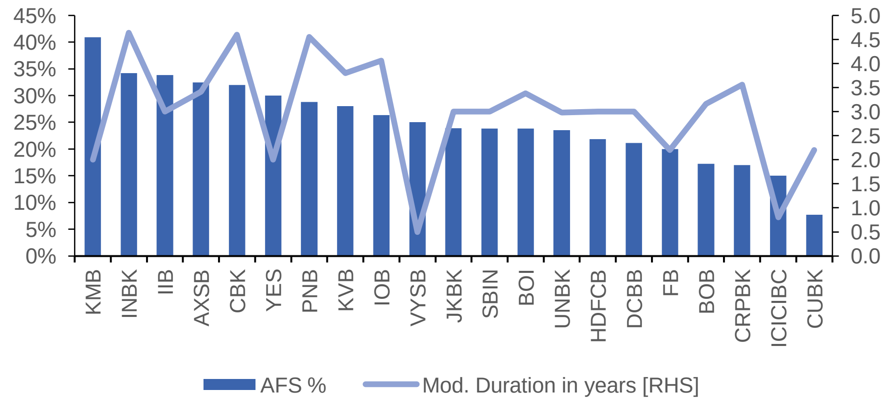
Source: Company,Spark Research

…leading to an investment book top heavy on SLR securities



Source: Company, Spark Research

Most banks maintain ~20-25% of investments in AFS with a m.dur of 3



Source: Company, Spark Research

- Indian banks currently hold 28% SLR against the mandated 22% , providing an attractive opportunity to benefit from a fall in yields
- Banks with a high AFS book and m.duration viz. KMB, IIB, AXSB and KVB are better positioned amongst private peers while CBK, PNB, INBK and IOB stand to benefit in the PSU pack

Potential drop in bond yields to offer a meaningful buffer to offset credit costs...

As bond yields ease, we estimate potential treasury gains to average 13-26% of NPA provisions for the system. Amongst private sector banks, JKBK, KMB, YES, DCBB, AXSB, KVB and FB stand to benefit the most, while INBK, CBK and PNB would benefit in the PSU pack.

	AFS Investments (Rs.bn)	Modified Duration	NPA Provisions Sum of FY15&16	100bps decline		150bps decline		200bps decline	
				Potential gains (Rs.bn)	Gains as % of NPA Provisions	Potential gains (Rs.bn)	Gains as % of NPA Provisions	Potential gains (Rs.bn)	Gains as % of NPA Provisions
JKBK	63	3.0	3	1.9	60%	2.8	91%	3.8	121%
KMB	104	2.0	4	2.1	50%	3.1	74%	4.2	99%
YES	123	2	8	2.5	30%	3.7	45%	4.9	60%
DCBB	8	3.0	1	0.2	28%	0.3	42%	0.5	56%
AXSB	369	3.4	47	12.6	27%	18.9	40%	25.2	54%
KVB	37	3.8	5	1.4	26%	2.1	39%	2.8	52%
FB	48	2.2	4	1.1	25%	1.6	38%	2.1	50%
IIB	73	3.0	9	2.2	24%	3.3	36%	4.4	48%
INBK	160	4.6	32	7.4	23%	11.2	35%	14.9	47%
HDFCB	264	3.0	35	7.9	22%	11.9	34%	15.8	45%
CBK	406	4.6	85	18.7	22%	28.0	33%	37.3	44%
PNB	414	4.6	111	18.9	17%	28.3	25%	37.7	34%
UNBK	221	3.0	52	6.6	13%	9.9	19%	13.2	25%
IOB	185	4.1	61	7.5	12%	11.3	19%	15.0	25%
BOI	272	3.4	95	9.2	10%	13.8	15%	18.4	19%
CRPBK	113	3.6	42	4.0	10%	6.0	14%	8.0	19%
SBIN	950	3.0	318	28.5	9%	42.8	13%	57.0	18%
BOB	200	3.2	77	6.3	8%	9.5	12%	12.7	17%
SIB	10	3.1	4	0.3	7%	0.5	11%	0.6	14%
VYSB	42	0.5	3	0.2	6%	0.3	9%	0.4	12%
CUBK	5	2.2	3	0.1	4%	0.2	6%	0.2	8%
ICICIBC	266	0.8	61	2.1	3%	3.2	5%	4.2	7%
System	**4,209**		**1,052**	**139**	**13%**	**209**	**20%**	**278**	**26%**

... however gains will be limited relative to earlier phases

Between FY01-FY04 10yr G-Sec yields declined by 501bps resulting in a phase of treasury gains offsetting NPA provisions														
Treasury gains/NPA provisions	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
AXSB	235%	160%	268%	125%	-1839%	31%	-8%	62%	25%	56%	28%	2%	58%	33%
HDFCB	-4%	99%	147%	15%	-144%	-62%	-10%	16%	26%	18%	-4%	-9%	6%	7%
ICICIBC	62%	114%	14%	321%	-4%	-10%	94%	90%	36%	19%	-11%	-4%	29%	20%
IIB	23%	69%	82%	143%	-8%	6%	29%	26%	99%	87%	26%	34%	28%	-11%
KMB		72%	-70%	547%	94%	-76%	-15%	11%	-1%	12%	38%	205%	108%	4%
YES								1876%	295%	130%	-94%	190%	109%	59%
BOB	9%	91%	156%	101%	-57%	-84%	-88%	112%	116%	123%	42%	24%	11%	19%
BOI	37%	67%	122%	143%	-89%	4%	36%	41%	44%	20%	18%	-1%	10%	18%
CBK	49%	172%	134%	93%	5%	-31%	-96%	34%	30%	85%	21%	13%	56%	-1%
CRPBK	38%	87%	129%	200%	-79%	46%	36%	121%	169%	72%	27%	50%	31%	-14%
INBK	21%	110%	176%	136%	37%	-58%	-56%	36%	-58%	74%	12%	-9%	20%	25%
IOB	25%	92%	81%	94%	119%	61%	186%	63%	174%	51%	10%	0%	3%	2%
PNB	70%	69%	65%	106%	131%	-134%	-50%	122%	107%	74%	8%	5%	11%	-5%
SBIN	22%	7%	49%	70%	-47%	-2240%	13%	82%	59%	60%	3%	-14%	19%	12%
UNBK	-8%	45%	114%	68%	110%	20%	-2%	44%	66%	99%	37%	26%	18%	19%
CUBK			101%	89%	-42%	21%	-7%	22%	93%	69%	-1%	1%	17%	15%
DCBB		144%	32%	45%	-29%	21%	23%	30%	-1%	14%	54%	44%	87%	78%
FB	18%	72%	84%	82%	-51%	23%	-13%	23%	17%	50%	7%	21%	131%	20%
JKBK	92%	716%	1558%	763%	-517%	-94%	-10%	175%	37%	142%	40%	26%	85%	58%
KVB	-127%	316%	320%	42%	-197%	113%	-54%	1224%	482%	199%	375%	-79%	124%	-58%
SIB	65%	167%	141%	173%	-200%	13%	28%	156%	54%	320%	145%	131%	35%	72%
VYSB	14%	170%	216%	271%	-248%	-69%	41%	65%	41%	35%	52%	16%	26%	57%
System	**29%**	**68%**	**81%**	**103%**	**-11%**	**-99%**	**11%**	**65%**	**52%**	**52%**	**10%**	**-1%**	**21%**	**11%**

Computing gains on the SLR book: Scenario #1, Bond yields dropping to 8% (55bps fall)

At yields of 8%, the losses from stressed assets written-off is covered by bond gains for only YES, JKBK, HDFCB, IIB & KMB

Bank	Advances [A]	Investments [B]	Other assets [C]	Total Assets [X=A+B+C]	Networth [D]	Other liabilities [E]	Total Liabilities [Y=D+E+F]	Stressed assets written off @ 45% LGD [G]	Advances net of written-off assets [P=A-G]	Gains in market value of Investment book [H]	Market value of Investment book [Q=B+H]	Market Value of Assets [Z=P+Q+C]	Accrual to Networth [(Z-X)/D]	Bond gains to written-off assets [G/H]
YES	51	38	11	100	7	93	100	0	51	0	38	100	6%	742%
JKBK	59	33	8	100	7	93	100	0	59	0	34	100	5%	717%
HDFCB	62	25	14	100	9	91	100	0	62	0	25	100	3%	353%
IIB	63	25	12	100	10	90	100	0	63	0	25	100	2%	181%
KMB	61	29	10	100	14	86	100	0	60	0	30	100	1%	122%
DCBB	63	28	9	100	9	91	100	1	62	0	29	100	0%	94%
VYSB	59	28	13	100	12	88	100	0	59	0	28	100	-1%	84%
CUBK	64	24	12	100	8	92	100	1	63	0	24	99	-6%	47%
KVB	66	26	8	100	6	94	100	1	65	1	26	99	-14%	37%
AXSB	60	30	10	100	10	90	100	1	59	0	30	99	-7%	36%
SIB	66	26	8	100	6	94	100	1	64	0	27	99	-17%	31%
ICICIBC	57	30	13	100	12	88	100	1	56	0	30	99	-7%	28%
FB	58	32	9	100	9	91	100	2	56	0	33	98	-17%	23%
BOI	65	20	15	100	5	95	100	2	63	0	20	98	-34%	19%
CRPBK	62	30	8	100	5	95	100	3	59	1	30	98	-52%	18%
SBIN	68	22	10	100	7	93	100	2	65	0	23	98	-29%	17%
UNBK	65	26	9	100	5	95	100	3	62	0	27	98	-46%	16%
CBK	61	26	13	100	5	95	100	3	58	0	26	98	-51%	16%
INBK	65	25	10	100	6	94	100	3	62	0	25	97	-41%	15%
BOB	60	18	22	100	5	95	100	2	58	0	18	98	-36%	14%
IOB	64	26	10	100	5	95	100	3	61	0	26	97	-54%	14%
PNB	63	26	10	100	6	94	100	4	60	0	27	97	-54%	12%

Assumptions: Mod. Duration of SLR book: 4, Stressed assets written off @ 45% Loss given default

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Computing gains on the SLR book: Scenario #2, Bond yields dropping to 7% (155bps fall)

At yields of 7%, the losses from stressed assets written-off is covered by bond gains for all private banks except SIB, ICICIBC & FB

Bank	Advances [A]	Investments [B]	Other assets [C]	Total Assets [X=A+B+C]	Networth [D]	Other liabilities [E]	Total Liabilities [Y=D+E+F]	Stressed assets written off @ 45% LGD [G]	Advances net of written-off assets [P=A-G]	Gains in market value of Investment book [H]	Market value of Investment book [Q=B+H]	Market Value of Assets [Z=P+Q+C]	Accrual to Networth [(Z-X)/D]	Bond gains to written-off assets [G/H]
YES	51	38	11	100	7	93	100	0	51	1	39	101	19%	2090%
JKBK	59	33	8	100	7	93	100	0	59	1	34	101	15%	2019%
HDFCB	62	25	14	100	9	91	100	0	62	1	26	101	12%	994%
IIB	63	25	12	100	10	90	100	0	63	1	26	101	9%	511%
KMB	61	29	10	100	14	86	100	0	60	1	30	101	6%	344%
DCBB	63	28	9	100	9	91	100	1	62	1	29	101	10%	266%
VYSB	59	28	13	100	12	88	100	0	59	1	29	101	5%	237%
CUBK	64	24	12	100	8	92	100	1	63	1	25	100	4%	133%
KVB	66	26	8	100	6	94	100	1	65	1	27	100	1%	105%
AXSB	60	30	10	100	10	90	100	1	59	1	31	100	0%	102%
SIB	66	26	8	100	6	94	100	1	64	1	27	100	-3%	89%
ICICIBC	57	30	13	100	12	88	100	1	56	1	31	100	-2%	78%
FB	58	32	9	100	9	91	100	2	56	1	34	99	-8%	65%
BOI	65	20	15	100	5	95	100	2	63	1	21	99	-19%	54%
CRPBK	62	30	8	100	5	95	100	3	59	1	31	99	-32%	50%
SBIN	68	22	10	100	7	93	100	2	65	1	23	99	-18%	47%
UNBK	65	26	9	100	5	95	100	3	62	1	28	99	-30%	46%
CBK	61	26	13	100	5	95	100	3	58	1	27	98	-33%	46%
INBK	65	25	10	100	6	94	100	3	62	1	26	98	-28%	42%
BOB	60	18	22	100	5	95	100	2	58	1	19	99	-25%	40%
IOB	64	26	10	100	5	95	100	3	61	1	27	98	-38%	40%
PNB	63	26	10	100	6	94	100	4	60	1	27	97	-41%	33%

Assumptions: Mod. Duration of SLR book: 4, Stressed assets written off @ 45% Loss given default

Computing gains on the SLR book: Scenario #3, Bond yields dropping to 6% (255bps fall)

At yields of 6%, the losses from stressed assets written-off is covered by bond gains for all private banks; BOI, CRPBK, SBIN & UNBK are the most covered PSUs

Bank	Advances [A]	Investments [B]	Other assets [C]	Total Assets [X=A+B+C]	Networth [D]	Other liabilities [E]	Total Liabilities [Y=D+E+F]	Stressed assets written off @ 45% LGD [G]	Advances net of written-off assets [P=A-G]	Gains in market value of Investment book [H]	Market value of Investment book [Q=B+H]	Market Value of Assets [Z=P+Q+C]	Accrual to Networth [(Z-X)/D]	Bond gains to written-off assets [G/H]
YES	51	38	11	100	7	93	100	0	51	2	40	102	31%	3438%
JKBK	59	33	8	100	7	93	100	0	59	2	35	102	26%	3322%
HDFCB	62	25	14	100	9	91	100	0	62	2	27	102	21%	1636%
IIB	63	25	12	100	10	90	100	0	63	2	27	102	16%	840%
KMB	61	29	10	100	14	86	100	0	60	2	31	102	12%	566%
DCBB	63	28	9	100	9	91	100	1	62	2	30	102	20%	437%
VYSB	59	28	13	100	12	88	100	0	59	2	29	101	11%	389%
CUBK	64	24	12	100	8	92	100	1	63	2	26	101	15%	219%
KVB	66	26	8	100	6	94	100	1	65	2	28	101	16%	172%
AXSB	60	30	10	100	10	90	100	1	59	2	31	101	7%	168%
SIB	66	26	8	100	6	94	100	1	64	2	28	101	11%	146%
ICICIBC	57	30	13	100	12	88	100	1	56	2	31	100	3%	129%
FB	58	32	9	100	9	91	100	2	56	2	34	100	1%	106%
BOI	65	20	15	100	5	95	100	2	63	2	22	100	-5%	89%
CRPBK	62	30	8	100	5	95	100	3	59	2	32	99	-11%	82%
SBIN	68	22	10	100	7	93	100	2	65	2	24	99	-8%	78%
UNBK	65	26	9	100	5	95	100	3	62	2	29	99	-13%	76%
CBK	61	26	13	100	5	95	100	3	58	2	28	99	-15%	75%
INBK	65	25	10	100	6	94	100	3	62	2	27	99	-15%	69%
BOB	60	18	22	100	5	95	100	2	58	1	19	99	-14%	67%
IOB	64	26	10	100	5	95	100	3	61	2	28	99	-21%	66%
PNB	63	26	10	100	6	94	100	4	60	2	28	98	-28%	55%

Assumptions: Mod. Duration of SLR book: 4, Stressed assets written off @ 45% Loss given default

Model Portfolio

Model Portfolio - Financials			
	Market Cap (Rs. bn)	Recommended Weights %)	Returns
HDFCB	2031	20	Relative
KMB	799	20	Relative
IIB	308	10	Absolute
YES	237	10	Absolute
ICICIBC	1800	10	Relative
POWF	330	5	Absolute
FB	103	5	Absolute
KVB	56	5	Absolute
CIFC	58	5	Absolute
JKBK	72	5	Absolute
CUBK	45	5	Absolute

Key Sells	
	Investment Thesis
CBK	Capital and Asset Quality concerns
UNBK	Capital and Asset Quality concerns
MMFS	Slowing rural demand & Asset quality

Buy on 20% correction	
	Investment Thesis
BOB	Low exposure to Infra & metals,
SBI	Low exposure to Infra, Strong liability franchise
AXSB	Improving liability and retail franchise

Portfolio Changes	
What's in	What's out

Source: Spark Capital research

Fiscal arithmetic: Lower fiscal deficit due to higher tax revenue and lower subsidy expenditure

Roadmap to fiscal consolidation: Economic recovery and lower crude oil prices to support

Fiscal deficit to narrow ahead							
Rs. bn	FY14	FY15BE	FY16E	FY17E	FY18E	FY19E	FY20E
Revenue receipts (i)	**10,293**	**11,898**	**13,861**	**16,262**	**19,098**	**22,171**	**25,411**
Net tax revenue	8,360	9,773	11,502	13,573	15,975	18,611	21,496
Non-tax revenue	1,932	2,125	2,359	2,689	3,123	3,560	3,915
Non debt capital receipts (ii)	**366**	**740**	**926**	**949**	**973**	**998**	**1,025**
Disinvestment of PSUs	258	634	800	810	820	830	840
Non plan expenditure (A)	**11,149**	**12,199**	**13,992**	**15,951**	**17,977**	**20,134**	**22,651**
Expenditure on subsidies	2,455	2,514	2,412	2,494	2,583	2,678	2,779
Food	920	1,150	1,265	1,328	1,395	1,464	1,538
Fertilizer	680	730	766	804	845	887	931
Oil	855	634	381	362	343	326	310
Other non plan expenditure	8,695	9,685	11,580	13,457	15,394	17,456	19,872
Plan expenditure (B)	**4,755**	**5,750**	**6,621**	**7,557**	**8,540**	**9,565**	**10,794**
Total expenditure (iii) = A + B	**15,904**	**17,949**	**20,613**	**23,508**	**26,517**	**29,699**	**33,445**
Fiscal deficit (iii-ii-i)	**5,245**	**5,312**	**5,825**	**6,298**	**6,446**	**6,530**	**7,009**
Fiscal deficit (% of GDP)	4.6	4.1	4.0	3.8	3.4	3.0	2.8
Net market borrowings	4,539	4,612	5,058	5,468	5,597	5,670	6,085
Net market borrowings (% of GDP)	4.0	3.6	3.5	3.3	3.0	2.6	2.4

Source: India Budget, Spark Capital Research

Key Assumptions

Gradual economic recovery to lead to higher tax revenue

Assume disinvestment to continue at ~Rs.800bn per annum

Expect gradual pass through of LPG and kerosene prices. Food subsidy is likely to increase at 5% CAGR on Food Security Act

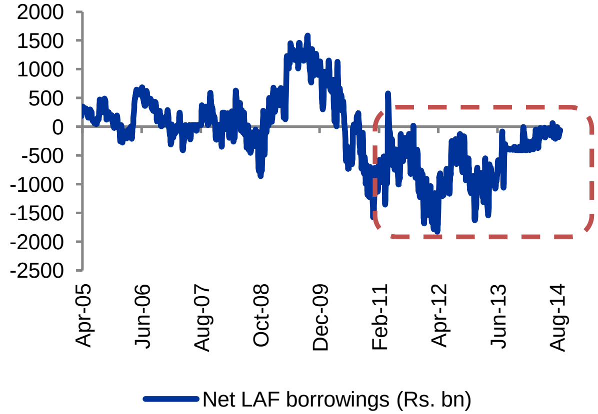
Higher provision from FY17 due to 7th pay commission

Assume avg. 13% increase in plan exp. as govt. focus shifts to productive spending

Lower fiscal deficit to result in lower net market borrowing

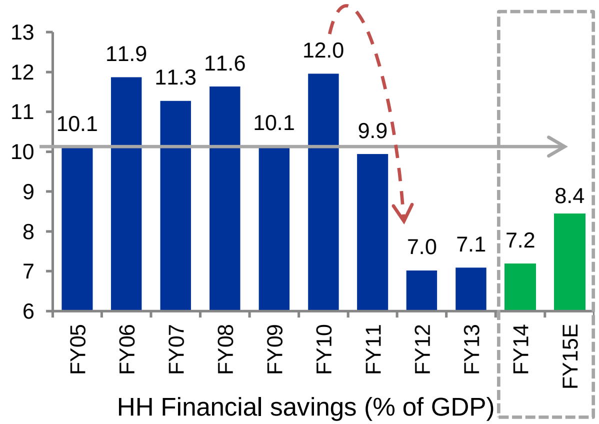
Shift in household savings towards financial savings to improve liquidity

Liquidity remained in deficit for 99% days for the last four years…



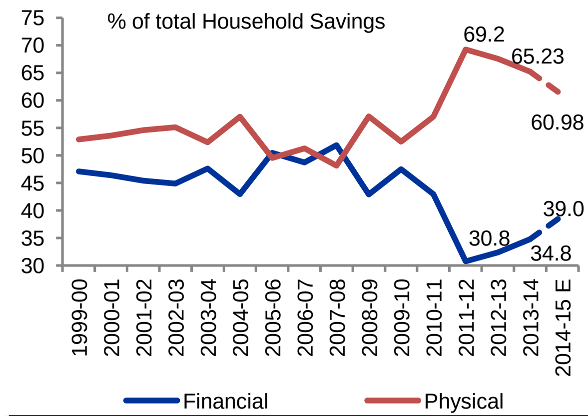
Source: RBI, Spark Capital Research

…due to a sharp decline in HH financial savings, but we expect it to increase…



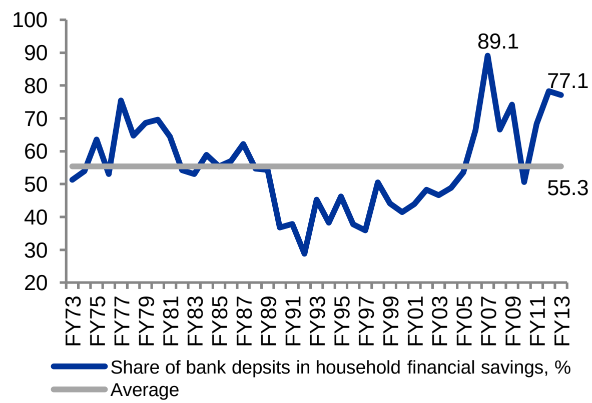
Source: RBI, Spark Capital Research

…due to a shift from physical to financial savings



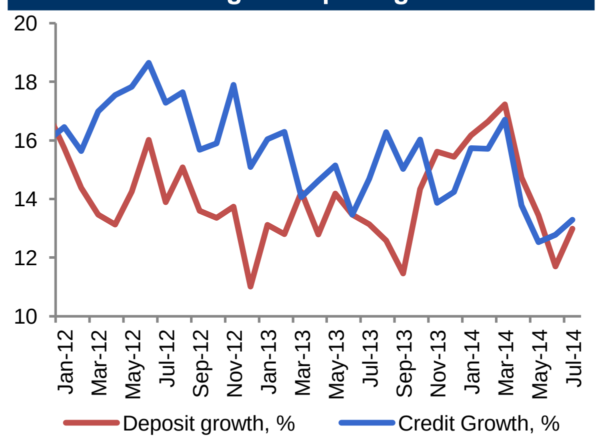
Source: RBI, Spark Capital Research

Bank deposits account for ~75% of household financial savings



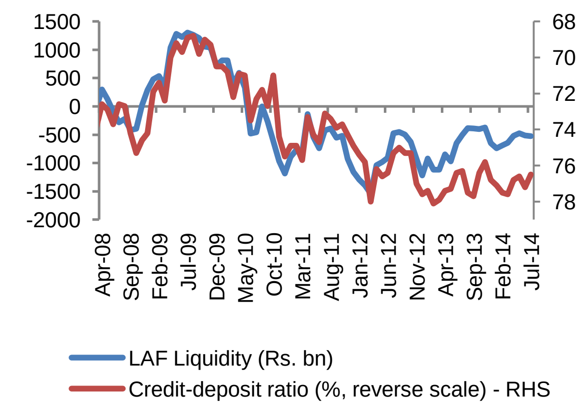
Source: RBI, Spark Capital Research

Thus, increase in HH financial savings would lead to higher deposit growth…



Source: RBI, Spark Capital Research

…leading to increase in liquidity



Source: RBI, Spark Capital Research

Absolute Rating Interpretation	
Buy	Stock expected to provide positive returns of >15% over a 1-year horizon
Add	Stock expected to provide positive returns of >5% – <15% over a 1-year horizon
Reduce	Stock expected to provide returns of <5% – -10% over a 1-year horizon
Sell	Stock expected to fall >10% over a 1-year horizon

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