FORTUNA PR
THE ECONOMIC TIMES

Fri, 28 Jun-24; Economic Times - Mumbai; Size : 62 sq.cm.; Circulation:220500; Page : 12

RBI's New Valuation Rule May Hit Banks' Trading Gains in Q1

But norms, which ask banks to treat marked-to-market gains differently, may boost capital ratios

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Mumbai: Banks, which tend to reap trading profits when government bond yields fall, may be deprived of large gains on that account in the June quarter due to recently implemented regulatory changes but the new norms will likely strengthen capital ratios for lenders.

Government bond yields have declined in the current quarter due to foreign inflows ahead of inclusion of domestic debt in JPMorgan's emerging market index. Yields on the 10-year benchmark government bond were at 6.99% on Thursday, down from 7.05% at the end of the March quarter.

A fall in bond yields — or rise in bond prices — generally translates into trading gains for banks. However, new Reserve Bank of India norms on valuation of banks' investment portfolios means that lenders would have to treat marked-to-market (MTM) gains differently. The norms came into effect from April 1.

Latest data from the Clearing Corporation of India shows public sector bank sold bonds worth ₹25,392 crore in May and ₹16,616 crore up to June 25 after buying bonds worth ₹31,763 crore in April, when global volatility pushed up bond yields. PSU banks typically emerge as net buyers when bond prices fall. However, this time, the advantage from lower bond yields will be limited for these lenders.

"The new investment guidelines will suppress banking trading profits in the first quarter. The new rules say that any unbooked profits in the AFS (available for sale) portfolio will have to be moved to the AFS Reserve account and considered as part of the capital. It will be considered as part of P&L (profit and loss) only when profit is booked," said Arun Bansal, head of treasury, IDBI Bank.

"This is a change from previously when marked-to-market gains were taken into P&L. The new rules also do not allow banks to shift their HTM (held-to-maturity) bonds into AFS to take advantage of the higher prices," he said.

Banks' investment portfolios are classified into three categories — AFS, HTM and a new category called the fair value through profit and loss.

According to RBI's new directions, valuation gains and losses for investments such as government securities held under the AFS book will be aggregated and the net appreciation or depreciation will be directly credited or debited to a reserve called the AFS reserve. The net appreciation or depreciation will not be routed through the P&L account, the RBI said, adding that the AFS reserve would be reckoned as common equity tier-1 (CET) capital.

"As the AFS reserve can be included in the core equity capital of banks, it will have a favourable impact on the capital ratios of the banks because of a decline in bond yields," said Anil Gupta, senior vice-president and co-group head at credit ratings firm ICRA.