

# Here's what will likely result in a better quarter for Indian banks

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Q2FY17 is likely to be a better quarter for banks compared to the past three quarters, given two main drivers—the rally in bonds and slower monetary transmission. However, at the sector level, outstanding system credit continues to decline as PSU banks consolidate their balance sheets further to tackle asset quality issues and incrementally corporates shift to the bond market due to ~200 bps cheaper cost of borrowing versus banks. As a result, the loan books for most PSU banks under our coverage are likely to have declined ~5-10% y-o-y whereas private banks are likely to show ~20% y-o-y growth.

**Rally in bonds:** Q2FY17 saw a significant drop in bond yields of 50-70 bps q-o-q across government securities (G-Secs) and corporate bonds. We expect most banks, especially PSU banks, to show strong treasury gains for Q2. Typically, a drop in bond yield implies higher pension liabilities, though our discussions with a few PSU banks suggest that most of them may postpone their provisioning to H2. Within private banks, IDFCBK could be a significant gainer, given bonds form ~50% of its balance sheet. Bond gains could comprise ~30% of its FY17e PBT.

**Steady margins:** While bonds yields have declined sharply, bank deposit rates and lending rates haven't declined much, indicating the pressure on banks to maintain margins to provide for credit costs. Margins are likely to remain stable in Q2.

**Asset quality steady, but credit cost to remain high:** With most of the asset quality recognition already done, we expect slippages to reduce to ~2-3% against 5%+ in recent quarters, though overall gross stress is not likely to increase, which is ~15% for PSU banks. However, as the NPL buckets deteriorate, credit costs will remain high at over 150 bps, similar to recent quarters. The only saving grace is that potential treasury gains will help them offset the provisions largely, which could lead to better RoA, albeit one-time. Overall, we expect PSU banks and private banks to deliver 2% and 15% earnings growth y-o-y for Q2FY17.

**Prefer private banks:** We believe much of the recent rally of PSU banks has been due to bond yield movement, though asset quality risks and capital issues still remain the bugbears for most of them. Private banks, on the other hand, continue to march ahead, capturing market share and delivering steady profitability. We therefore remain positive on them. IDFC Bank and HDFC Bank (both Buy) remain our top picks.

How have rates moved?

Most short and long rates have come off c.100bps over the last 14 months, roughly in line with the repo rate. But the question is, has this resulted in effective monetary transmission? And the answer we think is "No", at least if one were to compare it over the same period. It's interesting to see that banks have not cut either their deposit or lending rates by much. This, we believe, continues to be the effect of balance sheet consolidation that is under way.