

## Buyback of G-Sec

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### Boon or bane for Banks

The Government of India has announced 19 July 2003 as the date of commencement for the buy back of government securities. We believe that 24 securities to the tune of Rs1000bn would qualify in this auction process. The auction will be a screen-based one on the NDS segment where only banks and FIs will be allowed to participate. The indicative rate is 7.5%, which basically implies that the bids will be accepted below 7.5%. However, the government has the option to increase this premium if the bids are not there.

### Rationale for buyback of Securities

The last few years have seen interest rates on fall sharply. The 10-year bond currently trades in a range of 5.8 to 6%. However, the average cost of Gol's outstanding is around 9.5%. A lower interest rate regime has not benefited the Gol as a large number of banks and FIs hold G-Secs with high coupon yields. Earlier this year, the Gol had announced that it would like to initiate a voluntary buyback of securities, where profits booked on the sale of securities would not attract taxes if they were used for provisioning of NPAs. The buyback of these securities would be at a discount to the current premium on these securities. We had estimated at that time that the discount to the current premium should be equal to the tax benefit available plus the transaction costs involved in this process. Our estimates indicated that the high coupon bonds would have an average yield of around 11-11.3% and the tax neutral transaction rate would be about 8.4-8.5%.

The Banks would benefit in two way namely:

- High coupon bonds, which were illiquid, had huge gains that could actually not be realised, thus resulting in gains not accruing to the bank. The buyback process would unlock the gains.
- Secondly, the tax benefits will allow banks to make higher provisions while simultaneously restructuring its asset portfolio. This would allow the gap between book value and adjusted book value to reduce significantly.

On the flip side however, these high coupon securities generate interest income, which has allowed the average yields on PSU banks' portfolio to be around 9.5-10% resulting in sustainable interest income growth. If the G-Secs were sold, banks would lose this income and future income and profit growth would become muted, as the net interest margins (NIMs) would fall.

### What the future holds

The Gol has announced a comprehensive plan for the buyback of securities. The government will issue four securities after the bids are accepted and the premium will be paid in cash. The accrued interest on the new securities will be paid by the Gol and the bank in cash will pay the accrued interest on the returned securities too. Gol also has the option to increase or decrease the cut off premium rate depending on the bids. We also believe that these new securities will be fixed rate bonds, which will pose a potential hazard for the banks, as it will increase the interest rate risk on their balance sheet.

### How are the Banks positioned

The indicative rate of 7.5% is far below our expectations. We believe that individual banks will make their decisions based on the asset quality and cost benefits accruing to them. We believe that banks with good asset quality will stay away from the auction if the premiums are too low, as the sale of these securities will reduce their future income streams thereby reducing profits. Henceforth believe that they will only offer securities having a short residual maturity (2-3 years).

On the other hand, we believe that banks having bad asset quality will be ready to give a large amount of securities to improve their asset quality. However, we believe that all banks will take a cost benefit approach to see the trade off in income loss and balance sheet quality gain for making their bids.

We believe that Banks like OBC, SBI, BoB, Can Bank would do a thorough analysis before putting their bids. Syndicate Bank, Union Bank and Allahabad Bank, among others would stand to benefit more as their asset quality is still far below the PSU banking average.

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