RBI Rules on State Bond Valuations

Why in news?

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- RBI has announced major changes to how banks will have to value state government bonds.
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- It will have far-reaching implications for the bond market and for state and central finances.
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What is the present mechanism?

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- A government bond is a debt security issued by a government to support government spending.
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- Currently, state government bonds are accounted for on banks' books.
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- This is done using a straightforward yield-to-maturity approach.
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- Investors are allowed to value these holdings at a fixed markup of 25 basis points above the corresponding central government security.
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- This is irrespective of which state has issued it.
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- This approach largely enforced uniformity.
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What are the proposed changes?

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- A valuation that is more closely tied to observed market prices is announced.
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- This is relatively easy to do for those state government securities that are regularly traded.
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- For those that are not regularly traded, the valuation shall be based on the state-specific weighted average.
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- The average is for the spread over the yield of the central government securities of equivalent maturity.
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What is the rationale?

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- There has been an over-supply of state, central and quasi-government paper.
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- The simple 25-basis-point rule allowed states to raise money easily from the markets.
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- This was used even for extravagant and populist purposes.
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- The market was not allowed to discipline poorly run states.
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- The RBI was concerned about the general government deficit.
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- It cannot change a state government’s fiscal incentives directly.
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- It has thus done this indirectly by altering the bond valuation mechanism.
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What are the benefits?

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- Bond markets treat a debt-ridden state identically to states with better fiscal position.
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- The move could thus introduce greater transparency to banks' books.
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- It will also allow greater transparency in public finance.
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- It could make states reform their expenditure and revenue.
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What are the implications?

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- The move is a blow to state-run banks already reeling under bad loans and large trading losses.
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- The earlier mechanism allowed banks, to an extent, to mask actual trading losses.
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- Changing the earlier fixed premium rule would mean that banks' path to easy profits is closed.
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- Also, there is possibility of additional losses depending on the future direction of the government bond market.
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- The RBI has permitted the banks to spread out their treasury losses in the current June quarter over the next four quarters.
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- However, this may not be enough of a compensation from banks’ point of view.
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- Banks may no longer buy these state bonds.
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- This could push up yields, even for central government securities and corporate bonds
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Source: Economic Times, Business Standard

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