

## **New lending norms: banks will need to tackle loan-deposit mismatches more diligently**

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*Banks will have to ensure that deposits get re-priced faster than loans to maintain margins*



**BL Research Bureau:**

With the Reserve Bank of India issuing guidelines for banks to calculate the base rate based on the marginal cost of funds, commercial banks will have to work harder on their asset-liability management (ALM).

This means that banks will have to create a portfolio of deposits and loans with a balanced mix across tenors such that the overall asset-liability gaps are managed well not only to reduce liquidity mismatches but also to mitigate earnings volatility.

According to the new guidelines, all loans sanctioned after April 1, 2016, will be priced with reference to the marginal cost of funds-based lending rate (MCLR).

The MCLR differs from the existing base rate in that when calculating the cost of funds, the latest (at the time of review) rates offered on deposits or borrowings are taken into account. Banks will have to review and publish every month their MCLR of different maturities — overnight, one-month, three-month, six-month and one-year. Loans can be benchmarked against a particular MCLR.

### **The issues**

The RBI has recognised that the benchmark rate requires an associated tenor and hence, allowed banks to have different MCLR for different tenors.

Since MCLR is a tenor-based benchmark rather than a single rate, this will allow banks to price loans more competitively based on different MCLR.

For instance, a bank can fund a three-year loan on its one-year deposit, by benchmarking it against a one-year MCLR which can be reset when the MCLR is reviewed (this is done when the cost of funds changes). But managing asset-liability mismatches will become a huge challenge for banks.

Banks run into liquidity issues when their loans and deposits do not come up for payment at the same time. Let us say a bank funds a 10-year loan with a six-month deposit.

After six months, the bank will have to again raise funds for the loan. This creates liquidity mismatches.

But under the new method banks will also have to manage their ALM from an interest rate perspective.

In the above example, let us assume that 10-year loan is benchmarked against the overnight MCLR.

The loan will be re-priced if the MCLR changes. But the six-month deposit will re-price at a slower pace. So, from an interest rate perspective, the asset side (loans) is much shorter than the liabilities (deposits).

### **Managing risks**

To reduce the impact on margins, banks will first have to ensure that loan contracts are linked to MCLR spread across three-, six- and 12-month periods. This will ensure that all loans are not reset at the same time. They should also spread out in a manner that reflects the way deposits are bucketed. If a bank has more three-month deposits, then it will be comfortable with more loans linked to three-month MCLR.

On the other hand, if a bank has most of the deposits maturing only after a year, then it will have to ensure that it has more retail fixed rate loans that don't get re-priced or a corporate loan book that gets reset after nine or 12 months.

Hence, banks' ALM team has to work harder to ensure that asset and liabilities are matched from an interest rate perspective.

How will they do this? Banks will either have to stretch the duration from an interest rate perspective on the asset side (loans) or reduce the liability duration (deposits).

There are two ways to reduce liability duration. One is to take short-term deposits. So, in a falling interest rate scenario, the banks' deposits can get re-priced quickly and it can manage its loans getting re-priced quickly. But in such a scenario, bank will run a liquidity gap — funding a five-year loan with a one-month deposit.

So, banks will have to develop floating rate deposits which are currently not in existence. The problem is that the best time to market such deposits will be in a rising rate scenario because customers will be more open to it. Till then, banks will have to make do with volatility on earnings.

### **Gauging the impact**

One way to gauge the impact on earnings on account of holding assets and liabilities across different maturities or re-pricing dates is to look at the interest rate risk in the banking book (IRRBB), as disclosed under the Basel requirement by Indian banks. The banks report the absolute levels of change in net interest income for an assumed shift in interest rates (usually 100 bps) over a year.

For instance, for every 100 basis points fall in interest rates, ICICI Bank's earnings (NII) will fall by ₹ 822 crore. For SBI, every 100 bps drop in rates will reduce earnings by ₹ 6,882 crore. The interest rate risk to net interest income for Indian private and public sector banks varies from about 2 per cent to 9 per cent.

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