SBI interest rates: State Bank of India hikes bulk deposit rates; other banks set to follow

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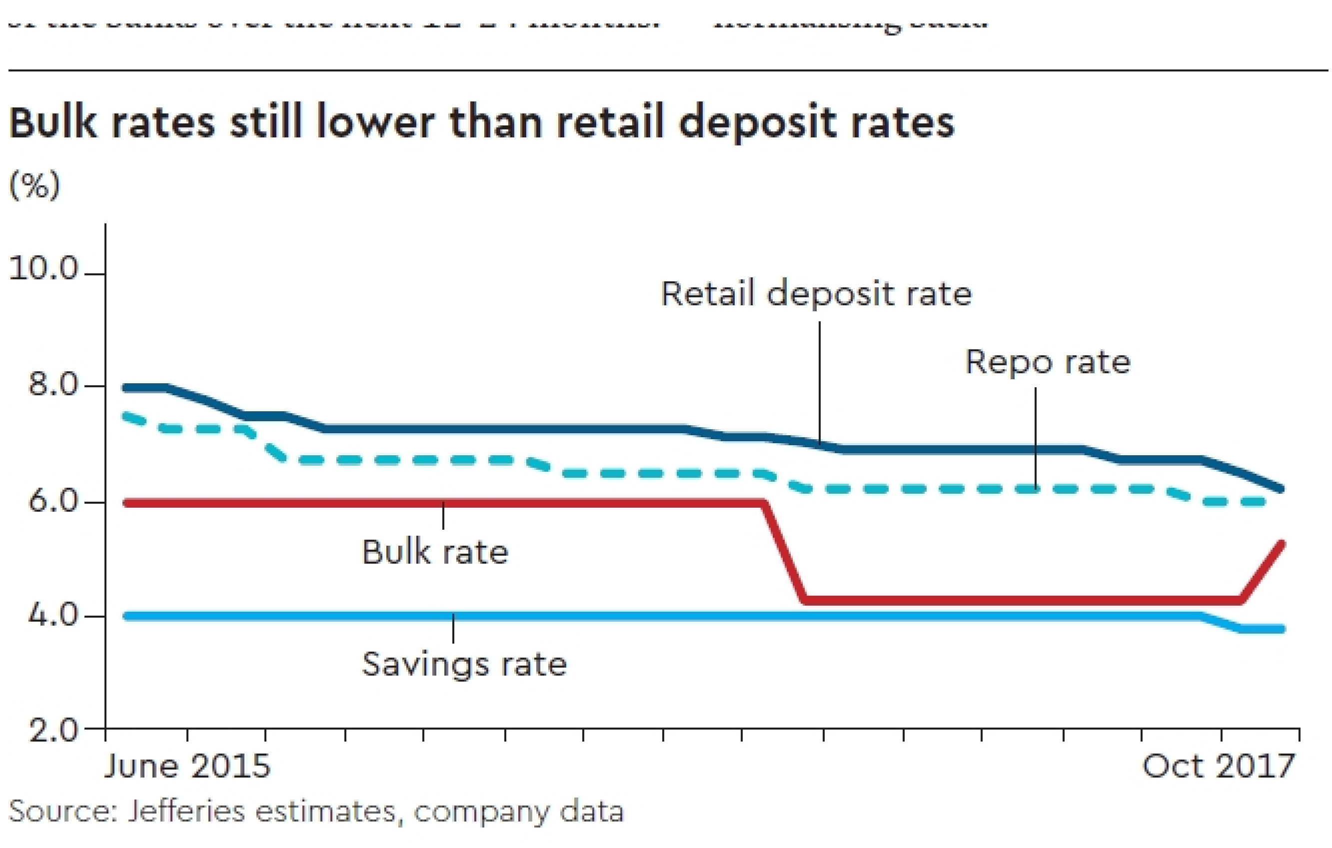
SBI raising its bulk rates signals a normalising macro. Interest rates can only head higher from here, even though policy rates don't immediately. To start with, banks would end up absorbing the higher cost of funds in favour of loan growth/NII, and cap NIM improvement for non-banks. However, the interplay of various drivers would ultimately result in NIM improving for the banks over the next 12-24 months. Corporate banks benefit the most—prefer Axis Bank. Interest rates can only head higher: The gap between the 10-year generic treasury and repo rate too has opened up considerably and is nearing the 1.5% mark from which a reversal usually takes shape. Likewise, the credit risk spread between BBB- and AAA is at its widest, usually the bottom of the cycle. Banking system is back to near full monetisation even as liquidity is back to normalised levels. Strains from demonetisation and GST would also slowly dissipate.

Banking system reflating up: Systemic credit growth too has picked up, while a high demonetisation base feeds in the weaker deposit growth. As a result, the banking system’s absolute and incremental (last 12 months) loan/deposit ratio (LDR) has started normalising back.



Loan pricing behaviour: In line with falling loan growth and stimulating policy environment, both lending and time-deposits witnessed a steady decline over the last 4 years. However, SOE Banks have been the most reluctant to pass on the benefits of falling time-deposit rates and have accumulated the spreads. Private banks have witnessed a larger compression in lending rates than SOE Banks which we believe reflects on the nature of loan mix which is more geared towards small ticket/SME and unsecured retail loans.

Bank NIM: We believe there’s a high degree of probability of seeing better NIMs over the medium term (12-24 months). There are six key drivers which influence banking spreads over different time horizons — their interplay should help in better NIMs for the system as a whole.

In the near term however, banks may end up sacrificing margins in favour of loan and NII growth — we would watch for SBI's move on lending rates here to provide more direction, although we suspect it may defer taking hikes. Over the next few quarters, we believe the improving loan-deposit ratio and unwind in SLR securities should create space for higher NIMs. We should also witness a decline in NPL formation and as a result the drag from interest rate reversals will reduce.

What the Street is currently not factoring in, and which we believe, could be a reality over the next 18-24 months is the loan mix gravitating towards higher ticket capex and SME lending — both typically higher spread businesses and brings scale to the balance sheet.