How external-benchmark impacts loan pricing

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NBFCs/ HFCs will need to follow banks to offer floating rate loans linked to external benchmarks

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Reserve Bank of India (RBI) has asked banks to implement external-benchmark-based loan pricing for all floating rate personal, retail and MSME loans from FY2020. The appropriate benchmarks chosen are repo rate, T-bill (91/182 days) or any other benchmark produced by Financial Benchmark India Pvt Ltd (FBIL). Banks can decide the spreads over the benchmark rate at the time of origination of the loan but this shall remain constant over the tenor of the loan.

The shift to external benchmarks for loan pricing will lead to greater volatility in spreads. Net interest margin (NIM) could come under sharp pressure during declining interest rates for low-spread products like housing loans. A fixed cost liability franchise could result in banks lowering the duration to reduce volatility of NIM. The ability of banks to address this risk is not clear as they would need (a) retail floating rate deposits and (b) interest rate hedging products.

The RBI is indeed likely to achieve its objective of faster transmission at the time of origination; however, we don't have clarity regarding the impact on growth, spreads and asset quality across the cycle. Origination of loans based on backdated data is not clear if the borrower's lifetime cost is better or worse as different vintages have different outcomes, which could be equally important for borrowers.

The trough-to-peak interest rate change in a short period (2-3 years) as we saw post global financial crisis, taper tantrum or demonetisation could result in higher EMI, as the duration increase may not be sufficient. This could also raise asset quality risk as these products are high on installment-to-income ratio.

HFCs: Pressure & volatility in NIM

We believe that non-banks/housing finance companies (HFCs) will need to follow banks to offer floating rate loans linked to external benchmarks, even if a similar guideline may or may not be followed by RBI/ NHB. With low spreads in home loans, we find volatility to NII increasing for HFCs. HFCs may risk asset liability mismatch (ALM), push for more floating rate borrowings and/or buy swaps against its long-term fixed rate borrowings, which will likely increase pressure and risk to NIM.

The committee has facilitated a gradual reduction in SLR by 25 bps every calendar quarter from 19.5% currently, starting January 2019, till the ratio reaches 18%. This will increase 'High Quality Liquid Assets' under computation of LCR and allow a smooth transition of 100% LCR by January 1, 2019.

Additionally, the committee has stipulated a minimum loan component of 40% in fund-based working capital finance for large borrowers (aggregate fund based working capital limit of more than Rs 1.5 billion). Drawings in excess of minimum loan component threshold may be allowed in the form of cash credit facility.

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