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# View: Challenges of rate benchmarking

BY ETMARKETS.COM | APR 10, 2019, 07:33 AM IST

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The Reserve Bank of India has proposed that all new floating rate loans to retail and micro and small enterprises (MSE) extended by banks from April 1, 2019 shall be benchmarked to one of the following (i.e., 91- or 182-day treasury bill yield, RBI's policy repo rate or any other benchmark rate produced by the Financial Benchmarks India Private Ltd which includes MIBOR and certificate of deposits). The final guidelines are still awaited, this is to be another step in RBI's efforts for better transmission of policy rates starting from BPLR in 1994 to present regime of MCLR. It has been observed that while rate movement has been swifter for fresh loans, it has not worked in the same way for existing loans, for small borrowers when the interest rates are declining. The large borrowers are generally able to negotiate rates with lenders due to their awareness and bargaining power, while small borrowers are less informed and have lesser bargaining power. RBI data shows about one third of total loans of scheduled commercial banks is to the retail and MSE sector.

As the system migrates towards the external benchmarking, the rate transmission is likely to be swifter. Having said that, there are pertinent challenges towards this new regime. The biggest challenge that may creep in is volatility in margins. Indian banks largely draw their funding from deposits (around 90% of their funding constitutes deposits), the cost of which is fixed for the tenor of the deposits. Hence, paying fixed costs and lending on variable costs with quarterly resets can induce interest rate risk and create volatility in the margins. Bankers have been arguing that for compensating for the increased volatility, they may need to charge additional spread, increasing the cost for end-borrowers. The spread offered by banks on deposits and repo rate could vary significantly depend on liquidity conditions in the country.

Ind-Ra believes linking of savings account (SA) to the external benchmark rate may be less problematic. A break-up of deposits composition for scheduled commercial banks shows that about 42% of total deposits constitutes current and savings account deposits while rest are term deposits (TDs). The money kept in savings account is largely for transaction purpose and is less volatile. This is reaffirmed from the fact that post deregulation of interest rate regime by RBI, few banks offered substantially higher interest rates on savings deposits; however market share shift has been slow and modest. Further, it has been observed that savings account balances do see a shift towards term deposits whenever there is a widespread differential between interest rate of SA and TD A and TD. On current account, banks do not pay any interest.

However, linking term deposit rates to external benchmark could be challenging. In the recent past, banks offered floating rate deposits to customers, however the response was lukewarm. One can argue that a sizeable portion of term depositors, especially the larger-ticket ones, prefers banks over capital markets on account of stability of returns and higher safety. There is a possibility that in the floating rate environment, either they would ask for higher rates to cover for the risk or simply move to capital markets. This can create competition among banks for deposits, pushing the rates higher.

In light of this, banks with a higher proportion of CASA deposits would be better placed as linking of CASA to the external benchmark could prove less problematic. However, banks dependent on large-ticket deposits, bulk and institutional deposits could see their borrowing costs move up, as they compensate their depositors for volatility on their returns.

While the detailed guidelines are still awaited, SBI has announced a shift to the external benchmark (repo rate) for pricing savings deposits and short-term loans. The direct linking of commercial rates (both lending and deposit) with the monetary policy rate may be considered a less appropriate choice within the contours of the monetary policy literature. This is primarily because the policy rate is set based on inflation outlook, especially under the inflation targeting framework, and system liquidity and subsequent pricing impact of liquidity outlook is a matter of market dynamism-based market expectations. Hence, benchmarking rates, particularly short-term rates, with the policy fails to factor in the prevailing liquidity conditions while pricing assets and liabilities of the banking system. The banks' ability to adjust the asset pricing will largely depend on the interest rate sensitivity of the advances at a system level, while the impact of banking sector liquidity on deposit rates will cease to reflect in the cost paid by the banks for the same.

However, banks may have to choose an external benchmarking for deposits and CD rates as an external benchmark among the options could be more acceptable, given that these rates generally reflect demand and liquidity conditions in the system.

The writer is Head - Financial Institutions, India Ratings and Research (Fitch Group)

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