After RBI delivers, the big question: Will the banks yield, too?

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Significant easing of liquidity is critical for better transmission

The RBI delivered on expected lines and cut its policy **repo rate** by 25 bps. While the central bank changing its stance from neutral to accommodative -- essentially implying that rate hikes are out of the way -- has further buoyed sentiments, the bigger question is whether banks will be more nimble in cutting lending rates now.

Banks have been dragging their feet, trimming benchmark lending rates by just 5-10 bps since January, as against the RBI's 50 bps rate cut up until the latest policy action. Tight liquidity has limited banks' ability to reduce deposit rates and, hence, lending rates.

For lending rates to come down significantly, liquidity conditions have to ease considerably. While there are initial signs of liquidity improving in June, sustainability of the trend will be key. The RBI setting up an Internal Working

Group to review the existing liquidity management framework is welcome, but it is still early days and what measures the group suggests, needs to be seen.

For now, while at the broader system level liquidity may appear to ease, a skewed liquidity picture across banks suggests that rate actions will be staggered and would vary across banks. Bottomline, while lending rates are likely to fall at a much faster pace in the coming months, across-the-board sharp cuts could take a while.

Liquidity easing?

When banks face a liquidity crunch, they are unable to toe the RBI's line and lower deposit rates in a hurry. With no relief on the cost front, their ability to lower lending rates without hurting margins is difficult.

Banks have been tackling tight liquidity conditions over the past few months. Banks borrow through the liquidity adjustment facility (LAF), which helps them manage temporary mismatches. During April and May, the RBI injected liquidity of Rs 70,000 crore and Rs 33,400 crore, respectively, on a daily net average basis under the LAF.

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It was only in early June that liquidity turned into an average daily surplus of Rs 66,000 crore, according to RBI. The sustainability of this trend needs to be seen. The RBI conducting OMOs (purchase of government securities) has also helped improve liquidity.

But at the micro level, a skewed liquidity scenario across banks is impeding transmission.

High credit-deposit ratio

After the credit-deposit (CD) ratio slipped to 71-73 per cent post-demonetisation --- implying that banks were able to deploy only Rs 71-73 out of every Rs 100 deposit as loans, the CD ratio has been steadily going up since the December

2017 quarter. Currently, the CD ratio is high at 77-78 per cent at the system level.

But a closer look at bank-specific numbers reveals that a few private banks sport a very high CD ratio of 80-100 per cent, on the back of strong loan growth. Public sector banks, on the other hand, have lower CD ratios of 70-75 per cent, owing to modest credit growth. This skewed trend presents multiple challenges.

One, given the excessive pressure on funding resources, private sector banks are unable to lower deposit rates and hence lending rates. Two, while public sector banks have better leeway to lower deposit rates, the fact that their deposit rates are already significantly lower than most private sector banks, is a hurdle. For instance, while SBI offers 6.75 per cent for deposits in the 2-3 year bucket, HDFC Bank and ICICI Bank offer 7.4-7.5 per cent for similar deposits. This wide gap will continue to limit public sector banks' ability to lower deposit rates sharply and, in turn, lending rates.

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