

Benchmarking hurts banks: New loan pricing norms will hit their margins

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With two significant events ahead, the Bank Nifty has crashed by close to 1,000 points over two trading sessions, with the State Bank of India (SBI) stock losing 10%. Investors' concerns are justified because once banks link interest rates—mainly home loans—and MSME loans to a benchmark from October 1, spreads will be under pressure.

The loans are to be benchmarked to the repo rate, the yield on the 3-6 month government bond, or certain other external benchmarks. With a chunky cut expected at the next monetary policy meet—Reserve Bank of India (RBI) is expected to reduce the repo rate by anywhere between 25 and 30 basis points—loan rates could fall further. It is not just new loans, even existing borrowers may be allowed to switch over, which means almost the entire portfolio will be repriced at lower rates. That is certain to crimp margins.

RBI's objective in asking banks to switch to an external benchmark is to bring about faster transmission; in the past, the cuts in the repo have not resulted in matching cuts by banks. To be sure, transmission has been slow partly because in 2015 and 2016, liquidity in the system was low; also, the NPA problems persisted, eating up capital, and lenders understandably preferred to wait until they were able to bring down the cost of deposits.

As liquidity became more abundant, loan rates fell and given how it has been in a big surplus of close to Rs 1.5-2 lakh crore over the past few months, rate cuts would have followed. RBI, however, is clearly unwilling to wait.

There is also some concern that customers once used to rates falling find it difficult to cope when interest rates go up, often extending the tenure of the loan rather than paying a bigger EMI. In many ways, therefore, at times like this, when we are closer to the bottom of the repo rate cycle, the current loan rates could be much like teasers. Banks might, therefore, go slow on long-term products, and wait for interest rates to settle down, and we could see volumes thinning.

Otherwise, with the interest rate on deposits not floating in nature, net interest margins (nims) could contract substantially. For instance, SBI's home loan is currently priced at about 8.1%, so, a cut in the repo would see an equivalent change in the loan rate. Once SBI drops the rate, other lenders would need to follow suit to stay competitive. Indeed, the SBI management has conceded that pricing the risk premium for a long term product like a home loan—25-30 years—is not easy and that managing the liabilities will be a challenge.

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