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Market Watch

External benchmarks may not bring down loan rates

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IST

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Home, auto and personal **loan** rates may not fall sharply as expected after the RBI's directive on Wednesday as baddebt-laden banks strive to protect profitability with higher spreads over benchmark rates.

Banking experts and analysts cautioned about pressure on banks' net interest margin after the **RBI** ordered lenders to ditch the current formula for setting rates and adopt a new one based on market-linked benchmarks.

Some bankers and analysts warned that rates may either rise in the short term or stay where they are, as banks' cost of funds is linked to deposit rates that are sticky and not benchmarked.

Banks may begin to charge a higher **risk premium** to cover the cost of deposits, which do not move in tandem with any of the RBI-suggested external benchmark interest rates — such as repo rate or treasury bills.

Implications for Bank Margins

If banks don't raise rates, they may be compromising on profitability.

"Linking all new retail loans (to external benchmarks) could lead to wide fluctuations in EMIs (equated monthly installments) for customers because these rates have to be reset every three months. The certainty that retail borrowers look for in EMIs will go. Also, with deposit rates not linked to the market, the transmission will not be total," said Prashant Kumar, CFO at **State Bank of India**. The country's largest lender has already linked cash credit overdraft rate up to Rs 1 lakh and home loan rates to the repo.

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Banks may Plan to...

Increase spreads over benchmark rates (Spreads may be up to 500 bps)

Raise administrative fees

Why?

To protect margins, since deposit rates are not linked to market

Banks fear migration of deposits to small savings schemes if they lower rates

Volatility for Borrowers

With RBI asking for rates to be reset every 3 months, there could be fluctuations in EMIs, leading to uncertainty for borrowers

On Wednesday, the RBI asked banks to peg loans to retail lenders and micro, small and medium enterprises (MSMEs) either to the central bank's repo rate, the threemonth or six-month treasury yield published by Financial Benchmarks India Ltd (FBIL) or any other benchmark published by the latter. The move is aimed at making banks transmit the RBI's interest rate actions. It has been observed that whenever the RBI raises rates, banks are quick to pass on the increase to borrowers. The reverse, however, doesn't happen as promptly.

The repo rate stands at 5.4%. If a bank with a **marginal cost** of lending rate of 9% charges a customer 100 basis points above it — or 10% interest rate — on a home loan, it will now be tempted to widen the spread because the new external benchmark rate would mostly be lower than the MCLR. In the current scenario, the spread between repo and the actual rate is 460 basis points. A basis point is one-

hundredth of a percentage point. Taking the same illustration forward, if the RBI cuts rates by, say, 40 basis points to 5% percent, the MCLR or the bank's cost based on deposit and other rates does not fall by an equal amount to 8.6%. The fall may be just 20 bps or 10 bps, depending on the strength of the bank's deposits franchise. Hence, to protect margins, the bank would have to create a buffer and widen the spread to maybe 480 bps or even 500 bps. Eventually, instead of giving out the home loan at 10%, the bank may offer it at 10.2% or 10.3%. "The RBI's move could have serious implications on bank margins because their liabilities are fixed and loans to retail borrowers and MSMEs constitute more than 50% of the loan book in some cases," said Prakash Agarwal, head (financial institutions) at India Ratings & Research. "Banks will have to keep a buffer to adjust lending rates because deposit rates will not come down at the same pace as lending rates."

Banks could also raise administrative fees to compensate for the additional risk. And this could also make payments volatile for individuals. Since May, SBI has linked its savings bank rate for deposits above Rs 1 lakh to the repo rate. However, it did not change the rate despite the 35 bps cut by the RBI earlier this month. SBI's savings bank rate is currently at 3%, higher than the 2.65% it should have offered taking into account the cut by RBI.

Bank deposits in India compete with government savings schemes such as public provident fund and national savings schemes, which offer higher rates and hence create a floor for cuts in deposit rates. A large number of households and senior citizens depend on bank rates for survival. Hence, any rate cut also has social implications.

"What happens if a bank links the rates to, say, three-month or sixmonth treasury bill and there is sudden liquidity crisis, which leads to rates shooting up? Does that mean a mortgage borrower will overnight have to pay 200 basis points more as interest?" said Suresh Ganapathy, an analyst at Macquarie Securities. "The bigger issue is that of banks' ALM (asset-liability management) over the longer term in the absence of floating rate liability market. Please note that SBI did launch floating-rate, fixed-tenure term deposits in the past only to fail miserably... No one in India will accept a floating rate on deposits, since what they need is income certainty," Ganapathy added.

Kotak Institutional Equities said the change would cast a shadow on bank margins as MCLR rates are currently higher than repo-linked instruments. It will also slow down transmission till all rates are aligned, and could lead to tweaks in bank spread or credit risk adjustment.

"Many banks are seen to be reluctant to link loan rates to external benchmarks because of the severe constraints they face in lowering deposit rates fearing migration of deposits to small savings schemes," said Ajay Bodke, CEO (PMS) at Prabhudas Lilladher.

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