Indian Economy

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Who's eaten my slice of the rate cut?

Are we going to see a regime of lower corporate lending rates post Global Covid Crisis (GCC)?

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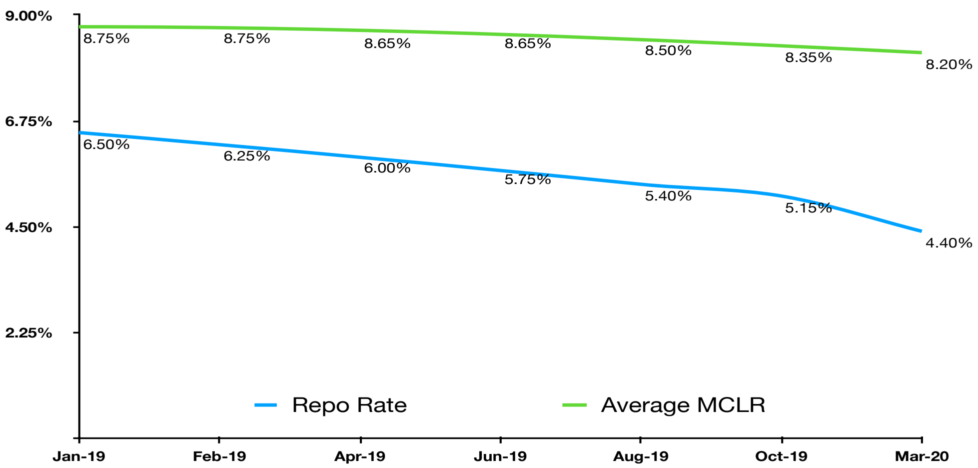
Repo rate cut has minimal transmission to the borrowers

Every time we hear in the news post Reserve Bank of India's (RBIs) rate cut announcement, that loans are going to be cheaper. But the reality is far away from it. Neither our Home Loans nor your Home Loans is cheaper in proportion to the rate cut announced by RBI. The same scenario is with Corporate borrower and Medium and Small Scale Enterprises (MSMEs), **the borrowing rate has not come down.**



Source: Reserve Bank of India

In the past 15 months, RBI has reduced the Repo Rate by 210 basis points. Ideally it should translate into reduction of approximately 200 bps in the lending rate. Right!

But things are not as it looks. The Average Marginal Cost of Funds based Lending Rate (MCLR) rate of Public Sector Banks during the same period has reduced by only 55 bps. MCLR is the rate to which most of the borrowings are linked. Borrowing rate is determined by MCLR plus a mark-up based on the credit profile of the borrower (CIBIL Rating or Credit Rating).

RBI implemented MCLR on April 1, 2016 to determine rates of interests for loans. The idea to implement MCLR over the earlier regime of Base Rate was to reduce the gap between RBI's reduction in repo rate and Banks reduction in lending rates for the borrowers. It also ensures the prospect of bank credits at the interest that is true to the consumers as well as the banks.

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Well the entire idea behind it has gone for a toss. Who has eaten my pie of the rate cut?

Now lets look closely how MCLR is determined. MCLR is a factor of four things:

- Tenure Premium: No brainier; higher the tenor higher the cost
- Negative Carry on Cash Reserve Ratio (CRR): CRR is the cash reserve, which Banks keep with RBI. Interest Free of-course!
- Operative Costs of Banks
- Marginal Cost of funds for Banks: Cost of incremental borrowing and return on net-worth.

Problem lies in 4. Marginal Cost of funds for Banks.

Marginal Cost of funds for Banks

This is the weightage average of cost of deposits, borrowing and return on net-worth of the Bank, with 92% of the weightage given to deposits and borrowing and balance 8% to return on net-worth calculated based on Capital Asset Pricing Model.

Table: Composition of deposits of the Bank

	17-18:Q1	17-18:Q2	17-18:Q3	19-20:Q2	19-20:Q3
Current	9%	9%	9%	9%	9%
Savings	32%	32%	32%	32%	33%
Terms	60%	59%	59%	59%	59%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Reserve Bank of India

Banks are typically dependent on deposits (Current, Saving and Term Deposits) to lend money. Deposits constitute almost 82% of the banks liabilities. There was no major change in composition of deposits in the last 2 years.

Cost of funds of bank is majorly dependent upon the interest they pay on term deposits as it constitutes about 50% of the total liabilities of the banks.

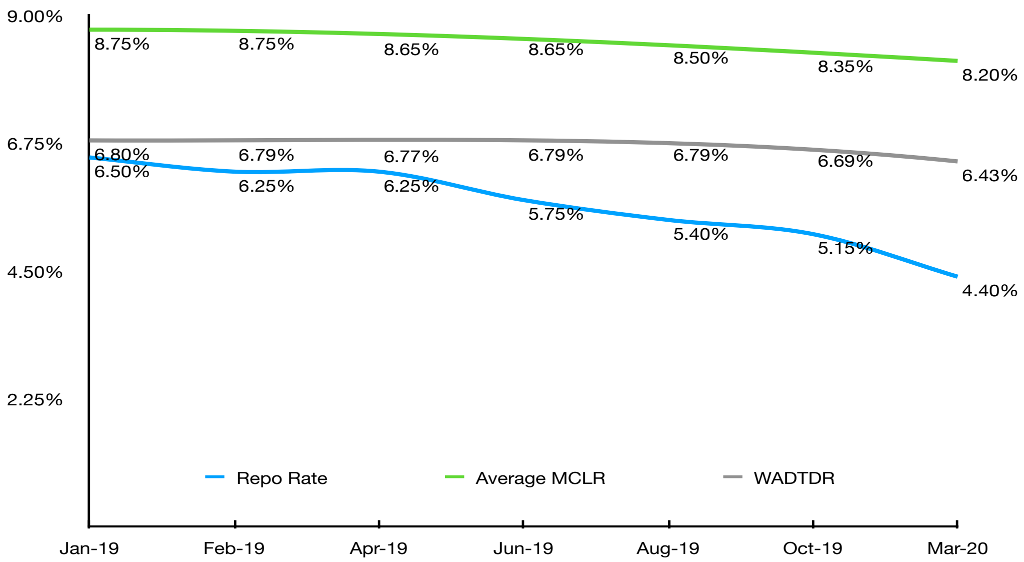
Banks are not able to reduce interest rate on Term Deposits due to inherent problem of Raising bad loans, liquidity, Asset Liability Mismatch and raising

Table: Composition of liabilities of all Public Sector Banks

Liabilities	2018	2019	Growth %
Capital	0.33%	0.50%	54.01%
Reserves and Surplus	5.54%	5.37%	-1.76%
Deposits	82.34%	83.50%	2.71%
- Demand Deposits	*5.42%*	*5.44%*	*1.62%*
- Savings Bank Deposits	*26.47%*	*27.55%*	*5.38%*
- Term Deposits	*50.45%*	*50.52%*	*1.42%*
Borrowings	8.44%	7.49%	-10.08%
Other Liabilities and Provisions	3.35%	3.13%	-5.52%
Total	**100.00%**	**100.00%**	**1.28%**

Source: Reserve Bank of India

Cost of funds of bank is majorly dependent on the interest they pay on term deposits as it constitutes about 50% of the total liabilities of the banks. So any reduction in MCLR is highly correlated to the reduction in interest rate of term deposit.



Source: Reserve Bank of India
WADTDR = Weighted Average Domestic Term Deposit Rates of Public Sector Banks

Now the question is why the banks are not able to reduce interest rate on Term Deposits. The reason is simple; Banks wants liquidity to survive, weaker banks pay more interest on term deposits to manage their Assets Liabilities Mismatch. Bad Assets push Assets maturity in longer maturity bucket and to fund that they need long-term money.

As the borrowings constitute only 8% of the total liabilities, any change in Repo Rate will only have minimal effect

Demand borrowing (saving, current and repo) will land the banks in trouble with repayment obligations, as their assets are of long-term maturity and if redemption demands comes from demand borrowings, they need to run to RBIs doors for help. So weaker banks start paying higher interest creating competition among the PSBs to match the interest rate on term deposits or loose customers to rival banks.

As the borrowings constitute only 8% of the total liabilities, any change in Repo Rate will only have minimal transmission of rate cut to the borrowers.

Talks of creating a Bad Bank are already in the air

Will there be a regime of low interest rate post Global Covid Crisis?

GCC or the Global Covid Crisis can be a boon for the banks and economy if played properly. With consolidation of the banks, the intense competition among the banks has come down (brothers are not fighting for survival).

GCC will create lot of bad assets among the borrowers and if not addressed properly, the push towards low interest rate will go in vain. Talks of creating a Bad Bank are already in the air and the same would help banks to capitalize their balance sheet, fix their Asset Liability Mismatch and lead to reduction in term deposit rate.

With expected 100 bps reduction of rates by RBI over the next one year, the Banks will find it cheaper to borrow more from RBI leading to shift from deposits to borrowing

Banks are flushed with funds, parking almost USD 100 Bn on daily basis with RBI at mere 3.75%. They are now finding government paper more attractive at around 6%. With expected 100 bps reduction of rates by RBI over the next one year, the Banks will find it cheaper to borrow more from RBI than take term deposits.

Hopefully, borrowers are going to see a regime of low interest rate post GCC in the medium term.

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