IMPACT OF 'NEW' BASE RATES OF BANKS

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On July 1, 2010, all banks announced their respective Base Rates to comply with the final guidelines released by the Reserve Bank of India (RBI) in its circular dated April 9, 2010. The Base Rates of Public Sector Banks range from 7.75% to 8.25% while those of Private Sector Banks ranged from 7% to 8.75%. In contrast, under the erstwhile Benchmark Prime Lending Rate (BPLR) regime the BPLRs for Public sector banks ranged from 11% to 13.5% while Private sector banks had BPLRs ranging from 12.75% to as high as 16%.

Most Private sector banks appear to have used a combination of historical cost of deposits and incremental cost of deposits as a benchmark to arrive at their respective Base Rates, which are closer to their Public sector peers.

With the Base rates for most banks being strapped to the cost of deposits coupled with the requirement to review at least once every quarter, we expect the final rate charged to the borrowers to mirror the change in bank's cost of deposits – atleast partially. It is also expected that this would aid better transmission of policy rates.

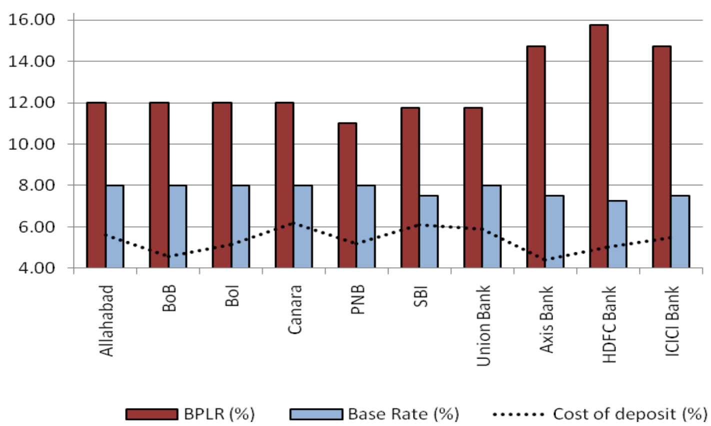
We believe that the implementation of the Base Rate will improve transparency to a certain extent. As a result, small borrowers, especially those in segments such as Home Loans could see their interest payments moving in tandem with the changes in policy rates in the future. However, the actual benefits of the Base Rate system to the small borrower would be clearer only in a declining interest rate scenario.

Currently, we believe that the rates charged on new loans (although they would now be linked to Base rates) would be closer to the rates being charged from the existing customers. We do not expect major shifts in lending rates charged to borrowers in the home loans/car/commercial vehicle/construction equipment/gold and personal loans segments on account of the Base Rate. SME and MSME borrowers may also not see any immediate change in the interest rate payable by them, though in the future, transparency could aid them in their negotiation with banks. Large, well rated corporates would now look to the Commercial Paper or the Non-Convertible Debenture (NCD) market for short term funding. Based on the above, we feel that the implementation of the Base Rate is not likely to have a significant impact on the NIMs of large sized banks for FY11, although slight impact may be visible for their mid-sized and smaller counterparts.

FROM BPLR TO BASE RATE…

Starting July 01, 2010, all the Indian Banks have migrated from BPLR system to Base rate lending. The Base Rates of Public Sector Banks range from 7.75% to 8.25% and those of Private Sector Banks ranged from 7% to 8.75%. The base rates announced by the various banks appear to be more indicative of the current short term cost structures and individual operating efficiencies. The difference in the Base Rates vis-à-vis the cost of deposits across various banks is in the range of 86-270bps.

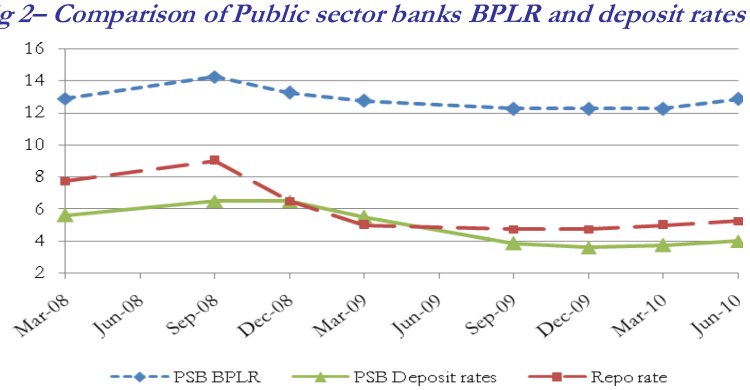
Fig 1– BPLR and Base Rates vis-à-vis cost of deposits for select banks



Source: Bank websites and CARE [1]

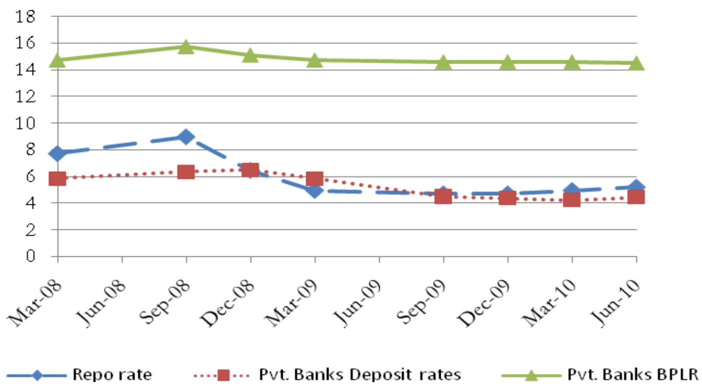
In contrast, under the erstwhile Benchmark Prime Lending Rate (BPLR) regime the BPLRs for Public Sector Banks ranged from 11% to 13.5% while Private Sector Banks had BPLRs ranging from 12.75% to as high as 16%. The BPLR system was introduced with a view to enhance transparency in the pricing of bank loans. However, over time the system of BPLR lost its relevance as a meaningful reference rate as the bulk of loans were advanced below BPLR. This not only made the loan pricing system non-transparent and impeded the smooth transmission of monetary signals but also led to cross-subsidization of large corporates.

Fig 2– Comparison of Public sector banks BPLR and deposit rates to Repo rates



[1] BPLR as on June 20, 2010, cost of deposits for FY10

Fig 3– Comparison of Private sector banks lending and deposit rates to Repo rates



Source: RBI and Bloomberg

We observe that BPLRs of public sector banks have moved from a high of 14.25% in Sep'08 to 12.25% in Mar'10 and the BPLRs for private sector banks moved from 15.75% to 14.75%. Further the quantum of movement in BPLR does not mirror the changes in policy rates leading to poor transmission of policy rates. Between the period Sep'08 to Dec'09, although repo rates have declined by 425bps; the BPLR of Public sector banks changed by 200bps while for their private counterparts BPLR changed only by around 100bps. This is despite the fact that the deposit rates for Public sector banks and private banks also declined by 288bps and 200bps respectively during the same period. Presently, the average BPLR of Public sector banks is lower by 204bps as compared to their Private sector peers.

IMPACT ANALYSIS OF BASE RATE:

a) Greater transparency

As per the final guidelines, banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate are also to be conveyed to the general public from time to time through appropriate channels. Although the final lending rate to be charged to borrowers would be arrived at after taking into account the tenor, credit profile etc, the disclosure of the Base Rate helps bring some transparency as compared to the relatively opaque BPLR system.

b) Transmission of Policy Rates

As witnessed earlier, banks were quick to pass on policy rate hikes to borrowers while there was always a lag in passing on the benefit of reduction in rates. Now, with the Base rates for most banks being strapped to the cost of deposits coupled with the requirement to review atleast once every quarter, we expect the final rate charged to the borrowers to reflect the changes in bank's cost of deposits atleast partially. It is also expected that this would enable better transmission of policy rates given the transparency aspect involved.

c) Small Borrowers to Gain

Given the relative transparency under the Base Rate system, small borrowers, especially those in segments such as Home Loans could see their interest payments moving in tandem with the changes in policy rates in the future. However, the actual benefits of the Base Rate system to the small borrower would be clearer only in a declining interest rate scenario.

Currently, we do not expect major shifts in lending rates charged to borrowers in the home loans/car/commercial vehicle/construction equipment/gold and personal loans segments on account of the Base Rate. While SME and MSME borrowers may also not see any immediate change in the interest rate payable by them, in the future, those borrowers with a relatively stronger profile can negotiate for better rates due to the transparency in Base Rate.

d) Limited impact on Short Term Lending for Banks

Under the BPLR regime, large, well rated corporates have borrowed at very low rates in the short term. However, since banks cannot lend below Base Rate, such corporates might have to look to the Commercial Paper (CP) or the short term Non-Convertible Debenture (NCD) market for funds. However, the shift to the CP or the NCD market is expected to be limited, since the market for instruments with a rating below PR1 is small. Investors in such instruments include banks and short term/liquid/money market schemes of mutual funds. Also, as short term CP rates have been rising recently, given the tightening of market liquidity, the rate differential vis-à-vis the Base Rates has narrowed further. So, corporates might consider issuing such instruments only after the liquidity situation improves.

The shift to CP markets is also expected to be lesser for banks which have a major part of their 'lower than base rate' advances in the form of letters of credit (LC) and bills discounting (BD) facilities; particularly banks in South India as smaller borrowers utilizing these facilities are unlikely to jump ship.

e) Marginal rise in short term borrowing costs for Higher rated Borrowers

In the past, highly rated corporates have raised short term loans from banks at rates as low as 5%. Since the announced Base Rates of most banks are higher than this and as banks cannot lend below Base Rate, such corporates might increase their reliance on other sources of funding – namely the issuance of CP/short term NCDs, once the liquidity in the system improves. However, the average three-month CP rate has increased from 4.8% in April 2010 to 6.5% in June 2010. Similar hikes were seen in the six-month CP rate (from 5.7% to 6.8%) as well as the twelve-month CP rate (from 6.7% to 7.2%). Hence, we believe that corporates may definitely see atleast a marginal increase in their short term borrowing costs, even if they shift to Private sector banks who have announced lower Base rates.

f) Neutral impact on margins

The existing BPLR linked loans can be shifted to Base Rate only at the time of their renewal and only on mutually acceptable terms. Further, despite the additional 25bps hike in repo and reverse repo rates, most of the banks are expected to refrain from hiking their lending rates for small and retail borrowers immediately – especially for products such as home loans/ car loans /personal loans etc. In case of new loans (which are necessarily linked to Base Rate), the final rates offered to the retail borrowers, are likely to be closer to those charged from existing customers. Also, we do not expect a significant migration of large corporates from banks to the CP/NCD market in the near term although there might be a slight shift to Private sector banks who have announced lower base rates. Both the Base Rate and the BPLR regimes would continue to co-exist for some time as existing borrowers are likely to wait and watch the effectiveness of the Base Rate system before switching over.

Hence we feel that the implementation of the Base Rate regime is not likely to have a significant impact on the NIMs of large sized banks for FY11, although slight impact may be visible for their mid-sized and smaller counterparts.

Base rate: Whether a conduit for effective transmission of monetary signals

One of the basic and important rationales behind introduction of base rate is effective transmission of monetary signals by way of passing on rate movements to the customers. Although banks have been quick to pass on rate hike to borrowers, there is usually a lag in passing on lower borrowing costs. Therefore, a true test for the effectiveness of the Base Rate mechanism would lie in the extent of monetary policy transmissions during softening rate scenario.

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