INSTITUTIONAL EQUITY RESEARCH

The marginal cost of fund-based lending rate

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INDIA | BANKING | Event Update

RBI has announced that all 'loans and credit limits from April 1 will be priced with reference to Marginal Cost of Funds based Lending Rate (MCLR)'.The final guidelines seem to have a minimal impact on margins as the MCLR prevailing on the day the loan is sanctioned will be applicable till the next reset date, irrespective of the change in the benchmark during the interim. The bank can determine the reset date any time within one year, which will be based on its interest-rate assessment. Hence, we believe that concerns about margin compression when interest rates are declining is addressed to a large extent.

Banks will also have to publish the base rates until all existing loans linked to base rate gets repaid or renewed. existing borrowers will also have the option to move to the marginal cost of funds based lending rate (MCLR) linked loan at mutually acceptable terms. However, this should not be treated as a foreclosure of existing facility.

Also the tenor-linked benchmark rate will provide an avenue for banks to lend surplus liquidity for shorter durations at a rate below the current base rate.

As per the RBI guidelines, banks will reset the loans as per the loan agreement, which we believe will allow them some time (maximum upto one year) to pass on the benefit of declining interest to its existing customer. Banks can protect NIMs to an extent, in this kind of a rate cycle. However, for the funds having maturity of more than one year, there can be some impact as the loan will get re-set earlier than the re-pricing of these funds. The proportion of deposit/fund having maturity of more than one year various between 10%-40%.

We calculate the difference between average cost of fund and marginal cost of fund for various banks at 20-50bps. Factoring different various scenario of long term liability re-pricing, we mention below the impact on NIMs for various banks

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Calculated impact on NIM due to MSLR

	Calculated				Sensitivity - percent of funds with re-pricing mismatch (bps)		
Banks	**Marginal cost of domestic deposit**	**average cost of deposit**	**difference**	**Base rate linked**	**20%**	**30%**	**40%**
Axis Bank	5.24	5.56	0.32	75%	0.05	0.07	0.10
HDFC Bank	5.54	5.90	0.36	30%	0.02	0.03	0.04
ICICI Bank	5.22	5.55	0.33	75%	0.05	0.07	0.10
SBI Bank	5.75	6.08	0.33	80%	0.05	0.08	0.10
PNB	5.65	6.01	0.36	80%	0.06	0.09	0.12
BOB	5.64	5.83	0.19	80%	0.03	0.04	0.06
BOI	5.56	5.80	0.25	80%	0.04	0.06	0.08
canara	6.35	6.60	0.25	80%	0.04	0.06	0.08
Union Bank	6.17	6.52	0.35	80%	0.06	0.08	0.11
IndusInd Bank	5.91	6.23	0.32	45%	0.03	0.04	0.06
DCB Bank	6.36	6.56	0.20	40%	0.02	0.02	0.03
OBC	6.12	6.40	0.28	80%	0.04	0.07	0.09
Yes	6.48	6.97	0.49	70%	0.07	0.10	0.14

Source: PhillipCapital India Research

The new regime will have multiple benchmark rates linked to various tenors. We believe that the MSLR (in the shortest tenor) can be 100bps lower than the current base rate. For example, the difference between average cost of funds and marginal cost of funds for SBI is ~33bps and the tenor premium currently in commercial paper is ~70bps between one-month and one-year paper. SBI's base rate is 9.3%, which can come down by ~100bps to around 8.3% under MSLR.

Banks	Current base rate (%)
Axis Bank	9.50
HDFC Bank	9.35
ICICI Bank	9.35
SBI Bank	9.30
PNB	9.60
BOB	9.65
BOI	9.70
canara	9.65
Union Bank	9.65
IndusInd Bank	10.60
DCB Bank	10.85
OBC	9.60
Yes	10.25

Source: PhillipCapital India Research

Detailed guidelines

RBI has released new guidelines on loan pricing where it has replaced **Base Rate** with **Marginal Cost of Funds based Lending Rate** (MCLR) which will be effective from 1st April 2016.

- As per the new methodology, all new rupee loans will have to be benchmarked MCLR instead of Base rate from 1st April 2016.
- The calculation of MCLR will be based on following key items:
  1) Marginal cost of funds – This will primarily include the incremental cost at which deposits and borrowings are raised and the return on net worth) (92% of borrowing cost +8% of RONW)
  2) Negative carry on CRR- Marginal cost of funds will be arrived taking the CRR into consideration.
  3) Operating cost associated in providing the loan will be added to the marginal cost of funds
  4) Tenor premium – The marginal cost arrived in step 3 will be adjusted for tenor premium and will not take into consideration the credit worthiness of the borrower. Consequently the bank will arrive at various MCLR based on different tenor, where higher the tenor, higher will be the MCLR.
     a) Overnight MCLR
     b) One-month MCLR
     c) Three-month MCLR
     d) Six month MCLR
     e) One year MCLR
     f) And option of publishing MCLR of any other longer maturity (Eg 1.5 or 2 year MCLR)

- In order to arrive at the lending rate, additional components of spread will be charged to the customer and these components will be determined by the business strategy and credit risk premium. The spread will remain unchanged except on circumstances where there is deterioration of the credit risk profile of the borrower which will force the banks to increase the spread (not applicable for loans under consortium). And there will be no lending below the MCLR.

- Loans covered under various government formulated scheme and working capital term loan, funded interest term loan as part of restructuring scheme will be exempted from MCLR based lending.
- Banks will have to review the MCLR on a monthly basis; while banks which do not have adequate systems in place review on a monthly basis may review every quarterly up to 31st March 2017, there after all banks will adopt monthly review.
- <u>The banks will have to reset the interest rates every year or in less than one year, the exact periodicity of resetting the interest rates will be governed by the terms of the contract. IF the bank reviews its MCLR, the new MCLR will be applicable only on the day of reset, till that the borrower continues to pay the MCLR decide on the day of sanction (we believe this clause will help the bank to protect its margin).</u>
- Banks will also have to publish the base rates until all existing loans linked to base rate gets repaid or renewed. existing borrowers will also have the option to move to the marginal cost of funds based lending rate (MCLR) linked loan at mutually acceptable terms. However, this should not be treated as a foreclosure of existing facility.

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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