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Why India's Lending Rates Are Sticky

By Kunal Kumar Kundu

Vivek Prakash/Reuters

The government wants the RBI to ease monetary policy faster.

The Reserve Bank of India and the Ministry of Finance haven't seen eye to eye on monetary policy for some time. The government wants the central bank to ease monetary policy faster, while the RBI wants New Delhi to prove it is fiscally responsible.

The central bank has actually eased quite a bit, cutting the repo rate (the rate at which banks borrow) by 1% between April 2012 and March 2013. It has also cut the cash reserve ratio (the percentage of deposits that banks have to keep with the RBI and on which they earn no interest) by 1.5% and the statutory liquidity ratio (money commercial banks must keep in cash, gold or government authorized securities) by 1%.

But this hasn't led to big cuts in lending rates by commercial banks. Research firm CEIC Data says the benchmark lending rate of State Bank of India and HDFC Bank dropped just 0.3% from April to March, while ICICI Bank's fell 0.25% and Axis Bank's didn't change at all. Even though the repo rate and the CRR have dropped, the cost of funds of the banks hasn't fallen enough to warrant bigger rate cuts.

This can be attributed to an asset liability mismatch and rising levels of Indian banks' non-performing assets.

India Ratings says the refinancing risk of banks has been growing, particularly for government banks, as long-term loans have increasingly been financed by short-term deposits.

The risk is partly mitigated by banks' solid domestic retail depositor base, but the high pace of refinancing squeezes quarter-end liquidity, keeps funding costs elevated and delays the transmission of any policy rate cut to borrowers.

According to the RBI, as of March 31, 2012, the number of sick (when accumulated loss equals or exceeds net worth) micro-, small- and medium-sized enterprises stood at 85,591, with outstanding loans totaling 67.9 billion rupees ($1.2 billion.) The situation likely worsened last year.

A study by NPAsource.com said the gross non-performing assets of Indian banks were at 530 billion rupees as of Sept. 30, up nearly 46% from a year earlier. Fitch Ratings has warned that the gross non-performing assets of the Indian banking system could have touched 4.2% of advances last financial year. That would be the highest since 2004-05, when the ratio stood at 5.2%.

Rating downgrades of Indian companies far exceeded upgrades last year. Crisil, for example, said on average it upgraded 64 companies for every 100 downgrades. ICRA upgraded 38 companies for every 100 downgrades. Even after the upgrades, many were still rated non-investment grade.

Delays in the implementation of industrial projects have prompted banks having to raise their provisioning requirements as companies are less likely to be in a position to repay loans.

A March 21 report in The Times of India, citing data compiled by state-run banks, shows that 215 projects, each involving investment of 2.5 billion rupees or more, are stuck at different stages of completion. Public sector banks have already disbursed loans amounting to 540 billion rupees for these projects.

This weakens the position of banks, and slows the transmission of monetary policy action onto the lending rate.

c *The author is an economist based in New Delhi. These are his personal views. For more from Mr. Kundu, go to his website.*