ICRA

Indian Banking Sector

Proposed changes in liquidity coverage ratio framework to slow down credit growth

JULY 2024

Highlights

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The proposed guidelines will reduce the liquidity risk in the banking sector. It will also align with the regulatory objective of moderating the credit-to-deposit ratio for the sector.

ICRA estimates the impact on RoA and RoE is expected at 6-7 bps and 70-90 bps, respectively, which could be offset by a 10-bps hike in lending rates by banks.

- The proposed changes in the Liquidity Coverage Ratio (LCR) guidelines will **reduce the system-wide reported LCR by 14-17%, i.e., from 130% reported during Q4 FY2024 to 113-116%** because of higher run-off factors for certain deposits and haircuts on the high-quality liquid assets (HQLA; government securities, or G-secs). This will require **banks to rework their strategy on credit and deposit growth**, especially where the LCR declines to a level closer to the regulatory requirement of 100%.

- As per ICRA's estimates, the average total HQLA for the banking system stood at Rs. 48.9 trillion as on March 31, 2024. To recoup the loss of LCR, **banks may adopt strategies** of focusing on retail deposits, reducing the share of wholesale deposits, moderating credit growth and deploying a higher share of deposits to HQLA. If the entire loss of LCR is recouped through additional purchase of HQLA, the **negative impact on Return on Asset (RoA) and Return on Equity (RoE) can be 6-7 bps and 70-90 bps, respectively**. This is assuming an opportunity loss of interest spread of 2.5% on HQLA.

- Overall, **banks are likely to moderate their credit growth targets** in the run up to the proposed implementation date of April 01, 2025, **resulting in an improvement (i.e., decline) in the credit-to-deposit ratios and increase in liquidity buffers for banks**. ICRA views these as positive development from the risk perspective for banks.

- The proposed changes are to improve the resilience of the banking sector; and this aligns with the series of recent regulatory actions to moderate the elevated credit growth. **ICRA maintains its earlier estimates of lower credit growth** in absolute incremental credit growth as well on a YoY basis of Rs. 19.0-20.5 trillion (11.6-12.5% YoY) in FY2025* over Rs. 22.3 trillion (16.3% YoY) in FY2024*. This shall reduce the credit growth and prevent unhealthy competition for deposits and rise in bank deposit rates.

- Decline in growth aspirations may drive improved pricing power for banks as they can be selective with the segments they choose to grow. **To neutralise the impact on profitability, banks will need to hike their lending rates by 10 bps.** This could mean a higher cost for the borrowers and large borrowers may choose to tap alternative funding sources, including bonds and external commercial borrowings.

**Growth rate for FY2024 excludes impact of the HDFC merger; growth rate for FY2025 is calculated by including the impact of the HDFC merger in FY2024*

Key proposals while reviewing the LCR framework

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Run-off Rate	**Run-off rate for retail deposits enabled with IMB* to increase by 5% points. Small business deposits also to have run-off rate as above**	With the availability of internet and mobile banking facilities, it has become easier for depositors to withdraw funds and, hence, the RBI has proposed to increase the run-off rate by 5 percentage points on digitally-enabled retail deposits. Similarly, small business deposits would also attract run-off rates similar to digitally-enabled retail deposits. This would increase the net cash outflow in the LCR computation.
HQLA Haircut	**G-secs (HQLA) to be valued at not more than their CMV*, adjusted for applicable haircuts in line with the margin requirements under the LAF/ MSF***	With the restriction on valuation of G-secs and application of haircuts, the available HQLA in LCR computation would reduce and ICRA estimates the reduction to be in the range of 2-3%. This will necessitate increased investments in HQLA by banks.
Pledged Deposits	**Non-callable deposits pledged as collateral to secure credit to be considered as callable for LCR and to be included in outflows**	With the inclusion of non-callable deposits in cash outflows and applying run-off factor as applicable on callable deposits would also have a negative impact on the LCR. However, the share of the same and, hence, its impact on LCR can vary from bank to bank and is not quantifiable based on public disclosures, but the impact is expected to be limited because of this.

**Internet and Mobile Banking (IMB) facilities include all facilities such as but not limited to internet banking, mobile banking and Unified Payments Interface (UPI), which enables a customer to digitally transfer funds from their account/s; CMV – current market value; LAF – liquidity adjustment facility; MSF – marginal standing facility*

Key revised metrices in the proposed LCR framework

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Exhibit 1: Changes in run-off rates across deposits

Deposits	Old Run-off Rate	New Run-off Rate
RD/SBD – Stable (IMB)	5	10
RD/SBD - Less Stable (IMB)	10	15
RD/SBD – Stable (Non-IMB)	5	5
RD/SBD - Less Stable (Non-IMB)	10	10
Operational Deposits	5-25	5-25
Non-Financial, Sovereign, Central Banks, etc.	40	40
Others	**100**	**100**

Source: RBI, ICRA Research; RD – retail deposit; SBD – small business deposit

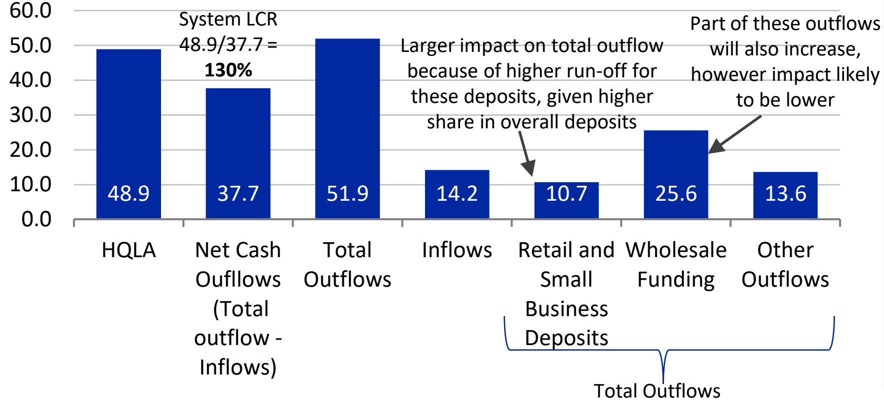
Exhibit 2: Haircuts on HQLA

Category of Collateral	Residual Maturity of Collateral				
	0-1 year	1-5 years	5-10 years	10-15 years	>15 years
Treasury Bills and Central Government Dated Securities (including Oil Bonds)	0.50%	1%	2%	3%	4%
SDLs (unrated)	2.50%	3%	4%	5%	6%
SDLs (rated)	1.50%	2%	3%	4%	5%

Source: RBI, ICRA Research; SDL – state development loans

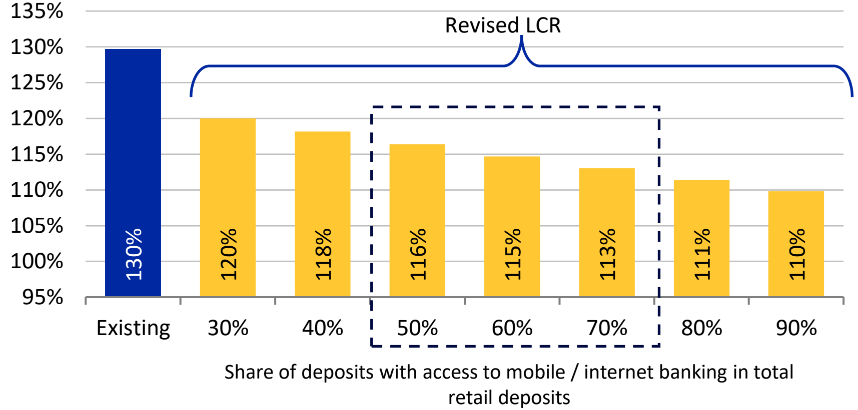
LCR at banking system level could decline to 113-116% from 130%

Exhibit 3: System-wide drivers and constituents of LCR



Source: Banks (13 PSBs including IDBI and 19 large PVBs), ICRA Research; Figures in Rs. trillion

Exhibit 4: Impact on LCR depending on share of impacted deposits

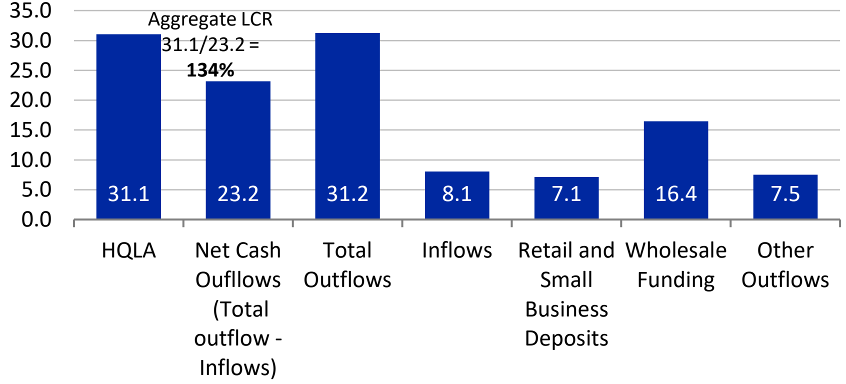


Source: Banks (13 PSBs including IDBI and 19 large PVBs), ICRA Research

- Retail and small business deposits account for a small share in total outflows for banks, but their share in overall deposits is estimated to be higher at over 55-60% of the total bank deposits, hence, a higher run-off factor on these deposits will have a larger increase in total outflows, given the penetration of digital banking among customers.
- Wholesale funding, though a large share of total outflows already attracts higher outflow rates, given the lesser coverage on deposit insurance and these could be non-operational in nature. Further, the break-up of retail and small business customers is not available in disclosures from banks.
- Digital banking penetration of 50-70% in retail/small businesses could impact the reported LCR by 14-17% at the system level, as shown in Exhibit 4. For a 10% decline in reported LCR (say 130% to 120%), the system HQLA requirement could rise by almost Rs. 4.0 trillion.

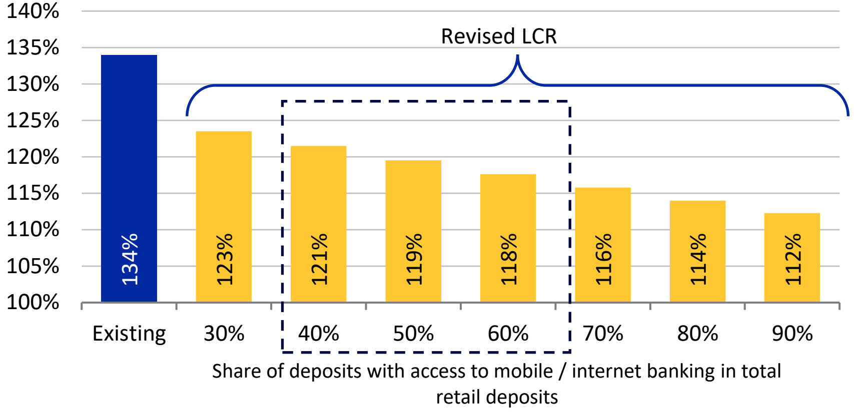
Public banks – LCR likely to remain comfortable

Exhibit 5: Drivers and constituents of LCR – Public banks



Source: Banks (12 PSBs and IDBI), ICRA Research; Figures in Rs. trillion

Exhibit 6: Impact on LCR depending on share of impacted deposits – Public banks

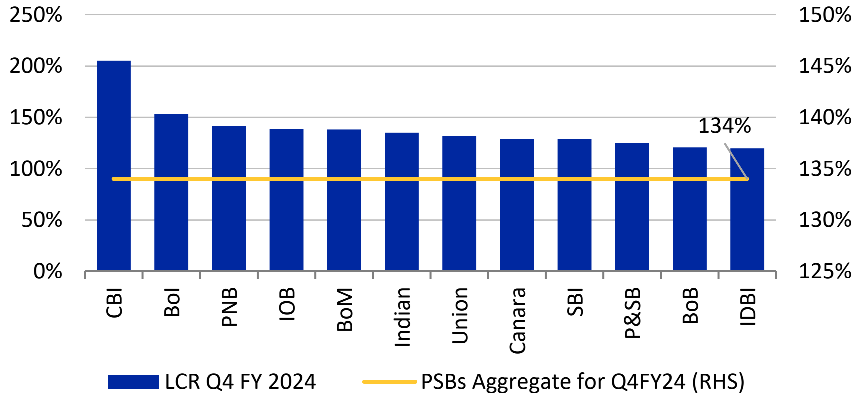


Source: Banks (12 PSBs and IDBI), ICRA Research

- The HQLA as % of total assets for public banks is estimated to be lower at 20% of their total assets, against 23% for private banks for Q4 FY2024.
- Despite this, the LCR for public banks is higher at 134% over 123% for private banks in Q4 FY2024 because of lower total outflows as % of liabilities, which in turn is estimated to be low towards non-operational deposits.
- Further, ICRA expects the penetration of digital banking among retail and small business customers of public banks could be lower than private banks, thereby the LCR could impact the reported LCR by 13-16% against the reported level of 134% for Q4 FY2024.

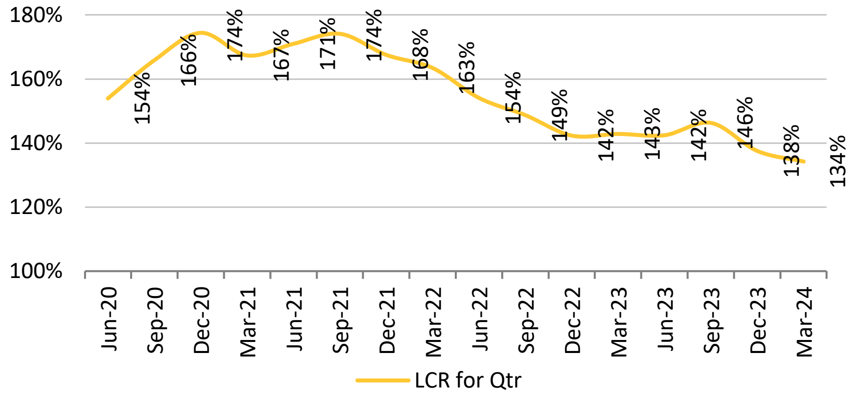
Public banks that went into PCA have higher LCR

Exhibit 7: Bank-wise LCR for Q4 FY2024



Source: Banks (12 PSBs and IDBI), ICRA Research

Exhibit 8: Aggregate movement in LCR for public banks

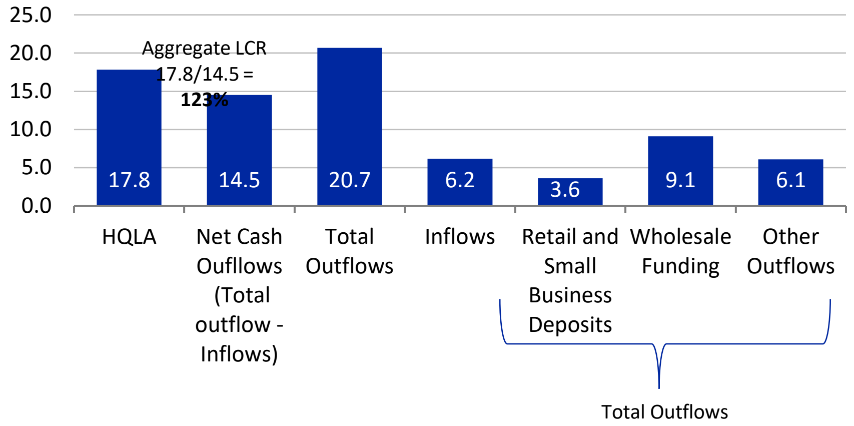


Source: Banks (12 PSBs and IDBI), ICRA Research

- The aggregate LCR for public sector banks (PSBs) declined from a peak of 174% during the Covid period because of decline in HQLA to total assets as well as increase in total outflows driven by higher outflows towards wholesale funding.
- The HQLA to total assets declined to 20% in Q4 FY2024 from the peak level of 25% during the Covid period.
- Some of the PSBs, which have high reported LCR were also the banks that went into the prompt corrective action (PCA) framework of the RBI and, hence, had lending restrictions. Their credit-to-deposit ratios were also at a lower level than the system average, thereby driving better LCR for these banks.

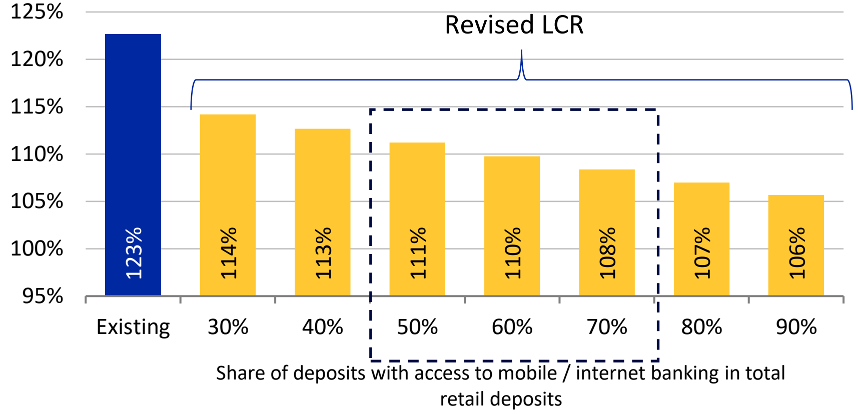
Private banks will need to rework business strategy to recoup the loss of LCR

Exhibit 9: Drivers and constituents of LCR – Private banks



Source: Banks (19 large PVBs), ICRA Research; Figures in Rs. trillion

Exhibit 10: Impact on LCR depending on share of impacted deposits – Private banks

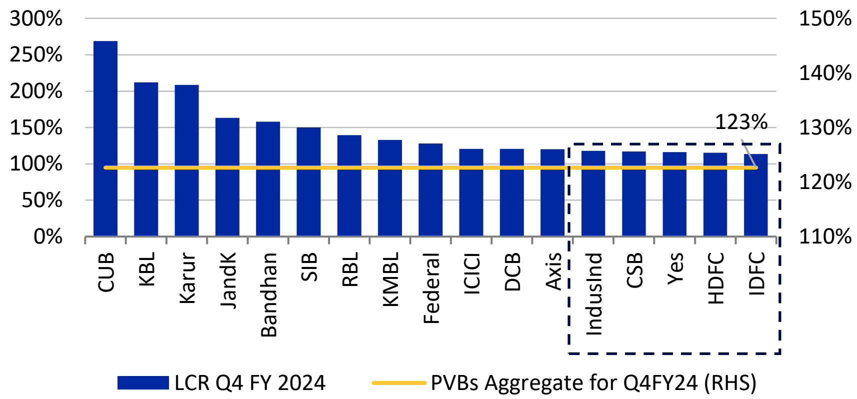


Source: Banks (19 large PVBs), ICRA Research

- ICRA expects the penetration of digital banking among retail and small business customers of private banks to be higher than public banks.
- Therefore, even though the impact on reported LCR is estimated to be similar at 12-15%, despite higher share of digital banking customers (13-16% for public banks), the lower level of absolute LCR will place more constraints on the credit growth of these banks.

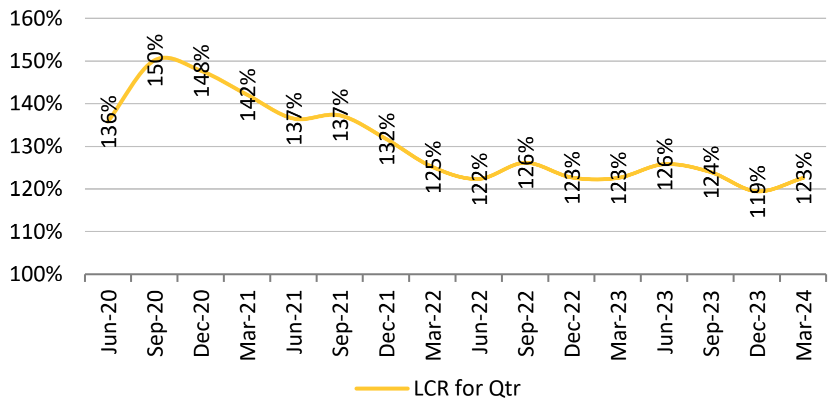
Some private banks will have to meaningfully slow down credit growth

Exhibit 11: Bank-wise LCR for Q4 FY2024



Source: Banks (19 large PVBs), ICRA Research

Exhibit 12: Aggregate movement in LCR for private banks

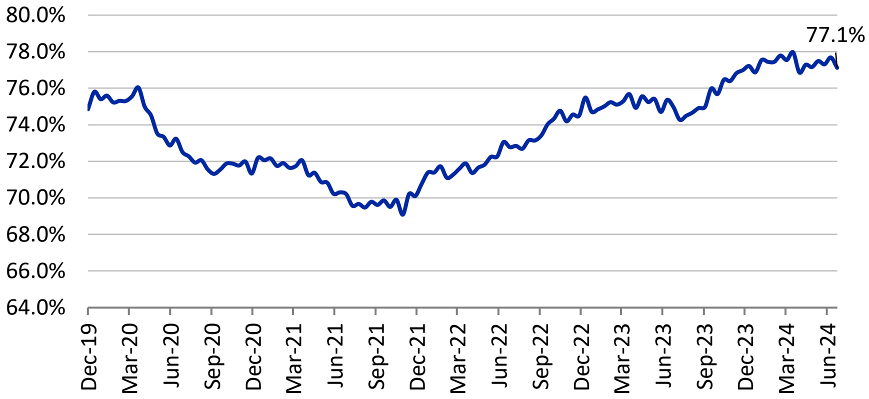


Source : Banks (19 large PVBs), ICRA Research

- Some of the old private sector banks like City Union Bank (CUB), Karnataka Bank (KBL), and Karur Vysya Bank (Karur) have high LCRs driven by lower share of wholesale funding.
- Banks that are closer to the lower end of the LCR (say lesser than 120%) appear to be more vulnerable to coming close to the regulatory level on LCRs, unless they can shore-up granular deposits and deploy them in HQLA.
- They can also relook at slowing their credit growth and reduce their share of wholesale funding to reduce their total outflows and recoup loss of LCR.

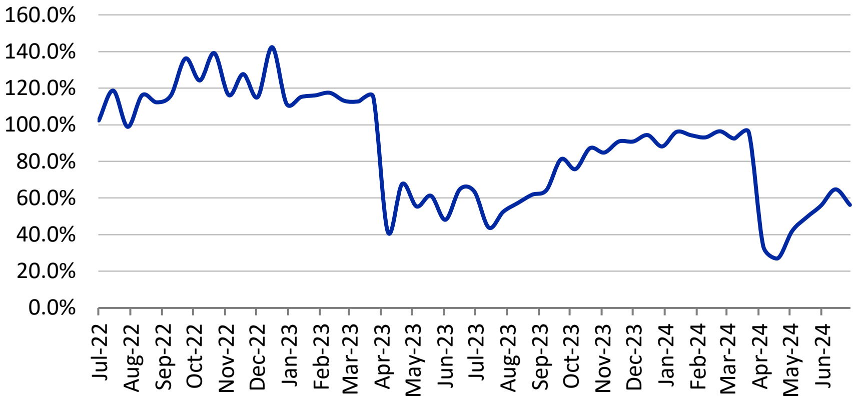
The credit deposit ratio is running uncomfortably high

Exhibit 13: Credit-to-deposit ratio



Source: RBI, ICRA Research (excludes impact of HDFC merger)

Exhibit 14: Incremental credit-to-deposit ratio

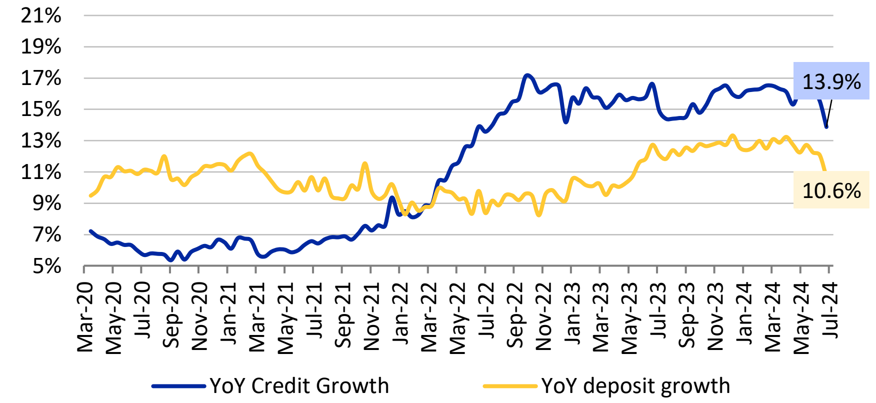


Source: RBI, ICRA Research (excludes impact of HDFC merger)

- With credit growth outpacing deposit growth, the credit-to-deposit (CD) ratio reached an all-time high of 78.0% as of March 2024 in the last five years.
- Thereafter, with regulatory nudge to banks to moderate their CD ratio, there has been slight moderation to 77.1% as of June 2024 with incremental CD ratio declining to 60% in Q1 FY2025.
- With the expectation of deposit growth continuing to lag credit growth in FY2025, ICRA expects the CD ratio (including the impact of the HDFC merger) to inch up to 81.7-82.1% by March 2025 from 80.2% as of March 2024. However, the impact of these LCR guidelines on nudging the banks to reduce credit growth in the run up to the implementation of these guidelines will lead to a lower CD ratio.

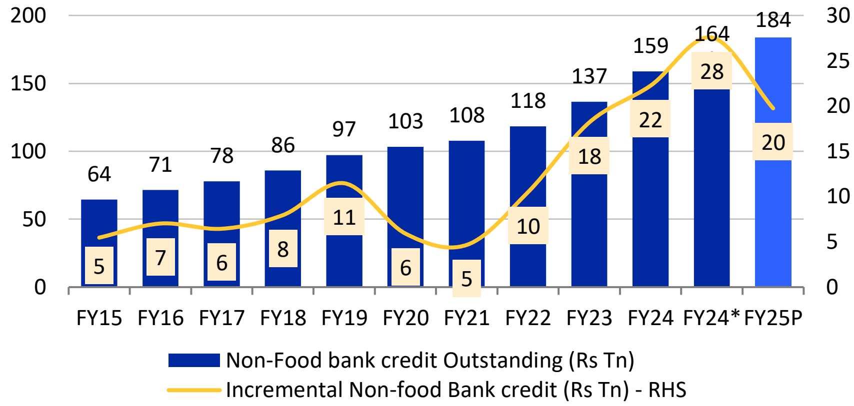
ICRA projects pace of credit growth to slow down in FY2025

Exhibit 15: Credit growth is outpacing deposit growth for over last 2 years



Source: RBI, ICRA Research (excludes impact of HDFC merger)

Exhibit 16: ICRA estimates credit growth to slow down in FY2025



Source: RBI, ICRA Research; FY24 – Excluding impact of HDFC merger; FY24 and FY25P including impact of HDFC merger; P-Projected; Amount in Rs. Trillion*

- Credit and deposit expansion remained robust during Q1 FY2025 and stood at Rs. 4.7 trillion (excluding the HDFC merger) and Rs. 8.3 trillion, respectively.
- This translates into a YoY credit and deposit growth of 13.9% and 10.6%, respectively, as on June 28, 2024.
- ICRA expects the pace to moderate to Rs. 19.0-20.5 trillion (11.6-12.5% YoY) in FY2025* from Rs. 22.3 trillion (16.3% YoY) in FY2024*.
- Incremental deposit growth is expected to moderate to Rs. 19.4-20.0 trillion (9.5-9.8% YoY) in FY2025* from Rs. 23.2 trillion (12.9% YoY) in FY2024*.

**Growth rate for FY2024 excludes impact of the HDFC merger; growth rate for FY2025 is calculated by including the impact of the HDFC merger in FY2024*

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Thank You!