Amid Global Market Volatility, Indian Banks Well Placed to Manage Risk

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Summary

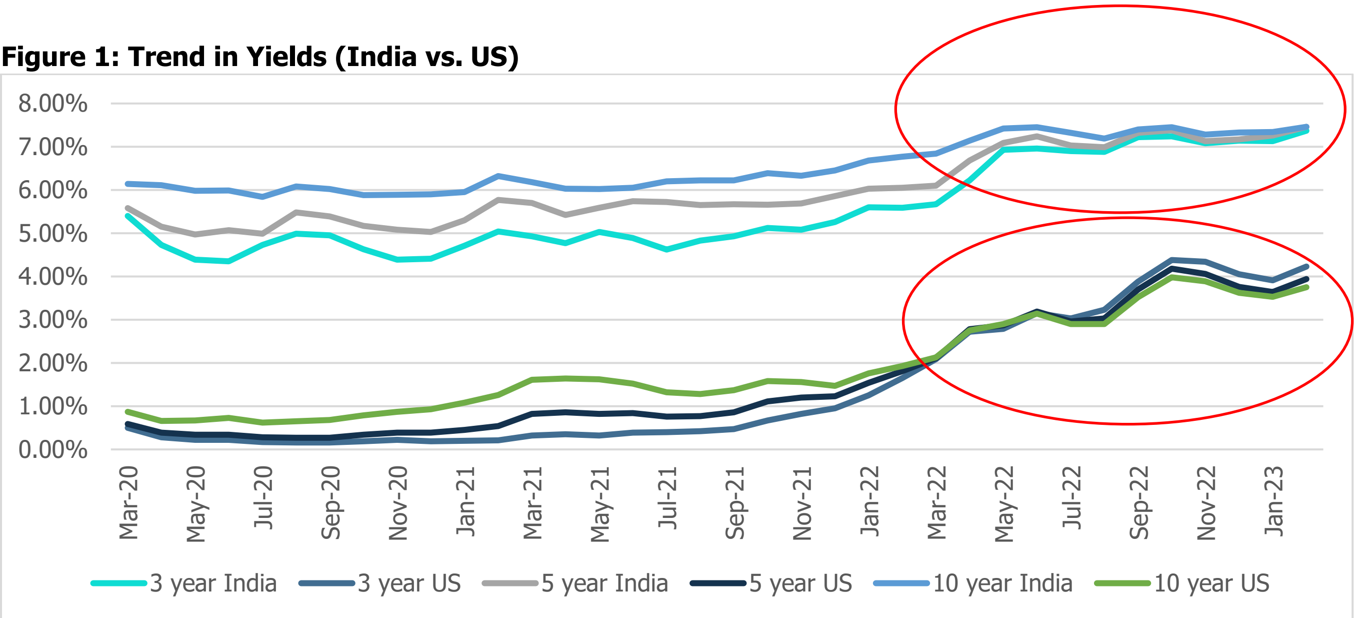
Bank failures especially in the US which have been attributed to rising interest rates have raised concerns about similar market risks faced by Indian banks. Indian banks have a preponderance of their assets as advances, compared to their US counterparts. Indian banks' investments are largely (> 80%) in G-Sec securities, whereas US banks' investments book also consist of other securities. Further, the increase in yields in Indian markets has been muted compared to yield increases in other markets such as the USA.

Hence, Indian banks have resilience towards interest rate risk driven by these market shocks, with adjusted capital adequacy ratios remaining within the required regulatory norms.

Overview

Recently, there have been failures of a couple of large banks in developed economies, marking the first major bank failures since the 2008 financial crisis. These failures have raised concerns about market risks faced by Indian banks. A sudden and significant increase in yields over a short period can hurt banks' investment books. As a result, there are concerns about how the rising interest rate scenario will impact banks' investment books, and to what extent.

Figure 1: Trend in Yields (India vs. US)



Source: Centre for Monitoring Indian Economy (CMIE), and St. Louis Fed Note 1: Indian Yields at Residual maturity; End of the period; Note 2: Market Yield on U.S. Treasury Securities at Constant Maturity, Quoted on an Investment Basis, Monthly, Not Seasonally Adjusted

Rising Interest Rates Impacting Bond Yields, Relatively Lower Increases on India

Globally, central banks have been hiking interest rates sharply in response to inflation and economic slowdown. From February 2022 to February 2023, the US Federal Reserve raised interest rates by 450 basis points, while the European Central Bank raised rates by 300 basis points during the same period. The Reserve Bank of India (RBI) has also been increasing rates since May 2022, albeit at a relatively lower rate of around 250 basis points, to curb inflationary trends.

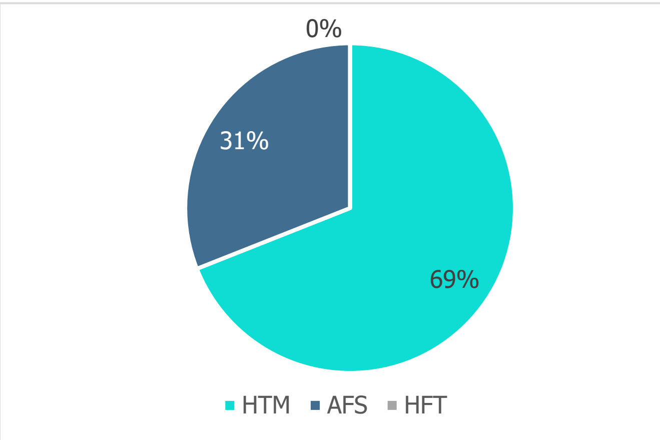
The unprecedented interest rate hike has increased sovereign bond yields, with the 10-year Treasury yield rising by 180 basis points from 1.93% to 3.75% (Figure 1) during February 2022 to February 2023 period. This sharp increase in market yields has had a significant impact on the value of investments held in the held-to-maturity (HTM) portfolio of US banks, resulting in some banks facing huge unrealised losses. In comparison, the 10-year G-Sec yield increased by around 70 basis points from 6.77% in February 2022 to 7.46% in February 2023. However, it is worth noting that the level of yield is still lower than the levels seen in October 2018, which were around 7.85%.

Impact on Indian Banks

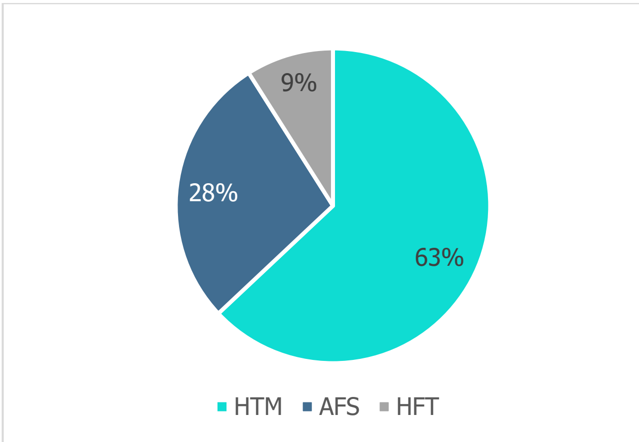
CARE Ratings Limited (CARE Ratings) has reviewed the investment portfolios of Indian banks to assess the impact of the HTM and available-for-sale (AFS) books based on public information. While banks are not required to mark-to-market the HTM portfolio, the AFS portfolio needs to be marked-to-market. For analysis, investments in both books are considered. Banks manage interest rate risk by managing the modified duration of their investment portfolios, recognising that changes in interest rates can impact the value of investments. Figure 2 provides a breakdown of the investments of Indian banks in HTM and AFS categories as of March 31, 2022.

Figure 2: Break-up of Investments (March 31, 2022)

Public Sector Banks



Private Sector Banks



Source: Bank Filings

The majority of the investment portfolio of banks is in the HTM category largely comprising of G-Secs, while the AFS proportion is relatively lower.

Figure 3: Likely impact of interest rate on investment (HTM and AFS) book and net worth cushion

Category of Banks	Net worth / Likely impact of 100 bps change in interest rates (HTM + AFS)$ (times)	Net worth / Likely impact of 100 bps change in interest rates (only AFS)$ (times)
Top 5 Public Banks	4.8	27.4
Overall Public Banks	4.8	28.2
Top 5 Private Banks	16.8	115.5
Overall Private Banks	15.1	110.7

$- as on March 31, 2022; Note: Assumed modified duration of HTM book at 4.5 and for AFS book as disclosed by the bank and assumed when not disclosed

The modified duration of the AFS book is low for Indian banks and the impact of interest rate changes would be very low. Private sector banks, especially the larger private sector banks are likely to have relatively lower impact of interest rate hikes considering their high capitalisation levels. The impact on the public sector banks is likely to be moderate in spite of being higher than on private sector banks as public sector banks have a higher proportion of HTM investments as compared to net worth. Figure 4 below shows the proportion of HTM to net worth for banks.

Figure 4: Proportion of HTM to Net worth (March 31, 2022)

Type of Bank	HTM / Net worth
Public Banks	3.8 (times)
Private Banks	1.5 (times)

Conclusion

Structurally, Indian banks deploy their assets mainly in advances, resulting in a higher Credit to Deposit (C/D) ratio in the range of 65% to 90%, while investments constitute around 25% of their total assets. As of March 31, 2022, Indian banks had a C/D ratio of around 72%. In contrast, their US counterparts have nearly one-third of their assets in investments and a credit-to-deposit ratio that is in the range of 45% to 70%. Moreover, the US has experienced a sharper increase in interest rates over the last 12 months, while in comparison, interest rates in India have risen at a lower rate and continue to remain lower than the rates prevailing during 2018. Indian banks have an adequate cushion to absorb interest rate change (Figure 5 shows the impact of a 100-bps change in the interest rate on the CET I Ratio).

Figure 5: Impact on Capitalisation Level

Banks	CET I Ratio 31-Mar-22	CET I Ratio post 100 bps interest rate impact on investment book (HTM+AFS)*	Minimum CET I Regulatory Requirement^
Public Banks	10.70%	**8.45%**	8.00%
Top 5 Public Banks	10.35%	**8.22%**	8.00%
Private Banks	15.54%	**14.93%**	8.00%
Top 5 Private Banks	16.67%	**15.56%**	8.00%

*without considering income tax set-off ^Domestically Systemically Banks (D-SIBs) have higher requirement of minimum CET I Ratio by 0.20% to 0.60%

Additionally, most Indian banks' investments (>80%) are in G-Sec securities, whereas US banks' investments in the HTM book also consist of other securities. Furthermore, it is worth noting that the regulator (RBI) has been prompt in addressing the issues faced by domestic banks during uncertain times. In April 2018, the RBI allowed banks to amortize MTM losses over a period of four quarters. Therefore, Indian banks have better resilience towards interest rate risk driven by these market shocks.

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