Banks now in better position to manage interest rate risks

Reduction in bond duration puts lenders on stronger footing amid higher yields

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For Indian banks, one of the most challenging aspects of a monetary tightening cycle is navigating the high degree of interest rate exposure that stems from a regulatory requirement to hold government securities.

But in the current cycle of interest rates heading higher, domestic banks are much better positioned than they were in the past tightening cycles, even as yields on government securities have soared to multi-year highs in a short span of time.

When interest rates are lifted, bond yields rise, resulting in a fall in their prices. With banks mandated to park a large portion of their deposits in sovereign debt, the decline in bond prices can extract a substantial cost.

Over the past few years, banks faced significant erosion of profitability when the Reserve Bank of India (RBI) embarked on a rate hike cycle, with the degree of treasury losses sometimes even posing a risk to financial stability.

In the present cycle of interest rate hikes, which started on May 4, the RBI has raised the repo rate by a total of 140 basis points. Hikes of 90 basis points came in the April-June quarter and this resulted in the yield on the 10-year benchmark government bond rising 61 basis points.

Analysts estimate the marked-to-market hit from the rise in yields at around ₹11,800 crore, of which around ₹8,600 crore would be for public sector banks. Among banks, state-owned lenders are the largest holders of government securities.

Even as treasury operations have taken a hit, the first quarter results show a relatively minor impact on banks' profitability from the marked-to-market losses on bonds.

Most banks have reported a healthy rise in net profit figures. The country's largest lender, State Bank of India, said that its provisions would remain firm even if the yield on the 10-year bond were to climb around 15 bps from current levels.

Barring Dhanlaxmi Bank, no bank reported a net loss in the first quarter of the current financial year. This is in stark contrast to the previous monetary tightening cycle in 2018 and the run-up to the same.

ILLUSTRATION: AJAY MOHANTY

In October-December 2017 and January-March 2018, several banks reported net losses after more than a decade — a significant reason for which was conditions in the bond market turning adverse.

SBI reported back-to-back quarterly losses in the last two quarters of 2017-18 — ₹7,718 crore in January-March and ₹2,416 crore in October-December — with the bank's management acknowledging that a rise in bond yields had dragged down the bottom line.

In October-December 2017, the yield on the 10-year bond rose 67 basis points — similar to the surge that occurred in April-June 2022.

The dexterity with which banks have handled the current monetary tightening cycle is reflective of a larger change in their, especially public sector lenders', approach to the management of interest rate risk, treasury officials said.

"There are a couple of factors that are playing to the advantage of banks in the current cycle. This time around, banks have proactively reduced the modified duration of their AFS (Available for Sale) books to limit the impact of the movement in yields," Karan Gupta, director of financial institutions, India Ratings and Research, told *Business Standard*.

"Further their profitability buffers are significantly better than in last cycle, allowing them to take the MTM (marked-to-market) hit through P&L (profit and loss), even while investment fluctuation reserve is available in most cases for dipping into," Gupta said.

Regulatory dispensations from the RBI have helped matters for banks, but the catalyst for the change may well have been a harsh missive from the central bank four years ago.

During a speech delivered in January 2018, then RBI deputy governor, Viral Acharya, severely criticised banks' management of interest rate risk and said that the central bank cannot always be called upon to provide regulatory dispensations when market conditions turn adverse.

Acharya exhorted banks to adopt more dynamic practices for managing the size and duration of bond portfolios. The central bank's message, it seems, was taken to heart by banks. The RBI's Financial Stability Reports show that from a modified duration of 4 for public sector banks in the June 2017 report, the modified duration has now come down to 2.2.

Modified duration refers to the change in the value of a bond when interest rates change. The higher the modified duration of the bond portfolio, the more the risk of incurring losses when bond yields rise.

"This time the investor balance sheets have a lower level of interest rate risk (lower durations) as compared to the earlier cycles. All said and done, post-Covid, banks did not buy too much of long-end securities," said Shailendra Jhingan, MD and CEO of ICICI Securities Primary Dealership.

"That HTM limits for banks are higher will also help them take greater interest rate risk without worrying about its impact on the P&L account," he said.

Banks would have learnt from the phase of immense market volatility that followed the demonetisation of high-value currency notes in November 2016.

At the time, bond yields fell sharply as the rush to deposit currency notes with banks led to a huge increase in banking system liquidity. The yield on the 10-year bond fell by 60 basis points during the phase.

At that time, banks were said to have been deploying the short-term surplus liquidity in longer-tenure bonds in order to lock in rich trading gains.

Prices of longer-tenure bonds move sharply relative to a minor movement in yields. While this provides an opportunity to maximise trading gains, it poses a commensurately greater risk when yields rise.

What provides further evidence of the change in banks' approach to interest rate management is the fact that the liquidity surplus during the Covid crisis was higher than that during demonetisation. At its height, the banking system surplus was around ₹9 trillion in 2020, as against maximum surplus liquidity of around ₹7 trillion in 2016.

While overall improvement in the resilience of the banking system – indicated by lower bad loan ratios – has helped banks improve profitability, it seems that the days of Indian lenders being compelled to depend on the RBI to manage excessive bond market volatility are coming to an end.