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## **New base rate = One-time Rs 20,000 cr profit hit for banks**

*Under new calculus, base rate could be lower by around 50 bps: CRISIL*

The Reserve Bank of India's (RBI) draft guidelines on computation of base rate, if implemented in its current form, will significantly impact profitability of banks.

The guidelines, released late Tuesday, require banks to follow the 'marginal cost of funds' method for base rate computation from April 1, 2016.

CRISIL's estimates show the change in methodology can lower banking system base rates by approximately 50 basis points (bps) from current levels. Crucially, it will reduce banking sector profitability because return on assets (RoA) will fall by 20 bps in fiscal 2017.

**Says Pawan Agrawal, Chief Analytical Officer, CRISIL Ratings: "Our base-case is that profitability of banks will have one-time impact of around Rs 20,000 crore in fiscal 2017, which would be equal to 15% of the total estimated profit of the banking system for that year. The actual impact will depend on whether the banks will be given a leeway to make this shift over a longer timeframe in the final guidelines."**

Further, for every subsequent 25 bps cut in the deposit rate, profits will be impacted by Rs 5,000 crore in a year from the rate cut.

Yields of banks that lend mostly on a floating rate basis will be significantly impacted in an environment of falling interest rates.

Banks with low levels of current and saving accounts, and/or relatively longer tenure term deposits, will also be majorly affected.

Nevertheless, in an increasing interest rate scenario, banks will tend to benefit as they will be able to immediately pass on any hike in deposit rate to the base rate.

The RBI has proposed the changes to ensure faster monetary transmission. The new calculus for base rate will increase the sensitivity of bank lending rates to changes in the RBI's policy rate.

However, given the impact on profitability, banks may shy away from cutting deposit rates, especially in times of low profitability, which will defeat the objective of quick transmission of cuts in the RBI's policy rates.

The guidelines will also impact the broader objective of encouraging corporates to increasingly resort to the bond market given that the arbitrage created between rates on bank loans and bonds, due to a lag in monetary transmission by banks, will now disappear.

**Says Rajat Bahl, Director Financial Sector Ratings: "Banks could look at mitigating interest-rate risks by sourcing more short-term deposits and borrowings. However, the flexibility for this would be limited given that they have to implement Basel III rules such as Liquidity Coverage Ratio and Net Stable Funding Ratio, which aim to improve liquidity and lower asset-liability mismatch risks."**

Alternatively, banks could look at offering floating rate deposit products, but this would depend on demand.

Media Contacts	Analytical Contacts	Customer Service Helpdesk
<p><b>Shweta Ramchandani</b> Media Relations CRISIL Limited Phone: +91 22 3342 1886 Mobile: +91 96 191 05070 Email: <a href="mailto:shweta.ramchandani@crisil.com">shweta.ramchandani@crisil.com</a></p> <p><b>Jyoti Parmar</b> Media Relations CRISIL Limited Phone: +91 22 3342 1835 Email: <a href="mailto:jyoti.parmar@crisil.com">jyoti.parmar@crisil.com</a></p>	<p><b>Pawan Agrawal</b> Chief Analytical Officer, CRISIL Ratings Phone: +91 22 3342 3301 Email: <a href="mailto:pawan.agrawal@crisil.com">pawan.agrawal@crisil.com</a></p> <p><b>Rajat Bahl</b> Director - CRISIL Ratings Phone: +91 22 3342 8274 Email: <a href="mailto:rajat.bahl@crisil.com">rajat.bahl@crisil.com</a></p>	<p>Timings: 10.00 am to 7.00 pm Toll free number: 1800 267 1301 Email: <a href="mailto:CRISILratingdesk@crisil.com">CRISILratingdesk@crisil.com</a></p>

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