Post the global financial crisis, bank exposures to sovereign debt have increased significantly in several economies, deepening the linkage of bank balance sheets with sovereign debt. In India, the linkage between sovereign debt and bank balance sheets has always been strong given the statutory liquidity ratio (SLR) prescriptions for banks which have been brought steadily in line with international levels of the Liquidity Coverage Ratio (LCR) under Basel-III. The large holding of G-Secs and SDLs by banks exposes them to re-pricing of governments’ borrowing costs which could rise due to inflationary, fiscal or other domestic as well as global macroeconomic developments.

Interest rate risk is the price equation for a bond portfolio when there is a change in the underlying interest rates, such as the level of government’s borrowing cost. In other words, the value of the investment portfolio is a function of three factors: size of the portfolio, duration and increase in yields. The investment in central government securities as a percentage of banks’ total investment and assets has noticeably increased. Often, banks end up holding high levels of government debt as residual holders in case of relative oversupply, as the appetite of other major institutional investor categories like insurance and pension funds is limited by their investment mandates. Also, the excess liquidity in the banking system was not parked at the Reserve Bank’s (RBI) liquidity mop-up operations, leading to duration risk. The surplus liquidity found its way into G-Secs, resulting in higher interest rate risk in proportion to total assets, for public sector banks relative to private banks.

The high interest rate exposure of banks from their G-Sec portfolios is also attributable to the increasing maturity of primary issuance. With relatively high duration and concentration of G-Secs in investment portfolio, bank earnings and capital remain exposed to adverse yield moves, especially as the share of investment income has been on the rise in the last few years. G-Sec yields in India have undergone episodic phases of sustained rise of close to 200 bps at regular intervals. Banks need to take note of the impact of large interest rate moves on their capital and profitability. During Phase I (second half of 2004), banks were permitted to hold G-Secs up to the mandated SLR of 25% of demand and time liabilities (DTL) under the Held to Maturity (HTM) accounting category, and allowed to shift securities from other accounting categories into the HTM category, as a one-time measure. A similar one-time transfer was also extended during Phase III (taper tantrum period of 2013). The impact of the persistent rise in yields during Phase II (post the global financial crisis) was eased to a great degree by regular open market purchases by RBI. Banks have been requesting RBI to adopt these measures yet again in the current phase of rising yields.

The interest rate risk of banks cannot be managed repeatedly by the regulator, thereby necessitating the banking system to build its own immunity and strength, and put in place processes for efficient management of interest-rate risk. Interest rate risk management at banks requires deeper long-term investor participation in government bond market - both domestically and internationally, and the maturity structure of government debt kept sensitive to implications for bank balance-sheets. Banks also

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need to manage the interest rate risk on the balance sheet by dynamically managing its size and duration as well as accessing markets for risk transfer.

Interest rate risk management options can be categorized as measures that address: G-Sec portfolio size of banks; duration risk and valuation impact in scenarios with potentially large changes in yield. The size of the G-Sec portfolio of banks is mainly a function of balance sheet choices made by banks among competing assets, and is subject to interest rate risk. Bank boards in consultation with the Treasury head and Chief Risk Officer (CRO) need to set the risk limit for the portfolio in a way such that the assigned risk capital is protected under reasonable stress scenarios. Given the non-linearity in yield movements, banks should also factor in historical stress scenarios and conduct reverse stress tests to ensure that the capital allocated to the treasury function should not get wiped out. Banks need to adopt robust risk controls, which include concentration limits, so not to exceed exposure to G-Seecs beyond an internally agreed total proportion of assets, and dynamic stop loss limits, to avoid further losses once a particular percentage of assigned risk capital is exceeded.

Management of duration risk requires wider participation by banks in interest rate derivative markets, both futures and swaps for improving liquidity in these markets, thereby enabling banks to off-load their significant duration risk onto others. Further, as more hedgers access these markets, there would be incentives for market makers to allocate more capital to these activities, kicking off a virtuous cycle of interest rate risk-sharing and leading over time to a more vibrant derivative market. Additionally, treasury functions at banks need to be modernized, subjected to careful scrutiny by Boards, overlaid with prudent risk management practices, and trained to employ hedging instruments specifically targeted at managing interest rate risk.

Banks need to manage exposures to large changes in yield with a multitude of instruments and trading platforms. Necessary steps have been taken by the RBI to create an enabling environment for markets to develop, creating trading, settlement and reporting infrastructure; introducing products; easing processes, and guaranteed settlement in G-Seecs, forex and interest rate swaps. RBI introduced the when issued market and STRIPS, and has permitted money market futures and interest rate options, although none of them have gained traction. Banks need to avail these risk management options, instead of hoping for regulatory forbearance when there are large changes in yields. FIMMDA is developing the code of conduct covering its members’ activities in the interest rate markets.

To sum up, market development is a two-way interactive process between market participants and regulators. Market liberalization not only involves the regulator easing business processes, introducing new products and creating new markets; but also requires participants to take initiative to reskill themselves for constantly evolving market conditions and products.

Source: www.rbi.org.in