

Developing the Inter-bank Term Money Market

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The development of term markets is one of the most widely discussed, written about, and debated subjects. Without getting into any technicalities, the basic issues that we need to address are: why do we need a term money market; why do we need it now; why has it not developed so far; and, finally, how will it develop.

Why We Need a Term Money Market

The option of using the term money market can reduce interest rate risk, as well as the risk of liquidity or funding risk, i.e. of not getting the money at all. A lot of banks today, are funding long term assets with overnight liabilities, and the risks inherent in such a strategy are obvious – the interest rates can move against you, or, when you need the money overnight, somebody might tell you, ‘sorry I don’t have the money’, or ‘sorry my lines for your bank are full’.

These are real possibilities. As our markets have witnessed in the last couple of years, the call rates have gone as high as 100%. If a bank used overnight funds to lend to its corporate customers at prime rates, it would have made money some times, but more importantly, lost it as well. Therefore,

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credible pricing benchmarks are essential, and that's where MIBOR and BIBOR come in – because ultimately, you cannot price your assets on overnight rates. What we need is a term market, and that term market will result in some credible benchmark. Ultimately, you need to have a single credible benchmark which is acceptable to everyone. We do see assets priced over treasury bills and over prime rates and so on, but that is not really sustainable because the prime rate may be an acceptable benchmark to the lender but not to the borrower. Finally, if you have a sensible term money market, it could lead to the development of the derivatives market. We see this happening in India within the next 3 to 5 years, as part of our normal banking operations.

Why We Need a Term Money Market Now

The above defined reasons have been largely true for a long time – so, why now? Firstly, interest rates are substantially free. This means that we do not really need to look at the RBI Circular anymore for our borrowing or lending rates. These rates are free, and we have to manage the risk that arises out of free interest rates. We are moving away from overdrafts to term loans. Earlier, a typical bank balance sheet would have current accounts and savings accounts, from which they could fund overdrafts. Today, we are moving towards term loans – both for working capital and for capital equipment, including project finance. These are longer term loans that carry the obvious risk of mismatches. Therefore, when considering a long term loan, should you lend at a fixed rate or at a floating rate?

A long term loan with a fixed rate is nothing short of speculation, because there is no way a borrower – or lender – can hedge himself in the market today. This means that we must have floating rates. The current situation suggests that many of the floating rate loans are priced on prime lending rates. In such a case, a bank may say, 'this is fine with me' but the borrower will say 'somebody else's prime rate is lower than yours, I'll go to him'.

So there is no realistic benchmark for pricing such loans, and thus, the development of a term yield curve would provide the necessary credibility to pricing.

Why has It not Developed So Far

With such strong arguments, why has it not developed so far? One commonly stated argument has been the distortion created by reserve requirements. Many of us have been shouting hoarse for the RBI to remove these distortions and they have been removed substantially in the last six months. The obvious next question is ‘How come there is still no money market?’

- Reserves are just one of the reasons that the term market has not developed yet. The high interest rate spreads in the banking industry have provided a great buffer, and therefore the ability of banks to absorb interest rate risks, liquidity risks, etc. has been substantially high all this while. As a result, banks have never felt the need to manage such risks. Today, this scenario is changing as the high spreads enjoyed by the banking system no longer exist. This will pressurise banks to manage their risks in a more focused manner.
- Another reason is the temptation of riding the yield curve. Given call rates of 4% or 5%, as in 1997, it is very tempting to go on borrowing short term. But we have seen, in living memory, inverted yield curves and, I am sure that, at some stage or the other, it is going to happen again. In such a case, the need to borrow long rather than short would be a real one.
- When the RBI looks at funding in the balance sheets of banks, it does not consider the borrowing from banks as being part of the credit deposit ratio. If you borrow Rs. 100 crore in the overnight market, the Reserve Bank may either say nothing, or it may say its too high or too low. Instead of considering this figure of 100, the RBI should consider the bank’s assets. If this Rs. 100 crore is funding a project loan, or a one or two year loan, this 100 is very high. It may be preferable to have a matched, or semi-matched, term borrowing from another bank. However, since regulators tend to focus a lot of attention on the credit deposit ratio instead of mismatches, there is a tendency among banks to go in for customer deposits rather than interbank deposits, and the maturity of interbank deposits is not an issue.
- Another issue is the so called herd market, which, unfortunately, it is a reality. Consider this : If a bank says, ‘I want to lend you 6 month money’ the immediate reaction is ‘Wait! Is something wrong? Does he know something? Why is he lending me 6 month money? I’ll play it safe. I will not borrow.’ The reverse can happen as well : If a bank says ‘I want to borrow 6 month money’, the lender would feel ‘Something is wrong

somewhere, I better stick to call'. If we look at the last one year, the average call rate has been around 4.7%, and repeatedly, thousands of crores of Rupees have been lent every single day in the market on an overnight basis. If we had polled the lenders and the borrowers on the first of January this year, as to what would be a one year rate, they would have all said 8% or 9% or 10%. Nobody would have said 4.7%. Yet, all the business happened at 4.7% and that leads me to the next point which is the mindset.

- Mindset is a very real problem. I have had bankers telling me that 'I think your argument is right, but if I lend you this much, I will have to deal with my superiors and frankly, why should I? For so many years I have been lending overnight, and I will continue to lend overnight.' The point is that thousands of crores which have been lent in the last one year, could have been lent at 3% to 4% higher. This may be a point to think about.
- The other mindset is that of the regulators. If regulators see borrowing and lending on the same day on the bank's book, several questions are asked. 'Are you speculating? Are you trading or are you borrowing or lending?' I think there can be no market – whether its an overnight market or a term market –without the ability for market players to deal both sides of the market. Therefore, one of the major hindrances to the development of the term market is this mindset on the part of the regulators, which does not allow simultaneous borrowing and lending. Banks are allowed to keep 10 million dollars overnight. Obviously, if you are going to do it on a daily basis, it is not efficient. But to take a view, and place it abroad for three months, we need a domestic term market where we can borrow for three months. In any case, regulators require explanations if you borrow for overseas lending. While senior regulatory officials appreciate these issues, it is desirable that this be communicated to the people who actually interact with banks as well. This mindset is certainly a major hindrance to the development of term markets.

How will It Develop?

We are already seeing a reduction in interest spreads for banks, and the more these spreads decline, the greater will be a reason for banks to actually look at their interest rates gaps. But it is not just a question of simply filling the gaps by borrowing or lending. You need to spread your balance sheet out into the future, view the maturities of the assets, as well as the maturities of liabilities, and identify the kind of interest rate risk you are taking. The ability to bear that interest rate risk will go down initially, because of the declining interest spreads. Finally, the RBI, which fully appreciates the problem, will tell us the right thing to do. It is my view that the Reserve Bank will one day, come out with a policy for mismatches. I believe that could well be the way the term market will develop.

I think there will be limits set up – similar to the Value at Risk (VaR) kind of limits – that are already applicable to the foreign exchange gaps. Foreign exchange gaps are monitored by RBI limits and these are really interest rate risks. The Reserve Bank may, sooner or later, step in on the commercial side and actually introduce a policy by which, borrowers will not be exposed to such risks, and lenders shall not have huge opportunity costs because they keep lending in the call market. So my own view is that, whatever the market says, finally the term money market will come through the Reserve Bank route.