Asian Journal of Research in Banking and Finance

Asian Research Consortium

www.aijsh.com

ISSN: 2249-7323
Vol. 11, Issue 8, August 2021
SJIF –Impact Fact = 8.174 (2021)

RISK MISPRICING OF LOANS BY INDIAN BANKS: WHETHER IT IS OWNERSHIP NEUTRAL

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ABSTRACT

All Scheduled Commercial Banks in India are expected to hold sufficient provisions to meet the expected loss from the credit portfolio. The build-up of provisions to meet expected losses is to be funded by charging a risk premium from the borrowers. This risk premium should form a significant part of the spread between the banks' cost of funds and the yield on their lending portfolio. When banks do not determine the risk premium appropriately and/or do not pass on the risk premium to the customer, the spread earned by them will not be sufficient to meet the expected credit losses and there will be erosion in the capital of the bank. This paper tried to determine if the Indian banks have been mispricing their loans by way of not factoring the risks underlying those exposures adequately, based on empirical data from 2010 till 2020, covering the full cycle of relatively good reported financial health of banks till 2015 and deterioration post the Asset Quality Review by RBI in 2015-16. The paper also tried to establish if this practice is ownership neutral.

KEYWORDS: *Loan Pricing, Interest Rates, Risk Mispricing, Capital Buffers, Recapitalisation.*
JEL Classification: G20, G21, E43, C23

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