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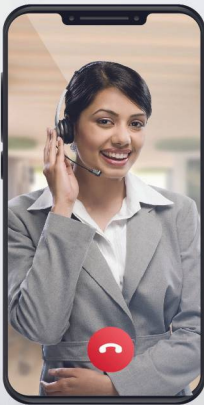
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NIM Compression in Indian Banking

*Why margins are shrinking, and
what banks are doing about it*



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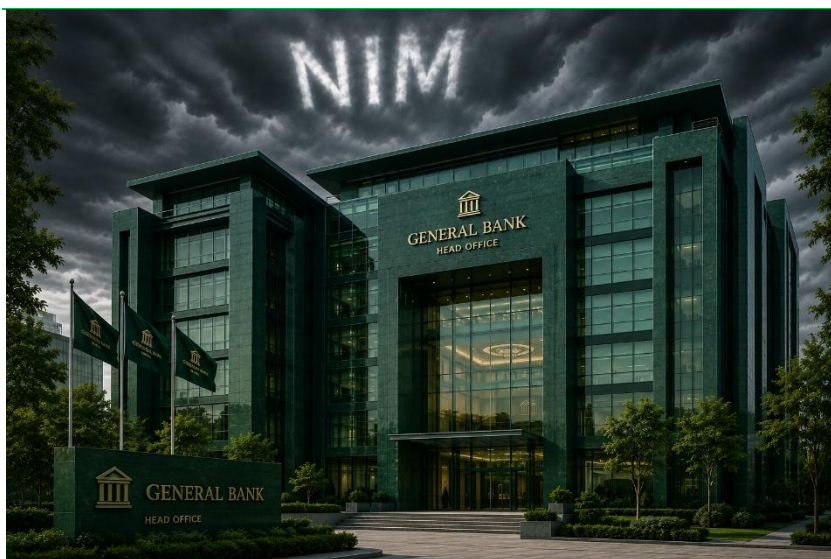
"Indian banks' net interest margins (NIMs) will likely decline by 10 basis points on average in 2025-26 due to the Reserve Bank of India's interest rate cuts, but the drop will be cushioned by the central bank easing liquidity conditions."

June 2026 | Theme 414

Fitch Ratings

Indian Banking Analysts - Feb 2025

The 'SIB Students' Economic Forum' is designed to kindle interest in the minds of the younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is **NIM Compression in Indian Banking**.



The net interest margin is the single number that tells you whether a bank is making money from its core business of taking deposits and making loans. Through FY 2025-26, that number has been under pressure across the Indian banking system. This article explains what a margin is, why it has been squeezed, and the levers a bank actually controls when the rate cycle turns against it.

What a Net Interest Margin Actually Measures

Every bank runs on a simple idea. It pays one rate of interest to attract deposits and charges a higher rate on the loans it makes. The gap between what it earns on its assets and what it pays on its liabilities, measured against the assets it holds, is the net interest margin, or NIM.

In plain terms, NIM is calculated as net interest income divided by average interest-earning assets. If a bank earns ₹100 of interest on its loans and investments, pays ₹65 to its depositors and lenders, and holds ₹1,000 of average earning assets, its

net interest income is ₹35 and its NIM is 3.5 per cent. That figure is the lifeblood of a commercial bank, because for most Indian banks net interest income still makes up the large majority of total income.

$$\text{Net Interest Margin (\%)} = \frac{\text{Net Interest Income}}{\text{Average Interest Earning Assets}} * 100$$

This is why a movement of even 20 or 30 basis points matters so much. A basis point is one-hundredth of a percentage point. On a loan book running into lakhs of crores, a 30 basis point fall in margin translates into thousands of crores of lost net interest income in a single year. The number looks small; the rupee impact is not. It also helps to be clear about what NIM is not. It is not the same as profit.

A bank can hold its margin steady and still see profit fall if loan losses rise or costs climb. And it is not the same as the spread on a single loan, because NIM is a blended figure across the entire balance sheet, including low-yielding statutory investments the bank is required to hold.

NIM is the system-level health check, not the price tag on any one product.

Why Margins Have Been Shrinking

Margin compression in FY 2025-26 was not caused by any single event. It was the result of the rate cycle, the structure of bank balance sheets, and competition for deposits all pulling in the same direction at once. Four forces deserve attention.

1. The rate cycle turned, and loans repriced faster than deposits

Between February 2025 and June 2025, the Reserve Bank of India cut the policy repo rate by a cumulative 100 basis points, taking it down to 5.50 per cent, before holding it steady through the August 2025 and subsequent meetings into 2026.

When the repo rate falls, it sets off a timing mismatch inside every bank. The reason is how loans are priced. A large share of Indian bank loans, especially retail and MSME credit, is linked to an external benchmark such as the repo rate under the EBLR framework. When the repo rate is cut, these floating-rate loans reprice downward almost immediately. Deposits, by contrast, are mostly fixed-rate term contracts that only reprice when they mature and are renewed.

Fitch Ratings estimated that around 45 per cent of system loans reprice down at once when the benchmark moves. So, the income side of the margin falls quickly while the cost side falls slowly. The gap narrows, and NIM compresses.

Table 1. The repo rate cycle that drove the squeeze:

Date	Repo Rate	Action
Feb 2025	6.25%	First cut in nearly five years (25 bps)
Apr 2025	6.00%	Second cut (25 bps)
Jun 2025	5.50%	Third cut (50 bps); CRR cut by 100 bps

Aug 2025	5.50%	Held steady
Apr 2026	5.25%	Held at 5.25% with a neutral stance
Jun 2026	5.25%	Held; MPC retained neutral stance

Cumulative 100 bps of cuts between February and June 2025 drove the repricing mismatch. Source: [RBI MPC decisions](#).

Bank leadership described this mismatch in exactly these terms. Reporting margin compression for the first quarter of FY 2025-26, the head of Bank of Baroda pointed to the realignment of both sides of the balance sheet and the lag in deposit costs that drives the squeeze:

“Pressure on NII will continue to be there for the next quarter, because the transition matrix both on the asset and liability side are going to fully realign in the next two quarters. Banks have a lower growth or a negative growth in NII because the cost of deposit will take a bit more time to realign.”

- MD & CEO, Bank of Baroda, on the Q1 FY26 results

2. The deposit mix has been working against banks

The cheapest money a bank has is its current and savings account balances, together known as CASA. Current accounts pay no interest and savings accounts pay very little, so a high CASA ratio is a structural defence for the margin.

The problem through this cycle has been that customers have been shifting money out of low-yielding savings accounts and into higher-paying term deposits, mutual funds, and other instruments. As the CASA share falls, the average cost of deposits rises even before any rate change, eroding the margin from the liability side.

3. Competition for deposits intensified

For several years credit growth outpaced deposit growth, leaving banks chasing a limited pool of deposits to fund their lending. That competition kept term deposit rates sticky and high. Even as the RBI cut the repo rate, banks could not cut deposit rates as freely as they cut loan rates, because doing so risked losing depositors to rivals. The result was a slower fall in funding costs than in lending yields, which is the textbook recipe for margin compression.

4. Statutory holdings cap the achievable yield

Indian banks must park a portion of their resources in non-earning or low-earning forms. The cash reserve ratio (CRR) is held with the RBI, and the statutory liquidity ratio (SLR) is held largely in government securities. These holdings yield little or nothing relative to loans, so they act as a permanent drag on the blended margin. When lending yields fall in a rate-cut cycle, this fixed drag becomes proportionally heavier.

Table 2. The forces compressing margins, at a glance

Force	Effect on the margin
Repo rate cuts	Floating-rate loans reprice down fast; deposits lag, so income falls before costs do.
Falling CASA share	Money shifts from cheap savings balances to costlier term deposits, raising funding cost.
Deposit competition	Tight deposit pool keeps term deposit rates sticky, slowing the fall in funding cost.
CRR and SLR drag	Mandatory low-yield holdings dilute the blended yield, a drag that bites harder when loan yields fall.

A Worked Example: How 100 Basis Points Becomes a Margin Squeeze

It helps to see the mechanics with numbers.

Consider a simplified bank with ₹1,000 of earning assets, of which ₹700 is floating-rate loans, ₹150 is fixed-rate loans, and ₹150 is government securities. It funds itself with ₹400 of CASA at an average 2 per cent and ₹600 of term deposits at an average 6.5 per cent.

Before the rate cut, suppose the floating loans yield 9.5 per cent, the fixed loans yield 9 per cent, and the securities yield 7 per cent. Interest earned is about ₹84. Interest paid is ₹8 on CASA plus ₹39 on term deposits, or ₹47. Net interest income is ₹37, so the margin is roughly 3.7 per cent.

Now the RBI cuts 100 basis points. The ₹700 of floating loans reprice down by the full 1 per cent almost at once, cutting income by about ₹7. But only a portion of the term deposits matures and reprices within the year, say a third, and at a lower rate, saving perhaps ₹2 on the cost side. Net interest income falls from ₹37 to about ₹32, and the margin drops from 3.7 per cent to roughly 3.2 per cent.

The income side moved fully and immediately; the cost side moved partially and with a lag. That asymmetry is margin compression in a single picture.

Table 3. The worked example, before and after a 100-bps cut (₹)

Line item	Before	After	Change
Interest earned on assets	84	77	-7
Interest paid on deposits	47	45	-2
Net Interest Income	37	32	-5
NIM (on ₹1,000 assets)	3.7%	3.2%	-50 bps

Illustrative figures, rounded for teaching. The point is the asymmetry: assets reprice fully and at once, liabilities only partially and with a lag.

What Banks are doing about it

A bank cannot control the repo rate. What it can control is the structure of its balance sheet, the discipline of its pricing, and the diversity of its income. The levers below are the ones management genuinely holds.

1. Defend and rebuild CASA

Because CASA is the cheapest funding, protecting it is the most direct margin defence. This is won through service quality, salary and current account relationships, transaction banking, and digital convenience that keeps balances parked rather than chased elsewhere. CASA is built slowly and lost quickly, so the work is continuous rather than a campaign.



2. Price loans with discipline through funds transfer pricing

Internally, well-run banks use a funds transfer pricing (FTP) system that charges each lending unit the true marginal cost of the funds it uses and credits each deposit-gathering unit for the funds it brings in. This stops branches from booking loans that look profitable on the surface but actually destroy margin once the real cost of funding is counted. In a compression environment, pricing discipline is what separates volume that helps from volume that hurts.

3. Manage the maturity and repricing structure

The treasury can soften the repricing mismatch by managing the duration of assets and liabilities, lengthening deposit tenors where sensible, and using the investment book and hedging tools to cushion the timing gap. The aim is not to eliminate the mismatch, which is impossible, but to keep it within limits the bank can absorb.

4. **Grow fee and non-interest income**

If the margin on lending is structurally tighter, the answer is to lean less on the margin alone. Fee income from wealth management, third-party product distribution, transaction services, and trade finance does not depend on the interest spread and is far less sensitive to the rate cycle. Building a durable stream of fee income is the strategic hedge against margin pressure, and it is the area where many Indian banks have the most room to grow.

5. **Protect the margin by protecting asset quality**

A margin earned on paper means nothing if the loan goes bad. Sound underwriting, early-warning systems, and recovery discipline keep credit costs low, and low credit costs preserve the profit that the margin is supposed to generate. In a tighter-margin world there is less cushion to absorb a bad-loan shock, so the quality of the book matters more, not less.

The Outlook and What to Watch

The pressure of FY 2025-26 should ease, but not vanish. Rating agencies expected the system-level margin to trend toward its long-run average of roughly 3 per cent, with the sharpest pain concentrated in the first half of the year as loans repriced down ahead of deposits. The expectation was that margins would stabilise in the second half and into FY 2026-27 as the high-cost term deposits taken on earlier finally mature and reprice at lower rates, allowing funding costs to catch up with lending yields.

Two policy supports work in the banks' favour. The RBI's staggered cut in the cash reserve ratio releases low-cost resources back into the system, and the surplus liquidity conditions through the year speeded up the fall in the cost of fresh deposits. Both help the cost side of the margin recover.

For a student following the sector, a handful of indicators tell the story without needing the full financial statements:

- *The CASA ratio.* A rising share signals a strengthening, cheaper funding base; a falling share is an early warning on costs.
- *The cost of deposits, quarter on quarter.* This shows whether the liability side is finally repricing down to catch up with loan yields.
- *The gap between credit growth and deposit growth.* When deposit growth lags, competition for funds intensifies and margins stay under pressure.
- *The reported NIM trend and management guidance.* The direction and the bank's own forecast matter more than any single quarter's number.
- *Credit cost and slippages.* A protected margin can still be undone by a deterioration in asset quality.

The central lesson is that the net interest margin sits at the meeting point of macro policy and bank strategy. The rate cycle is set in Mumbai by the RBI and is outside any single bank's hands. But the mix of deposits, the discipline of loan pricing, the breadth of fee income, and the quality of the loan book are all decided inside the bank. Margins shrink when the cycle turns; the banks that come through best are

the ones that spent the good years building the structural defences that the bad years test.

Key terms:

NIM (*Net Interest Margin*)

NII (*Net Interest Income*)

CASA (*Current and Savings Accounts*)

EBLR (*External Benchmark Lending Rate*)

FTP (*Funds Transfer Pricing*)

CRR (*Cash Reserve Ratio*)

SLR (*Statutory Liquidity Ratio*)

bps (*Basis Points, One Hundredth of One Percent*)

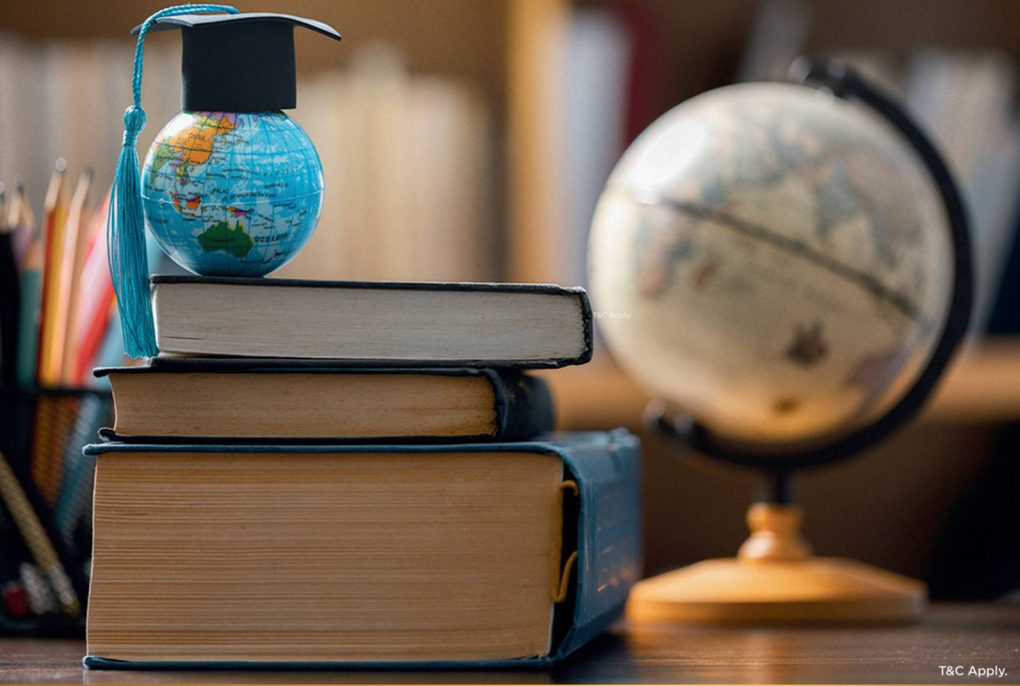
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