SOUTH INDIAN Bank

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## Theme 225
## BASE RATE - BASIS FOR LENDING RATES
## PART I

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# Theme No. 225 : BASE RATE – BASIS FOR LENDING RATES - PART I

The phenomenon of credit creation by the banks is a great driving force of economic development. Bank credit catalyses economic development by providing finance for starting enterprises that generate goods and services, provide employment and create income and all the more importantly results in surplus for further investment and growth. A healthy balanced growth of credit is an indicator of the stage of the economic development. Thus, credit should be available in adequate volume for the growth of the economy. Along with the availability of credit, the cost of credit should be affordable, i.e. interest rates play a critical role in facilitating off-take of credit from the banking system. Bank credit should be available to various sections and segments of the economy in an equitable manner to ensure socially balanced economic growth. The quantum of credit and cost of credit should thus reflect allocative efficiency in the economy. Further, the lending rates of banks in a developing economy should reflect the movements in the policy rates of the regulating authority – the RBI in India. The monetary policy is effective to the extent of monetary transmission taking place by way of synchronous changes in the policy rates and the lending rates of the commercial banks.

**What is the significance of interest rates in the economy?**

A lower interest rate leads to expansion of bank credit and thus acts as a propelling force of economic growth. In the aftermath of the global economic recession, all economies followed a concerted policy action of monetary easing to gear up both consumption and investment expenditure in the economy. Thus liquidity was injected and interest rates were reduced. There is a wide spectrum of interest rates in the economy, representing interest rate as a reward for savings and as a cost of credit from the banks. In a deflationary situation, lower interest rates, devoid of inflation, are ideal and in an inflationary condition, interest rates should account for inflation factor also, and are thus likely to be higher. What really matters most to the borrowers and from the economy's point of view is the real interest rates. The nominal interest rates move with inflation. The real interest rate can be computed as nominal interest rate minus inflation rate.

From business cycle perspective, the relationship between real interest rate and credit growth can be examined. The movements in lending rates are related to cyclicality of economic activity. It is found out that high real interest rates coincide with low credit growth and low interest rates coincide with high credit growth. Studies also indicate that real sector economic activity, approximated by the index of industrial production (IIP), picks up with lower interest rates. Thus industrial growth cycles are also inversely related to the real interest rate cycles. Also, the effective lending rates should not be too high or too low, this being a pre-condition for financial stability. Now let us examine the relationship between real GDP growth and real lending rates. The real GDP growth is a measure of average real rate of return in the economy. Ideally, the real lending rates should be in alignment with the real GDP growth rate. In India, the real lending rates were higher than GDP growth rate during 1997-98 – 2003-03. Since 2003-04, average real lending rate has remained below the real GDP growth rate. The average lending rates of commercial banks in India have gradually declined from a range of 16-17 percent in 1990s to about 11.50 percent by 2008-09.

**What is meant by monetary transmission in the economy?**

The RBI, as the autonomous monetary authority, will make appropriate changes in the reserve ratios such as Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) to control the volume of money supply in the economy. The funds available with the commercial banks for lending to the public will be accordingly increased or decreased. This ratio also indicates statutory investment activity of the banks. The funds earmarked for this purpose will be termed as investment – deposit ratio. Thus changes in statutory ratios affect the volume or quantity of credit that is made available in the economy. The reserve ratio mechanism is almost automatically transmitted in the economy. The funds are immediately made available with the banks. The cost of credit is signaled via changes in the policy interest rates such as bank rate, repo rate and reverse repo rate. By effecting changes in the policy interest rates, it is expected that lending rates can be correspondingly moved. But this is not automatically transmitted. The banks find it difficult to revise the rates downward due the stickiness of the term deposit rates. Thus monetary transmission is not found to be effective to the extent desired as regards the prices, i.e. interest rates.

The policy rates give signals as to movement of the actual interest rates in the economy. Though in a pure market –driven economy, interest rates are allowed to be determined by supply and demand factors, regulations and interventions in guiding the actual interest rates are required dependent on the economic scenarios. Monetary policy instruments such as reserve ratios and policy interest rates are moved upward or downward to give direction to the economic growth trajectory or general price movements. This is to be used in a balanced manner so that the overall objectives of economic growth and price stability are realized with the least adverse consequences. While the reserve ratios impact liquidity in the system, the policy rates impact the prices, .i.e. cost of credit or interest rates. Though economic growth with price stability is the ideal objective, in practice, when high economic growth is targeted, price increase or inflation may occur, thus dragging the positive impact of economic growth.

When it is required to hike economic growth, reserve ratios are reduced to improve liquidity and policy interest rates are decreased to reduce cost of credit. If in the process, supply bottlenecks emerge i.e. supply of goods and services become limited, and inflationary trends arise, then reserve ratios and policy rates may be increased to contain demand-pull inflation. Thus, monetary policy instruments are to be adjusted in a balanced manner to effectively guide the economy.

**Briefly trace the evolution of the lending rates of the commercial banks in India:-**

Till late 1980s, the interest rate structure on loans and advances extended by commercial banks was largely administered by the RBI. This is termed as the regulated interest rate regime. This was a mechanical transmission of the interest rates and over a time does not take into account the competitive features of the economy, when the rates are decided by the market factors of supply, demand and risk characteristics. This was done to ensure flow of credit at affordable cost to the productive sectors of the economy. With the introduction of financial sector reforms in 1990s, the RBI initiated steps to simplify and rationalize the complex interest rate structure and to bring in transparency in the loan pricing system. This resulted in almost a complete deregulation of lending rates in 1994. The system of Prime Lending Rate

(PLR) was introduced. The interest rates for loans above Rs. 2 lakh were deregulated. The banks could fix interest rates based on commercial wisdom and risk-reward perception.

The PLR was determined on the basis of cost of funds, transaction cost etc. and it acted as the floor rate for credit above Rs.2 lakh. Later, banks were directed to announce the maximum spread that would be charged over the floor rate for loans above Rs. 2 lakh.

In 1997, a new rate called Prime Term Lending Rate (PTLR) was introduced. PTLR was made applicable for loans having tenure of 3 years and above and banks were free to fix PTLR. PLR was applicable for working capital loans and short-term loans. PLR was also prescribed as the maximum ceiling rate for loans to small borrowers with exposure to Rs. 2 lakh.

The banks wanted the PLR to be made a reference rate and not the minimum lending rate. The banks were permitted to offer loans at sub-PLR rates to exporters and other creditworthy borrowers even for loans above Rs. 2 lakh. Instead of convergence of rates, there was widespread variance in the PLRs / spread across the banks.

**What is BPLR and how did it function?**

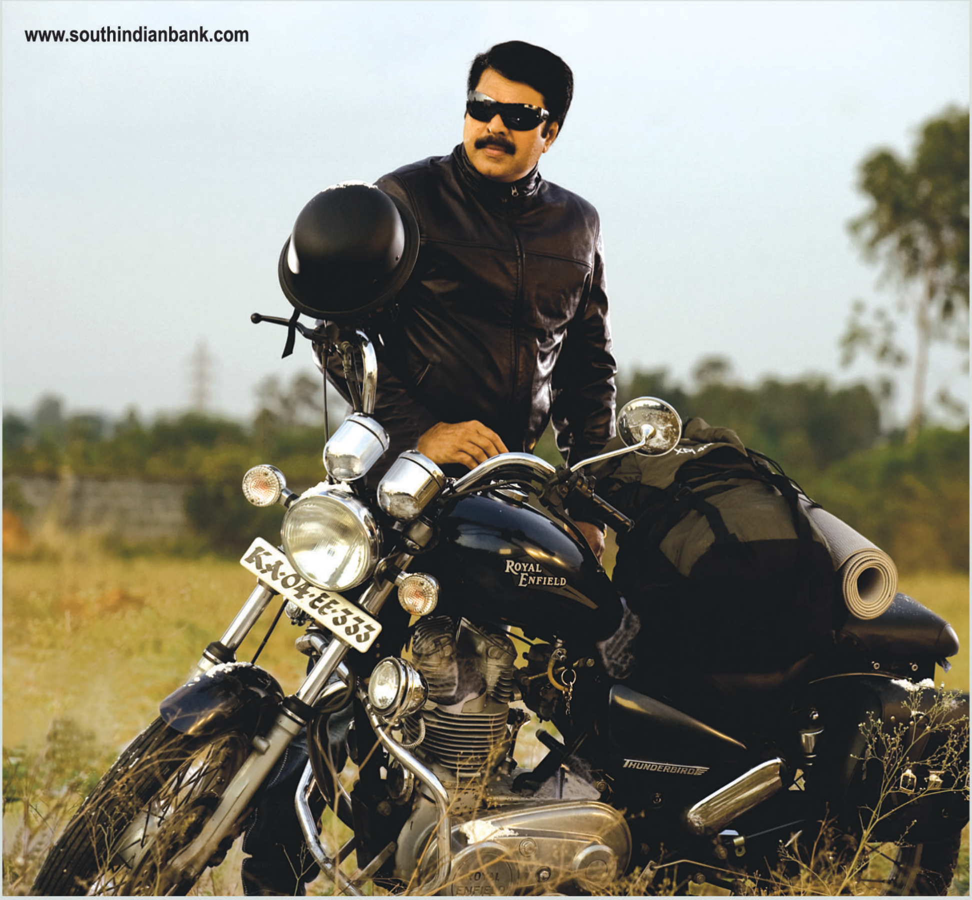
Hence, the system of BPLR (Benchmark Prime Lending Rates) was introduced in the year 2003. In the monetary policy 2003, the RBI advised banks to announce a Benchmark PLR (BPLR). The aim was to bring transparency in pricing loan products. The system of tenor-linked PLR was discontinued.

The BPLR was seen as a reference rate and it was to be computed taking into consideration factors such as cost of funds, operational expenses, a minimum margin to cover regulatory requirements of provisioning, capital charge and profit margin. More flexibility in pricing floating rate loans and advances using market benchmarks was envisaged and time varying spread was to be done in an objective and transparent manner. The pricing strategies should account for risk of default which requires different load factors for capital charges. The banks sought more flexibility in loan pricing based on credit risks and market risks and also ‘structuring’ of products. The transactions costs are different for different sectors like consumer loans and corporate business accounts. The BPLR regime did not work well and had various shortcomings.

## Evolution of Lending Rates of Commercial Banks in India

| Year | Key Changes |
|---|---|
| **Till late 1980s** | Interest rate structure was administered by the RBI. Banks had no freedom to fix interest rates on loans and advances. |
| **Sep 1990** | The structure of lending rates was rationalized into six size-wise slabs. The slabs were reduced to four, in the year 1992, and further reduced to three in the year 1993. Of these, banks were free to set interest rates on loans of over Rs. 2 lakh with minimum lending rates prescribed by the RBI. |
| **Oct 1994** | Lending rates for loans with credit limits of over Rs. 2 lakh deregulated. Banks were required to declare their Prime Lending Rates (PLRs). |
| **Feb 1997** | Banks were allowed to prescribe separate PLRs and spread over PLRs, both for loan and cash credit components |
| **Oct 1997** | For term loans of 3 years and above, separate Prime Term Lending Rates (PTLRs) were required to be announced. |
| **April 1998** | PLR converted as a ceiling rate on loans up to Rs. 2 lakh |
| **April 1999** | Tenor-linked Prime Lending Rates (TPLRs) were introduced |
| **Oct 1999** | Banks were given flexibility to charge interest rates without reference to the PLR with respect to certain categories of loans / credit. |
| **April 2000** | Banks allowed charging of fixed / floating rates on their lending for credit limits of over Rs. 2 lakh |
| **April 2001** | The PLR ceased to be the floor rate for loans above Rs. 2 lakh and banks were allowed to lend at sub-PLR rates for loans above Rs. 2 lakh. |
| **April 2002** | Dissemination of range of interest rates through the RBI website was introduced |
| **April 2003** | Benchmark Prime Lending Rate (BPLR) system was introduced and tenor-linked PLRs were discontinued |
| **July 2010** | **Base Rate system replaces BPLR system** |

*Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in*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