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Theme 226

BASE RATE - BASIS FOR LENDING RATES

PART II

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SIB STUDENTS' ECONOMIC FORUM

SEPTEMBER 2010

Theme No. 226 : BASE RATE – BASIS FOR LENDING RATES - PART II

Why was it required necessary to replace BPLR with Base Rate?
The system of BPLR failed to meet its original intention of introducing transparency in the lending rates. This was mostly due to increasing competition. Intense competition among banks led to pricing of loans out of alignment with the BPLR. Highly rated corporates could bargain and avail short-term finance at very low rates. The rates were sometimes as low as 5 or 6 percent. Poor credit off-take and surplus liquidity in the system were cited as the reasons by banks for this.

As the major share of the bank loans were at sub-BPLR, it became evident that the BPLR lost its relevance as the reference rate. Moreover, sub-BPLR lending was a major hurdle in effective transmission of the monetary signals emanating from the RBI. The following were found to be the shortcomings of the BPLR system.

Sub-BPLR lending: Competitive pressures forced banks to resort to sub-BPLR lending in a big way and this resulted in mis-pricing of loans on a large scale. The share of sub-BPLR lending went up from 30 percent in 2004 to77 percent in 2008.

Non-transparency in dealings: Banks were resetting lending rates arbitrarily. Many banks were charging lending rates with reference to benchmarks which were internal and hence, non-transparent.

Downward stickiness in interest rate trend: Banks were quick in raising lending rates during an upturn in interest rate cycle. But they were slow to bring down interest rates in the downturn of the interest rate cycle.

Cross-subsidization in lending: Large corporates could bargain for lower rates and the banks could accommodate this under the sub BPLR category.

This was cross-subsidized by retail and small borrowers by over-pricing of their loans. This resulted in discrimination of small borrower segment.

Breaking the portfolio: There was also unhealthy competition among the banks by offering low interest rates to corporates or large borrowers. Generally, short-term unsecured loans at extremely low rates of interest are given to large corporates to shore up the balance sheets. This has introduced an element of instability in several banks' asset structures. Thus lending below BPLR without any floor rate fixing will be disastrous to the banks as this will have direct bearing on the yield on advances and on the Net Interest Margin (NIM) of the banks. Banks preferred sub BPLR lending as interest rate on other avenues such as reverse repo window was even lower.

How was monetary transmission operating under the BPLR?

The changes in the RBI's policy rates were quickly transmitted to the money and debt markets. The money market rates moved in tandem with the policy interest rates. However, transmission to the credit market was slow due to several rigidities in the system, especially the dominance of fixed term deposit liabilities in banks' balance sheets at fixed interest rates. As a result, despite ample liquidity in the system post-crisis, though the banks reduced deposit rates, the effective lending rates did not moderate to the extent desired. This reduces effective monetary transmission.

The sub-BPLR lending was a major hurdle in effective transmission of monetary signals emanating from the RBI. In fact, almost all banks reduced their lending rates to big-ticket borrowers by resorting to sub BPLR lending. Over time, the sub-BPLR spread increased, reflecting further lowering of the actual lending rates, but without BPLR getting actually reduced by the banks. The BPLRs were not moving in sync with the changes in the key policy interest rates of the RBI.

The system has not responded adequately to changes in the monetary policy. The banks were often quick to increase the lending rates during an upturn in the interest rate cycles. They were slow to bring down lending rates in the downturn of the interest rate cycle. This results in poor transmission of monetary policy in credit markets.

How did the system of 'base rates' evolve?
The RBI constituted a working group to examine issues related to BPLR and suggest a transparent credit pricing mechanism. This should ensure effective transmission of the monetary policy rates from time to time. Thus the concept of 'Base rate' emerged, and it was to replace the existing BPLR. The Base rate will be a sort of 'floor rate' below which banks can not lend. It should factor in basic cost of funds and a basic return on funds and hence minimum safety of the bank's portfolio is taken care of.

What are the factors that determine the 'Base Rate'?
The base rate is built up on a reference rate related to cost of deposits / funds/ any other suitable benchmark rate, negative carry in respect of CRR and SLR, unallocated overhead costs and average return on net worth. The reference rate constitutes the important component of the base rate. This depends on the composition of the low cost deposits of the bank. The 'negative carry' is a compensating factor for low yields on statutory investments of the banks. The final lending rates include the base rate plus the variable factors called as customer specific charges - product charges, risk charges and tenor charge.The base rate thus becomes minimum 'constant factor' or 'basic minimum cost' in pricing of loans. Therefore, lending rates should not be below the 'base rates'. Thus any changes in the basic cost of funds should be reflected in the upward or downward movement of 'Base Rate'. This is expected to improve the mechanism of monetary transmission in the economy.

Banks can choose any benchmark to arrive at Base Rate which has to be disclosed transparently and made available for supervisory review. The most important feature is that once the Base Rate is implemented, banks will not be able to lend below the published base rate. Besides, the Base Rate could serve as the reference benchmark rate for floating rate loan products.

How is 'Base Rate' system implemented?
The commercial banks switched over to the Base rate regime from July 1, 2010. The information on the Base rate should be exhibited in the website. The changes in the base rate should be communicated to the general public. The base rate will now be applicable to new loans or to old loans that are due for renewal or when the customer wants to take a new rate. Thus the BPLR will continue along with the Base Rate until the transition is complete. There are

certain categories of loans that will be exempted from the application of base rates. These are differential interest rate (DRI) advances, staff loans given by banks, and loans to banks' depositors against their own deposits. The banks are given time to perfect the method of calculation of the Base Rate. They are expected to streamline the calculation in line with the market trends. The BPLRs of the commercial banks ranged from 11 to 16.75 percent at the time of switch-over to the base rate system. The Base Rates announced by the banks ranged from 6.75 to 8.75 percent.

What are the benefits expected of the 'base rate' system?
The 'base rate' system leads to deregulation of lending rates and this will enhance allocative efficiency of financial disintermediation process by banks. This will lead to more transparent and responsible lending practices by the banks. The base rates of banks will show up relative efficiency and cost structure of the banks. As a result, the overall lending rates in the economy will come down over a longer term. The base rates are expected to respond to the changes in the policy interest rates of the RBI more automatically than it is now and this will strengthen effectiveness of monetary transmission in the economy.

Why is it stated that 'Base Rate' system will facilitate Financial Inclusion?
The deregulation of lending rates will promote financial inclusion with greater credit flow to agriculture and small business at lower interest rates. Thus these types of borrowers will come closer to formal financial sector from the informal financial sector. The stipulation of BPLR as the ceiling rate for loans up to Rs. 2 lakh stands withdrawn. This deregulation of lending rates is expected to increase the credit flows to small borrowers at reasonable rate. This will facilitate better credit penetration. The corporates who were benefitting from the under-pricing of loans may opt for other avenues to seek cheaper funding. Thus they may start exploring alternative sources to meet fund requirements or borrowings from abroad.

Further refinements and improvements in the 'Base Rate' system will better ensure deregulation, transparency, non-discrimination and more effective 'monetary transmission' in credit markets.

Base Rate System

- Base Rate system is implemented with effect from July 1, 2010
- Banks can choose any benchmark to arrive at Base Rate. It has to be disclosed transparently
- Banks have to determine actual lending rates on domestic loans and advances with reference to the Base Rate
- Banks can change the benchmark and methodology any time till December 2010
- The actual lending rates are to be transparent and consistent and be subject to scrutiny by the RBI
- All categories of loans should be priced with reference to the Base Rate except DRI advances, loans to banks' own employees and loans against deposits
- Base Rate will serve as the reference benchmark for floating rate loan products
- Base Rate will be the minimum rate for all loans and banks are not permitted to resort to any lending below the Base Rate
- There will be no ceiling rate for loans up to Rs. 2 lakh.
- It is expected that the deregulation of lending rates will increase credit flow to small borrowers at reasonable rate of interest
- An illustrative methodology for computation of Base Rate: Base Rate = Reference rate related to cost of deposits/funds/any other suitable benchmark rate + Negative carry on CRR and SLR + Unallocatable overhead cost + Average return on Net worth

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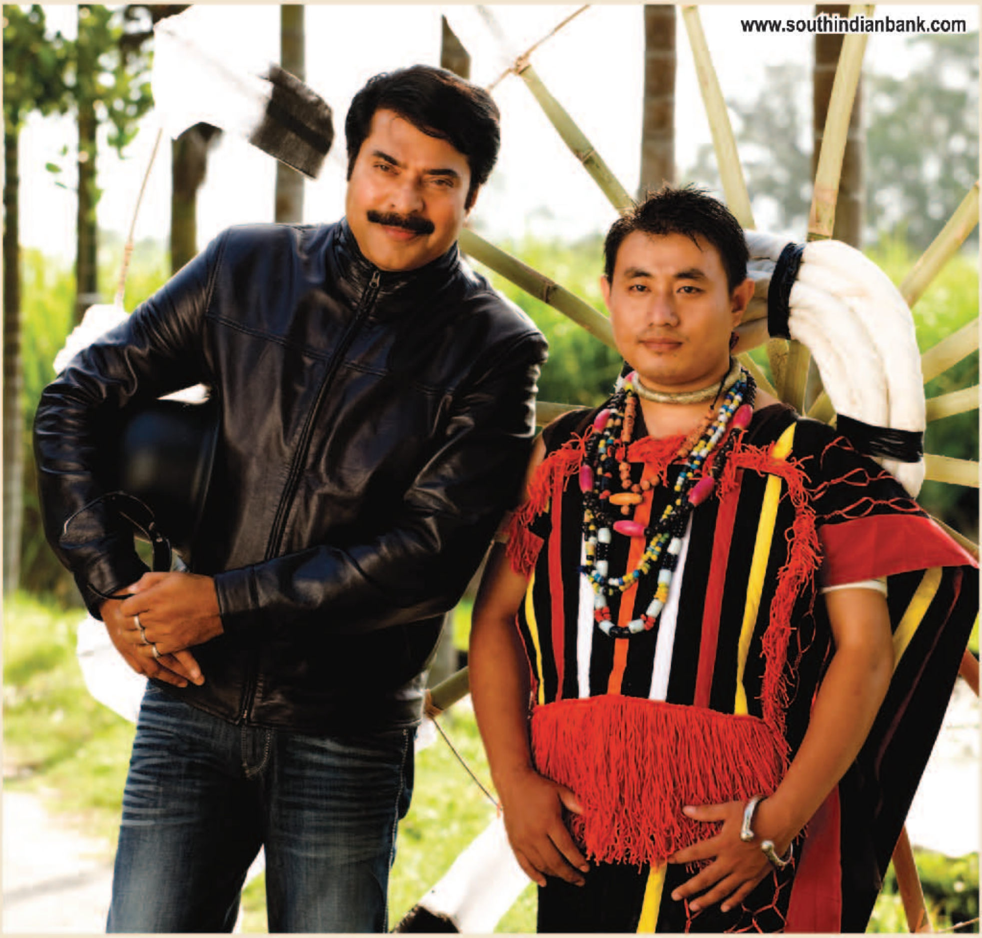
Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in



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