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BASE RATE: THE NEW BENCHMARK RATE

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ABSTRACT

Consumers didn't know the manner in which the benchmark rate—more commonly known as the Benchmark Prime Lending Rate (BPLR)—is computed. Benchmark Prime Lending rate is a term applied to a reference interest rate used by banks. The BPLR failed to construct sync with the changing market conditions. BPLR does not sufficiently respond to changes in monetary policy. The Reserve Bank announced the constitution of the Working Group on BPLR in the Annual Policy Statement of 2009-10. The Base Rate serve as the reference benchmark rate for floating rate loan products, apart from the other external market benchmark rates.

In this paper an attempt has been made to study the problems with BPLR as benchmark rate that ultimately led to its replacement with Base rate. Furthermore, the problems with Base rate that can hamper its successful implementation are studied. The other various aspects analysed were finding out the possibility to lend below base rate with the proposed system.

KEY WORDS

Base rate, BPLR, Lending, RBI, Benchmark rate

1. INTRODUCTION

Think of a situation in which you have taken a home loan last year and paying 16 per cent interest rate for 20 years and your neighbor also followed your foot steps one year later but surprisingly he has availed the service at 14% interest rate for 15 years. How can a lending institution lend to a new customer at a lower rate even though for a short period but not offer the same rate to an old customer who has been regularly servicing his loan? This was the state of affairs that sent the wave of restlessness not only to the individuals but to the banking sector officials that ultimately led to the replacement of the benchmark rate. Consumers didn't know the manner in which the benchmark rate—more commonly known as the Benchmark Prime Lending Rate (BPLR)—is computed. Most retail loans especially floating rate home loans are linked with this benchmark rate. Although public sector banks have a common BPLR across loan products but, in private sector banks there are different benchmarks for different products.

Mr. M D Mallya*,* Chairman and managing director of Bank of Baroda said in an interview given to a financial daily in August 2009 that *"although BPLR is a benchmark, the banks do quote their lending rates at less than BPLR levels.* As many as 35% of our loans are given at below BPLR. I suppose the Reserve Bank of India, too, believes that BPLR as a concept in the Indian banking system needs a radical change now". No doubt for a long time BPLR (Benchmark Prime Lending Rate) has lost its significance. The BPLR was gradually becoming immaterial as the benchmark for bank lending, negating the reason for its existence. Banks were generously lending at 3-4 percentage points higher or lower than the BPLR, depending on the borrower. This also created a huge transparency problem, as borrowers had no standard to refer to. Therefore responding to the call that banks do not set their lending rates in a scientific and transparent manner, RBI's verdict to ask banks to price their loans using a *base rate* rather than BPLR from April 1, 2010, is welcome. The proposed system will replace the existing system of benchmark prime lending rates (BPLR) with base rates. The RBI working group headed by Mr. Deepak Mohanty, Executive Director, RBI recommended that the nomenclature be scrapped and a new benchmark rate known as base rate should replace it.

2. OBJECTIVES OF STUDY

The study has following objectives:

- To study the problems with BPLR as benchmark rate.
- To analyse the concepts and benefits of Base rate.
- To find out the possibility to lend below base rate with the proposed system.

3. PROBLEMS RELATED TO BENCHMARK PRIME LENDING RATE

Benchmark Prime Lending rate is a term applied to a reference interest rate used by banks. The term indicates the rate of interest that banks charge (or we can say they are expected to charge) their most credit-worthy customers. According to the Reserve Bank of India banks are free to fix the Benchmark Prime Lending Rate (BPLR) for credit limits over Rs.2 lakh with the approval of their respective Boards. Banks are free to decide the BPLR but their interest rates should have a reference to the BPLR fixed. BPLR has to be declared and made uniformly applicable at all the branches.

The BPLR is the rate offered to the best borrower, so no one would expect any loans to be made below the BPLR and being a floating rate, it should respond to changes in the RBI's policy rates. Unfortunately neither expectation has been met for several years now. Sub-BPLR lending has become the norm — nearly 70% of all loans are today below the BPLR. It is difficult for the apex bank to have a clear picture of trends in lending rates by looking at BPLRs. The range of banks' BPLRs is pretty wide stretching over 4%. The BPLR failed to construct sync with the changing market conditions. Incidentally, one-year deposit rates have been coming down steadily in recent months after the crisis broke, and are hovering at between 5% and 6%. The BPLR has failed to keep pace with that decline, as a benchmark lending rate ought to.

Typically, in a falling interest rate scenario, banks and lending institutions increase the spread to give the benefit of falling interest rate only to new customers. However, in an increasing interest rate scenario, banks increased the BPLR itself. With the help of a hypothetical example we can have a better understanding of the concept

- *Falling Interest Rate Scenario*: When rates fall, banks typically increase the spread. So, if the spread earlier was 2 per cent, if the rates fall, they would increase the spread to, say, 3 per cent. An old customer will keep paying the old rate, i.e., 10 per cent as the BPLR is unchanged, but a new customer pays 9 per cent.

- *Rising Interest Rate Scenario:* When rates move up, banks increase the BPLR. So, if the earlier BPLR was 12 per cent, the bank could increase this to 13 per cent. This way, rates for all customers go up. From the above example, if the customer was earlier servicing the loan at 10 per cent when the BPLR was 12, as the BPLR moves to 13, the rate of interest for him also moves up to 11 per cent.

BPLR does not sufficiently respond to changes in monetary policy. Lending rates don't fall when the RBI cuts policy rates. For example, RBI reduced its benchmark lending rate by 425 basis points in the last one year, but banks reduced their BPLR by about 200 basis point cut. This was mainly because bulk of their lending was below their BPLR. This tendency of banks to lend at sub-BPLR rates on a large scale was the most critical aspect. Although, prime rates of Indian banks ranged between 11 percent and 15.75 percent, yet three-fourths of their total loans are made below these levels. As per the study made by working group "An examination of the data on sub-BPLR lending reveals that the share of sub-BPLR lending (excluding export credit and small loans) for scheduled commercial banks, which was at 28 per cent in March 2002, increased to 77 per cent in September 2008.

3.1 REASONS TO TRADE LEND THE BPLR

There could be many reasons for this practice of trading below BPLR in use but the very basic answer lies in the formula that calculates BPLR. This formula for arriving at BPLR takes in to account actual cost of funds that is weighted average of all historical costs, operating cost, margins to cover provisions and profit. When the policy rate declines, only incremental costs change significantly and the actual cost of funds changes very slightly. Banks cannot afford to lower their BPLR as that would result into lower rates on the entire loan portfolio. Rates can fall only on incremental loans. Many banks fixed their BPLR at a time when the cost of funds was high. Thereafter, as incremental costs fell, banks kept the BPLR unchanged and passed on the benefit to incremental borrowers through sub-BPLR rates. The present situation, where 70% of loans are below BPLR, is the logical height of this process.

Banks decided to lend below BPLR because they were trying to beat the competition in a fiercely competitive environment where money was in plenty and credit off take lethargic. So, instead of parking their large surpluses with Reserve Bank of India (RBI) in reverse repo and earning 3.25%, it was better to lend to a triple-A customer at 7%, even if 7% was way below the BPLR of perhaps 11%.

The Working Group set up on Benchmark Price Lending Rate (BPLR) in its report submitted in October, 2009, has also strongly felt that, "On account of competitive pressures, banks were lending at rates which did not make much commercial sense." So, the Group after having carefully examined the various possible options, the views of various stakeholders from industry associations and the public and international best practices was of the view that the existing benchmark prime lending rate (BPLR) system has fallen short of expectations in terms of enhancing transparency in lending rates charged by banks and there was worth in introducing the new system.

4. BASE RATE: THE MOST OPTIMAL RESOLUTION

The Reserve Bank announced the constitution of the Working Group on BPLR in the Annual Policy Statement of 2009-10 (Chairman: Shri Deepak Mohanty) to review the BPLR system and suggest changes to make credit pricing more transparent.

The Working Group was assigned the following duties:- (i) to review the concept of BPLR and the manner of its computation; (ii) to examine the extent of sub-BPLR lending and the reasons thereof; (iii) to examine the wide deviation in BPLRs of major banks; (iv) to suggest an appropriate loan pricing system for banks based on international best practices; (v) to review the administered lending rates for small loans up to Rs 2 lakh and for exporters; (vi) to suggest suitable benchmarks for floating rate loans in the retail segment; and (vii) consider any other issue relating to lending rates of banks.

This was not the case that working committee straightaway proposed the base rate system in place of BPLR. There were other options as well but nothing was as good as base rate. Let's think what could have been the other alternatives. It is clear that sub-BPLR lending cannot end as long as lending rates are based on historical costs. They need to be forward-looking. Since most of the loans today are for one year or more, the one-year deposit rate is the appropriate choice for an advanced cost.

But would a PLR that is linked to the one-year deposit rate tackle the sub-BPLR problem? Not quite. We have to think about another element in the pricing formula, operating costs which are the average costs. For some products, such as housing loans, the operating costs are much lower than the average. The lending rates for such products would be lower than the PLR and again there would be sub-BPLR lending.

Another option could have been having two BPLRs, one for wholesale and another for retail. The problem with this alternative was within wholesale, there is a big difference in operating costs for large corporates and for small enterprises. In retail, a gap separates housing from credit cards. In such a case we could have thought of having a BPLR for each business segment. But, then, we would end up creating a clutter in the name of lucidity.

The Working group concluded, therefore, that we need to move away from the very concept of BPLR. It opted for a reference rate called the base rate, which could serve as the basis for loan pricing. The base rate will set a floor for lending rates. Each bank will have a specific base rate that will be linked to the one-year deposit rate and banks will not be allowed to lend below the base rate as it represents the bare minimum rate below which it will not be feasible for the banks to lend.

The criteria to be used for determining the base rate would be:

i) Card interest rate on retail deposits (deposits below Rs 15 lakh) with one year maturity (adjusted for current account and savings account deposits)

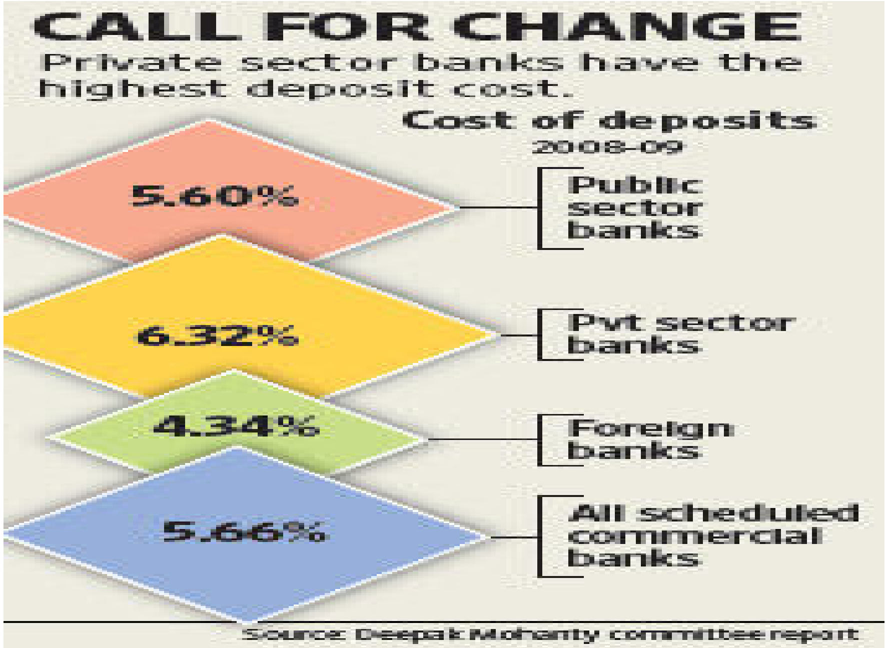
ii) Negative carry on cash reserve ratio/ statutory liquidity ratio; and

iii) Un-allocable overhead costs for banks.

Banks would also add a profit margin to arrive at the base rate. The actual lending rates charged to borrowers would be the base rate plus borrower-specific charges, which will include product-specific operating costs, credit-risk premium and tenor premium. Under the proposed mechanism, all banks will be required to declare a base rate and charge interest rates over that depending upon the credit profile of the borrower and repayment period. The Base Rate system recommended by the Group will be applicable for loans with maturity of one year and above (including all working capital loans). Banks may give loans below one year at fixed or floating rates without reference to the Base Rate. At present, at least ten categories of loans can be priced without reference to BPLR. The Group recommends that such categories of loans may be linked to the Base Rate except interest rates on (a) loans relating to selective credit control, (b) credit card receivables (c) loans to banks' own employees; and (d) loans under DRI scheme.

Analysts say the base rate for even the best banks would be in the range of 9%. With the cost of deposits at around 6% and adding around 0.75% to compensate for the lower yields on statutory holdings of government bonds and zero yield on cash reserves, an additional 1.25% to unallowable overheads and an average of 1% return on assets, the base rate would add up in this illustrative case to 9%.

The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from the other external market benchmark rates. This base rate will be revised every quarter depending on the deposit rate so it will overcome the problem of downward stickiness in rates.



4.1 PROBLEMS OF LENDING BELOW THE BASE RATE

Lending below BPLR was big problems in front of working group so they were suppose to answer the question whether there is any provision or possibility for lending below Base Rate as well. The RBI working group, however, recognizes certain situations when lending below the base rate may be demanded by market conditions. The committee is of the view that the need for such lending may arise as an exception only for very short-term periods. However, in order to ensure that sub-Base Rate lending does not proliferate, the Group recommends that such sub-Base Rate lending in both the priority and non-priority sectors in any financial year should not exceed 15 per cent of the incremental lending during the financial year. Of this, non-priority sector sub-Base Rate lending should not exceed 5 per cent. That is, the overall sub-Base Rate lending during a financial year should not exceed 15 per cent of their incremental lending, and banks will be free to extend entire sub-Base Rate lending of up to 15 per cent to the priority sector. Only short-term loans of up to one year and working capital loans to companies can be given below the base rate.

4.2 MORE TRANSPARENCY WITH BASE RATE

No doubt the base rate will bring in more transparency in the operations of the banking system. Although banks will add their operational costs to the base rate to decide on the actual lending rate but it will now be in the interest of banks to keep costs low because now banks will not be able to lend below base rate and prime lenders would like to borrow only from those banks that offer the rate closest to the base rate. This will help promote greater competition and efficiency across the banking system. Moreover it will be difficult for any single bank to charge rates that are much higher than others.

Information on the base rate will need to be put up on the Web sites and at the branches, and banks also need to disclose the maximum and minimum rates for the major categories of borrowers.

Banks may also add different risk weightages to different categories of borrowers. Again it will be a move to a very transparent system where lenders will be accountable to explain the rates they are charging borrowers and borrowers will have full information about banks' lending rates for different categories.

4.3 PROBLEM WITH BASE RATE AS BENCHMARK RATE

The key problem in the base rate system is the calculation of the base rate as base rate is the bare minimum cost of deposits i.e. average cost. But what matters banks the most is the marginal cost of funds. In some cases, banks charge interest rates based on the rates at which they can raise money for the same tenor as the loan, and if the base rate has to be on a historical cost basis, these kinds of loans will no longer be possible.

There is also no clarity about the tenor for which the base rate applies and bankers say that since RBI has said the base rate will be the minimum rate and borrowers will be charged a tenor premium, which implies the base rate should be for the shortest possible maturity. In fact, some banks now lend at rates linked to the overnight Mibor, or Mumbai interbank offered rate. These kinds of loans would also not be possible as they will have to be priced at some absurd average of deposit rates of all maturities.

This problem could have been solved if this base rate would have been linked to market rate of interest but in India the term money market has not been developed so far because of requirement of CRR and SLR by RBI. So given the set of situation this was the best possible option to allow the banks to price their own products any way they see fit while the needs of regulation would best be served by prudential norms.

4.4 SMALL SCALE ENTERPRISES: THE REAL GAINERS

Why banks have inclined to keep the BPLR at artificially high rates so far? To get more profit from big corporate is one aspect but it is also due to the reason that all small loans (up to Rs 2 lakh) and export loans are limited at the BPLR and if the BPLR is amending downwards, it means that the smaller loans need to be repriced, too, something that banks are unwilling to do. Small scale borrowers were the real victims of the BPLR regime as small borrowers today end up borrowing at very high rates from intermediaries; some microfinance institutions, for instance, reportedly earn a return of over 20% on their investments. In order to increase the flow of credit to small borrowers, the current condition of BPLR as the ceiling for loans up to Rs 2 lakh stands withdrawn. It is expected that the deregulation of lending rates will increase credit flow to small borrowers at reasonable rates as the new base rates are likely to be lower than BPLRs. After considering the costs incurred while sanctioning a loan, the proposed base rate could be as low as 6-7 per cent in the current interest rate scenario while at present, bank BPLRs range between 11 per cent and 16 per cent. Banks should be free to lend to small borrowers at fixed or floating rates, which would include the Base Rate and sector-specific operating cost, credit risk premium and tenor premium as in the case of other borrowers. It is argued that as non-bank credit is invariably costlier; making small loans affordable for banks will raise the supply of such credit and thus be beneficial on the balance to small borrowers. Currently more than half of bank loans are sub-PLR and a huge chunk of loans goes to the big corporates. But after base rate system the big corporates will not be able to dictate terms to the banks as banks cannot rate below the base rate. So the banks will have surplus funds with them, it can also be used for the development and growth of small industries. Simply put, borrowers in the small and medium enterprise category will no longer bear the burden of higher interest rates so that corporates can enjoy sub-prime lending rates.

Apart from this the working group has suggested that interest rate on rupee export credit should not exceed the Base Rate of individual banks. As export credit is of short-term in nature and exporters are generally wholesale borrowers, there is need to incentivize export credit for exporters to be globally competitive. By this change exporters can still access rupee export credit at lower rates as the Base Rate is expected to be significantly lower than the BPLRs. The proposed system will also be more flexible and competitive.

In view of the critical role played by education loans in developing human resource skills, the interest rate on these loans may continue be administered. But as Base rate would be lower than currently prevailing BPLR, the Group recommends that the interest rates on all education loans may not exceed the average Base Rate of five largest banks plus 200 basis points. Even with this provision, the actual lending rates for education loans would be lower than the current rates prevailing. The information on the average Base Rate should be disseminated by IBA(Indian Banks' Association) on a quarterly basis to enable banks to price their education loan portfolio.

5. CONCLUSION

There is no hesitation in saying that proposed base rate system is better than BPLR. Highly rated corporate have been taking advantages of the excess of liquidity and resorting to short-term loans instead of taking working capital loans in order to bring down their borrowing cost. But now with the new base rate system these ultra low cost borrowings of corporate will become the things of past as banks will completely stop fresh lending below the new benchmark rate- Base rate from April, 2010. As far as banks are concerned they are happy about the decision as from the margin point of view, there will be no change for banks because earlier they were charging more (above BPLR) from small scale and individual borrowers and low (Sub BPLR) from corporate but now with the proposed base rate the loans that were above PLR will get better rates while those that were sub-PLR will see rates going up. But this proposed system will not be successful unless banks are able to assess correctly the appropriate risk that a customer attracts and are serious about charging them for it. After all, even in the earlier system, banks were free to bill clients whatever spread they felt was correct based on the credit risk perception of the customer. Moreover RBI is hoping that the base rate will always move in line with any changes that it might effect in the repo rate. It might not be possible as interest rates will depend on the demand and supply of money in the system.

It can be summed by saying that BPLR is a completely outdated aspect of the Indian banking system and against the broader canvas of banking sector reform; it is a low-hanging fruit that should be grabbed immediately.

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