Draft Circular

RBI/2009-10/ February , 2010
Ref.No.MPD.BC. /10.14.01/2009-10 Magha , 1931(S)

To
All Scheduled Commercial Banks

Guidelines on the Base Rate

1. Following the announcement in the Annual Policy Statement for the year 2009-10, the Reserve Bank constituted a Working Group on Benchmark Prime Lending Rate (Chairman: Shri Deepak Mohanty) to review the present benchmark prime lending rate (BPLR) system and suggest changes to make credit pricing more transparent. The Working Group submitted its report on October 20, 2009 and it was placed on the Reserve Bank's website for public comments. After considering the recommendations of the Group and the suggestions from various stakeholders, the Reserve Bank has decided as follows:
2. The Base Rate system will replace the BPLR system with effect from April 1, 2010. Banks may determine their actual lending rates on loans and advances with reference to the Base Rate. Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. While each bank may decide its own Base Rate, some of the criteria that could go into the determination of the Base Rate are: (i) cost of deposits; (ii) adjustment for the negative carry in respect of CRR and SLR; (iii) unallocatable overhead cost for banks such as aggregate employee compensation relating to administrative functions in corporate office, directors' and auditors' fees, legal and premises expenses, depreciation, cost of printing and stationery, expenses incurred on communication and advertising, IT spending, and cost incurred towards deposit insurance; and (iv) profit margin. An illustration for computing the Base Rate is set out in the Annex.
3. 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.
4. All categories of loans should henceforth be priced only with reference to the Base Rate. The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from the other external market benchmark rates. The floating interest rate based on

external benchmarks should, however, be equal to or above the Base Rate at the time of sanction or renewal.

5. Since the Base Rate will be the minimum rate for all commercial loans, banks are not permitted to resort to any lending below the Base Rate. Accordingly, the current stipulation of BPLR as the ceiling rate for loans up to Rs. 2 lakh stands withdrawn. It is expected that deregulation of lending rates will increase the credit flow to small borrowers at reasonable rate. Thus, direct bank finance will provide effective competition to other forms of high cost credit.
6. Interest rates on loans under the DRI scheme will continue to be fixed without reference to the Base Rate.
7. The Reserve Bank will separately announce the stipulation for export credit.
8. Since transparency in the pricing of lending products has been a key objective, banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels. Banks are required to provide information on the actual minimum and maximum lending rates charged to major categories of borrowers to the Reserve Bank on a quarterly basis. Apart from transparency, banks should ensure that interest rates charged to customers in the above arrangement are non-discriminatory in nature.
9. The Base Rate system would be applicable for all new loans and for those old loans that come up for renewal. However, if the existing borrowers want to switch to the new system before the expiry of the existing contracts, in such cases the new/revised rate structure should be mutually agreed upon by the bank and the borrower.
10. In line with the above Guidelines, banks may announce their Base Rates after seeking approval from their respective Boards.

Kindly acknowledge receipt.

Yours faithfully,

(Janak Raj)
Adviser-in-Charge

Encl: as above

Annex 1: Illustrative Methodology for the Computation of the Base Rate

Base Rate $= \boldsymbol{a} + \boldsymbol{b} + \boldsymbol{c} + \boldsymbol{d}$

a - Cost of Deposits $= D_{cost}$

b - Negative Carry on CRR and SLR $= \left[\left[\frac{\{D_{cost} - (SLR * T_r)\}}{\{1-(CRR+SLR)\}}\right] * 100\right] - D_{cost}$

c - Unallocatable Overhead Cost $= \left(\frac{U_c}{D_{ply}}\right) * 100$

d - Average Return on Net Worth $= \left[\left(\frac{NP}{NW}\right) * \left(\frac{NW}{TL}\right)\right] * 100$

Where:
D_{cost} : Cost of Deposits
D : Total Deposits $=$ Time Deposits $+$ Current Deposits $+$ Saving Deposits
D_{ply} : Deployable Deposits
$=$ Total deposits less share of deposits locked as CRR and SLR balances, $i.e.$
$= D * [1-(CRR+SLR)]$
CRR : Cash Reserve Ratio
SLR : Statutory Liquidity Ratio
T_r : 364 T-Bill Rate
U_c : Unallocatable Overhead Cost
NP : Net Profit
NW : Net Worth $=$ Capital $+$ Free Reserves
TL : Total Liabilities

Negative Carry on CRR and SLR

Negative Carry on CRR and SLR $= \left[\left[\frac{\{D_{cost} - (SLR * T_r)\}}{\{1-(CRR+SLR)\}}\right] * 100\right] - D_{cost}$

Negative carry on CRR and SLR balances arises because the return on CRR balances is nil, while the return on SLR balances (proxied using the 364-day Treasury Bill rate) is lower than the cost of deposits. Negative carry on CRR and SLR is arrived at in three steps. In the first step, return on SLR investment was calculated using 364-day Treasury Bills. In the second step, effective cost was calculated by taking the ratio (expressed as a percentage) of cost of deposits (adjusted for return on SLR investment) and deployable deposits (total deposits less the deposits locked as CRR and SLR balances). In the third step, negative carry cost on SLR

and CRR was arrived at by taking the difference between the effective cost and the cost of deposits.

Unallocatable Overhead Cost

$$\text{Unallocatable Overhead Cost} = \left(\frac{U_c}{D_{ply}}\right) * 100$$

Unallocatable Overhead Cost is calculated by taking the ratio (expressed as a percentage) of unallocated overhead cost and deployable deposit.

Average Return on Net Worth

$$\text{Average Return on Net Worth} = \left[\left(\frac{NP}{NW}\right) * \left(\frac{NW}{TL}\right)\right] * 100$$

Average Return on Net Worth is computed as the product of net profit to net worth ratio and net worth to total liabilities ratio expressed as a percentage.