4. Benchmarks for Floating Rate Loans

4.1 In the annual policy statement for 2000-01, banks were allowed to charge fixed/floating rate on their lending for credit limit of over Rs. 2 lakh. In terms of the extant guidelines on "Interest Rates on Advances", banks should use only external or market-based rupee benchmark interest rates for pricing of their floating rate loan products, in order to ensure transparency. The guidelines further state that the methodology of computing the floating rates should be objective, transparent and mutually acceptable to counterparties. Banks should not offer floating rate loans linked to their own internal benchmarks or any other derived rate based on the underlying. The major advantage of external market benchmark rate is that the customer has the access to information of these rates, as it is available publicly. Further, this will also help the customer in evaluating the benefits of fixed and floating interest rates, while choosing to apply for loans.

4.2 Banks are finding it difficult to use external benchmarks for pricing their loan products, as the available external market benchmarks (MIBOR, G-Sec) are mainly driven by liquidity conditions in the market, and do not reflect the cost of funds of the banks. Various representations from the banks and IBA have been received in this regard to allow them to continue to use their respective bank's BPLR as the reference rate for pricing the floating rate loan. Banks have also pointed out that BPLR is not changed frequently as the external rupee market benchmarks, viz. MIBOR, G-Sec, Repo Rate, CP and CD rates which are volatile given that many of these products can be traded in the secondary market. Besides, the yields on some of the instruments may not suggest any representative pricing yardsticks given that they have limited volumes compared to the overall size of the financial market. The linkage of interest rates with external market benchmarks may create operational difficulties for banks keeping in view the large geographical spread of branches, particularly in to rural regions that having poor connectivity and awareness amongst people.

4.3 The IBA was earlier of the view that interest rate on advances may be linked to BPLR as it may be considered a floating rate in view of its re-fixation on periodic basis. The flexibility to price a floating product using market benchmarks is an option given to banks in addition to pricing with reference to BPLR. With the new Base Rate system proposed by the Group, the determination of the Base Rate would be much more transparent and flexible which can serve as a credible reference rate for floating rate loan products. In addition, banks may choose other market benchmarks to price floating rate loans, although the Group expects that Base Rate would be much more flexible akin to a floating benchmark. The Group, therefore, recommends that banks can offer floating rate loans by using external market-based benchmarks, apart from the Base Rate. However, while the floating interest rate based on external benchmarks (other than the Base Rate) can be set below the Base Rate for advances of tenure up to or lower than one year, all other floating rate advances (more than one year) would be charged lending rates equal to or above the Base Rate at the time of sanction.