Executive Summary

The Reserve Bank announced the constitution of the Working Group on Benchmark Prime Lending Rate (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 terms of reference (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 divergence 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. The main recommendations of the Group are set out below:

- The BPLR has tended to be out of sync with market conditions and does not adequately respond to changes in monetary policy. In addition, the tendency of banks to lend at sub-BPLR rates on a large scale raises concerns of transparency. The Working Group also noted that on account of competitive pressures, banks were lending at rates which did not make much commercial sense. Accordingly, the Group is of the view that the extant benchmark prime lending rate (BPLR) system has fallen short of expectations in its original intent of enhancing transparency in lending rates charged by banks and needs to be modified.
- After carefully examining the various possible options, views of various stakeholders from industry associations and those received from the public, and international best practices, the Group is of the view that there is merit in introducing a system of Base Rate to replace the existing BPLR system.
- The proposed Base Rate will include all those cost elements which can be clearly identified and are common across borrowers. The constituents of the Base Rate would include (i) the card interest rate on retail deposit (deposits below Rs. 15 lakh) with one year maturity (adjusted for CASA deposits); (ii) adjustment for the negative carry in

respect of CRR and SLR; (iii) unallocatable overhead cost for banks which would comprise a minimum set of overhead cost elements; and (iv) average return on net worth.

- 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.
- The Working Group has worked out an illustrative methodology for computing the base rate for the banks. According to this methodology with representative data for the year 2008-09, the illustrative Base Rate works out to 8.55 per cent.
- With the proposed system of Base Rate, there will not be a need for banks to lend below the Base Rate as the Base Rate represents the bare minimum rate below which it will not be viable for the banks to lend. The Group, however, also recognises certain situations when lending below the Base Rate may be necessitated by market conditions. This may occur when there is a large surplus liquidity in the system and banks instead of deploying funds in the LAF window of the Reserve Bank may prefer to lend at rates lower than their respective Base Rates. The Group is of the view that the need for such lending may arise as an exception only for very short-term periods. Accordingly, 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. 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.
- 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.

- The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from the other external market benchmark rates.
- In order to increase the flow of credit to small borrowers, administered lending rate for loans up to Rs. 2 lakh may be deregulated as the experience reveals that lending rate regulation has dampened the flow of credit to small borrowers and has imparted downward inflexibility to the BPLRs. 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.
- The 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 incentivise export credit for exporters to be globally competitive. By this change in stipulation of pricing of export credit, exporters can still access rupee export credit at lower rates as the Base Rate envisaged is expected to be significantly lower than the BPLRs. The Base Rate based on the methodology suggested by the Group is comparable with the present lending rate of 9.5 per cent charged by the banks to most exporters. The proposed system will also be more flexible and competitive.
- At present the interest rates on education loans are linked to ceilings with reference to the BPLR. 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. However, in view of the fact that the Base Rate is expected to be significantly lower than BPLR, the Group recommends that there is a need to change the mark up. Accordingly, 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 stipulation, 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 on a quarterly basis to enable banks to price their education loan portfolio.

- In order to bring about greater transparency in loan pricing, the banks should continue to provide the information on lending rates to the Reserve Bank and disseminate information on the Base Rate. In addition, banks should also provide information on the actual minimum and maximum interest rates charged to borrowers.

- All banks should follow the Banking Codes and Standards Board of India (BCSBI) Codes for fair treatment of customers of banks, viz., the Code of Bank's Commitment to Customers (Code) and the Code of Bank's Commitment to Micro and Small Enterprises (MSE Code) scrupulously. The Group also recommends that the Reserve Bank may require banks to publish summary information relating to the number of complaints and compliance with the codes in their annual reports.