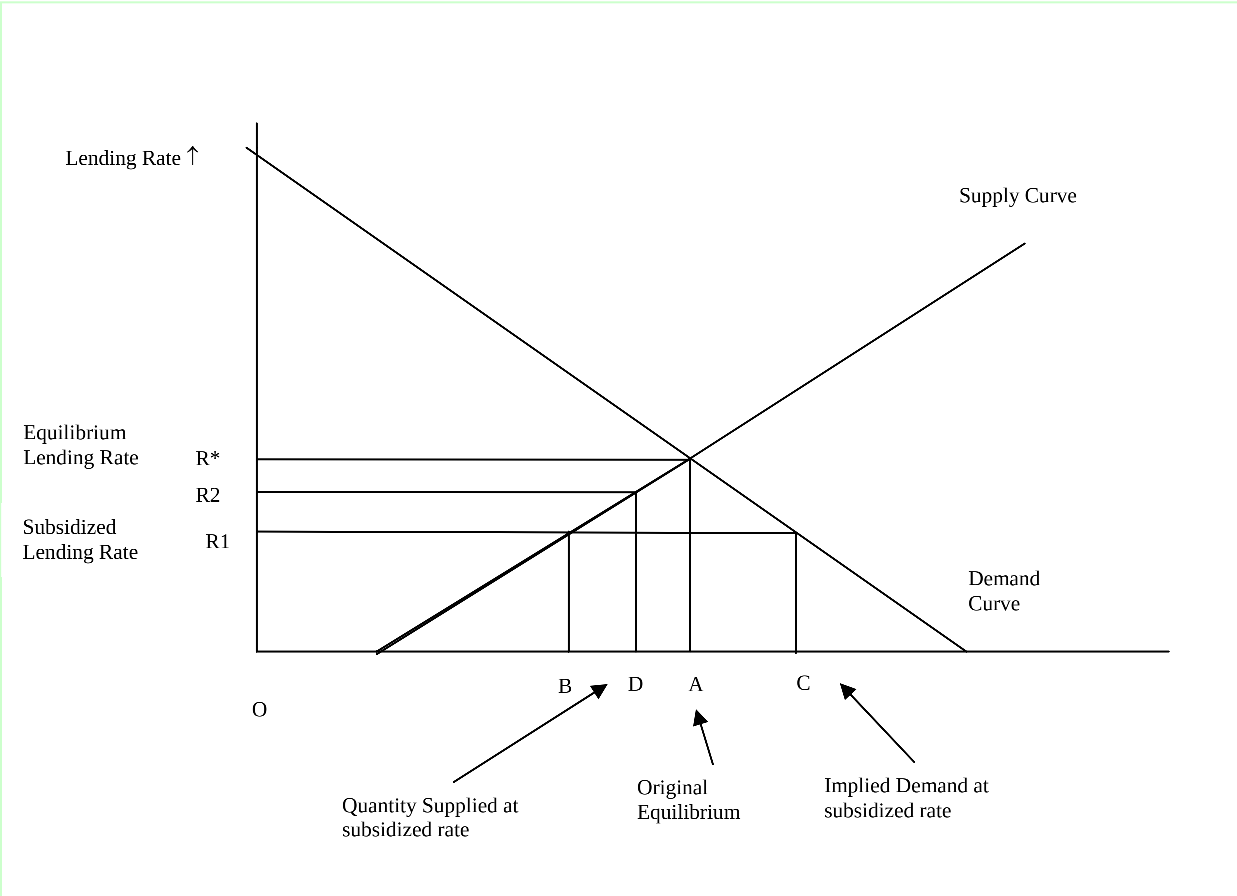
5. Review of Administered Lending Rates

5.1 Removal of interest rate distortions is an important objective of financial sector reform programmes in several countries. Since it is in the interest of economies to improve efficiency of resource allocation, it is important that interest rate distortions such as in the form of large interest rate subsidies, pervasive interest rate controls, or policies that cause extremely high interest rates, are minimized, if not regulated altogether.

5.2 Analytically, subsidies are inefficient to both the provider and receiver of subsidies. For example, if banks are forced to provide a subsidy to a particular segment in an environment of less than competitive or supply constrained credit market, they will reduce the supply of loans to the subsidised segment to reduce their losses. The subsidised segment is also not benefitted, since it is not getting adequate funds demanded at the subsidized rate. Thus, because of the introduction of subsidy, the allocative efficiency is distorted. The effect of subsidy on supply is illustrated in Chart 8. The equilibrium lending rate is determined at the intersection of demand and supply curve. At the equilibrium lending rate, the loan supplied is OA. Now suppose banks are required to subsidise the lending rates. At this subsidised rate, the borrowers will demand OC amount of loans from the banks. But the banks will reduce their supply of loans at the subsidised rate, in order to reduce their losses. They will be providing only OB amount of loans, which is less than the amount supplied under the equilibrium rate of interest. Thus, under the subsidised interest rate, the level of supply will be reduced. Even when the banks are compensated by interest subvention, the loan supply OD would still remain below the loan demand at OC. Hence availability of credit will be constrained by prescription of low interest rate unrelated to the cost of funds.

Chart 8: Lending Rates and Subsidy



5.3 Provision of this extra credit requires resources that have higher opportunity costs than that of the extra credit. Economic opportunity cost is the value that must be forgone in order to provide one more unit of subsidised credit, and this cost exceeds the cost of the credit with the subsidy. The subsidy causes banks to divert more economically valuable resources and to transform them into less valuable resources. Since there is a waste in this process, it is reckoned in the form of "welfare loss".

Review of Administered Lending Rates for Small Loans up to Rs. 2 lakh

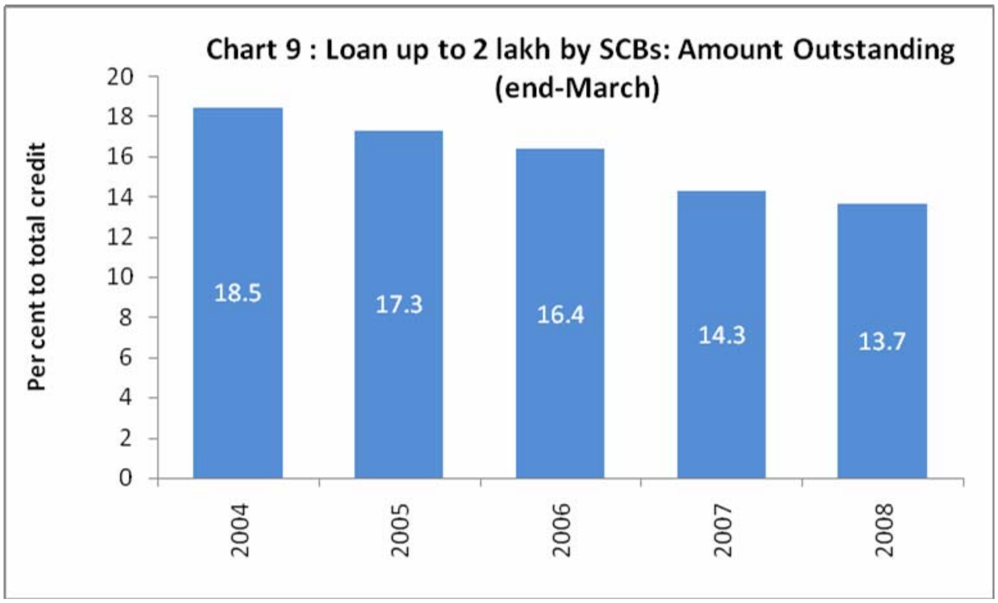
5.4 In a major step towards deregulation of lending rates, it was decided in October 1994 that banks would determine their own lending rates for credit limits over Rs.2 lakh. Interest rates on small loans upto Rs. 2 lakh continued to be administered. Initially, PLR acted as a floor rate for credit above Rs. 2 lakh. In order to remove the disincentive to the flow of credit to small borrowers below Rs.2 lakh, instead of prescribing a specific rate uniformly for all banks, PLR was converted as a ceiling rate on loans up to Rs.2 lakh in April 1998. Keeping in view the international practice and to provide further operational flexibility to commercial banks in deciding their lending rates, it was decided to make PLR a benchmark rate. Accordingly, commercial banks were allowed to lend at sub-PLR rate for loans above Rs.2 lakh effective April 19, 2001. Nevertheless, PLR remained the ceiling rate for loans up to Rs.2 lakhs.

5.5 In April 2006, the Reserve Bank requested the Indian Banks' Association (IBA) to undertake a comprehensive review of the interest rate on savings bank deposits and lending rates on small loans up to Rs.2 lakh. In January 2006, Indian Banks' Association submitted a technical paper on deregulation of interest rates on small loans upto Rs. 2 lakhs. The IBA in its technical paper opined that "by deregulating the interest rates for advances upto Rs. 2 lakhs, there may not be any major change as these interest rates have stabilised. On the contrary, it may help in creating more competitive market for such advances and would increase the reach of the banks".

5.6 The various committees such as the High Level Committee on Flow of Credit (Chairman: Shri R.V. Gupta), the Expert Committee on Rural Credit (Chairman: Shri V.S. Vyas) and the Committee on Issues Pertaining to Rural Credit (Chairman: Shri Anant Geete), which had gone into the issues of rural credit, were all in favour of removing the stipulation on interest rate on small loans.

5.7 The Report of the Committee on Financial Sector Reforms (Chairman: Shri Raghuram G. Rajan) had also deliberated on issue of interest rate ceilings for small loans. The Committee was of the opinion that low interest rate ceilings on small loans, in a scenario of substantial unfulfilled demand for credit, could only result only in corruption in loan disbursements and exclusion of the very high-credit risk poor. Furthermore the increased bureaucratic norms imposed to avoid the same results in making small loans less flexible and attractive.

5.8 The Group is of the view that regulation of interest rate on small borrowers has not served the desired purpose. If any, such regulation has reduced the flow of credit to small borrowers. The whole idea of administering interest rates on loans up to Rs. 2 lakh is that the small borrowers are not able to manage interest rate risk and that given the high transaction cost of small ticket loans, banks otherwise might be reluctant to extend loans to such borrowers. However, the actual experience reveals that lending rate regulation has dampened the flow of credit to small borrowers and has imparted downward inflexibility to the BPLRs. It may be mentioned that the share of small loans up to Rs. 2 lakh has declined steadily in the recent years (Chart 9).



5.9 Small borrowers have also not benefitted from the general reduction in interest rates as is reflected in the large share of sub-BPLR lending, while BPLRs have remained relatively sticky. The administered lending rate for small borrowers has also imparted downward rigidity to BPLR. One of major reasons for the high share of sub-BPLR lending is the reluctance on the part of banks to reduce interest rates on small borrowings and export credit. Banks, therefore, have preferred to reduce interest rates for other borrowers and extend such facilities on an increasingly large scale rather than bring down their BPLRs. The linkage of concessional administered lending rates for small borrowers and exports to banks' BPLRs makes overall lending rates less flexible, constrains credit flows and hinders monetary policy transmission to the credit market. That the banks are reluctant to lend to those sectors where credit pricing is fixed is also borne out by the empirical analysis, which postulates the link between small loans and BPLR. The analysis reveals that although the demand for credit for small loans is sensitive to changes in the ceiling rate, viz., BPLR, the supply of credit by banks to this sector remains insensitive to changes in the BPLR[4]. In other words, supply of credit of small loans does not increase/decrease on account of changes in BPLR. This suggests that banks may be reluctant to increase their exposure to small borrowers.

5.10 The credit market over the years has become competitive. It, therefore, should be possible for all categories of borrowers to obtain credit at a price consistent with their risk profiles. It may be noted that RRBs and co-operative banks, which cater to small borrowers are free to determine their lending rates and there are no restrictions on lending rates of micro-finance institutions (MFIs). The experiences of several successful self-help groups (SHGs) in India suggest that they charge relatively higher interest rates on loans to beneficiaries (Table 13). Despite charging higher interest rates, MFIs they are able to keep their delinquencies at low levels. Besides, successful cross-country experiences in micro and rural credit also underline that the timely availability to credit is more important then the cost of credit.

Table 13: Charges by Micro Finance Institutions (March 2006)

(per cent)

State	Range of cost to the borrower
Andhra Pradesh	17.0 to 32.5
Karnataka	12.0 to 40.0
Orissa	14.0 to 24.5
Rajasthan	16.0
Uttar Pradesh	13.0 to 26.0

Source: Report on Costs and Margins of Micro Finance Institutions, College of Agricultural Banking, Reserve Bank of India, Pune, January 2007.

5.11 Given that the existing system has not served the desired purpose and the large benefits that would accrue from a simple and flexible system as proposed, the Group recommends that the interest rate for loans up to Rs. 2 lakh may be deregulated. That is, banks should be

[4] A demand –supply for small loans (up to 2 lakh) estimated using the standard Two Stage Least Squares (TSLS) for the period March 1999 to March 2007 is given below: The variables considered for the analysis were annual Growth in Small Loans (GSL), the BPLR of SBI (SBI PLR), Growth of Non-Food Credit (NFCG) and Service sector output growth (SERV GROWTH)

GSL = 56.83 -4.93SBIPLR + 2.52 SERV GROWTH (-1)- 0.52GSL(-1) **Demand Equation**

(1.81) (-1.96**) (2.52*) (-1.71)

DW 2.91 SEE 4.86

SBIPLR = 12.98 - 0.04 GSL -0.05 NFCG **Supply Equation**

(13.20) (-0.50) (-0.90)

DW 1.17 SEE 5.03

Note : Figures in parentheses represent ‘t-statistics’

* and ** denote that the coefficient is significant at 5 and 10 per cent level, respectively.

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. As the Group expects the Base Rate of the banks to be lower than their current BPLRs, the effective lending rate for low risk small borrowers could turn out to be lower. In addition, the flow of credit is also expected to improve. The availability of credit is important for small borrower as they lack access to alternative sources of funding. If the recommendation of the Group is implemented, it would lead to increased flow of credit to small borrowers at competitive rates.

Administered Lending Rates for Exporters

5.12 Prior to May 2001, export credit was provided at specific rates of interest in respect of pre-shipment credit and mostly as a ceiling in the case of post-shipment credit. Subsequently, the rupee export credit interest rate structure was rationalised by prescribing ceiling rates linked to the relevant prime lending rates (PLRs) of banks. Accordingly, the ceiling rates in respect of first slab of pre-shipment rupee export credit up to 180 days and post-shipment credit up to 90 days was fixed at PLR minus 1.5 percentage points beginning May 2001. Similarly, the ceiling in the interest rate on the second slab of pre-shipment rupee export credit beyond 180 days and up to 270 days and post- shipment credit for beyond 90 days and up to six months (from the date of shipment) was fixed at PLR plus 1.5 percentage points. Under the system, banks were permitted to charge interest rates up to or within the ceiling rate specified for the purpose. One advantage of a 'ceiling' rate instead of a fixed 'rate' was that it permitted banks to price credit below the ceiling rate in case their cost of fund permitted them to do so, thereby helping market based price discovery of interest rates. The deregulation of the interest rates on rupee export credit was expected to introduce healthy competition and provide exporters a greater choice to avail banking services in terms of interest rates, quality of services and transaction costs. The PLR linked interest rate ceiling on export credit was a part of the deregulation programme that was expected to provide flexibility to both bankers and exporters and respond to monetary policy stance and actions.

5.13 The ceiling interest rates have been altered according to evolving macroeconomic circumstances, global developments and movements in Indian trade. Accordingly with effect from September 26, 2001, the ceiling interest rates on pre-shipment and post-shipment rupee export credit were reduced across the board by 1 percentage point, *i.e.*, PLR minus 2.5 percentage points for the first slab of the pre and post shipment rupee export credit and PLR plus 0.5 percentage points second slab of rupee export credit.

5.14 Interest rate regulation on export credit has been favoured for making available credit to exporters at internationally competitive rates. In the monetary policy announcement made on April 29, 2002, the Reserve Bank had observed that linking of domestic interest rates on export credit to PLR did not serve much purpose in circumstances where effective rupee export credit interest rates were in any case substantially lower than the PLR related ceiling rate. In the Mid-term review announced on October 29, 2002, the Reserve Bank indicated that the PLR-linked ceiling rate lost its significance in view of the freedom given to banks for lending at sub-PLR rates to creditworthy borrowers. The Mid-term Review also mooted deregulation of interest rate on rupee export credit in phases to encourage greater competition in the interests of exports. Accordingly, the ceiling rates of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days was deregulated effective May 1, 2003. With the switchover of PLR to BPLR system by banks, the ceiling interest rate on rupee export credit was changed to BPLR minus 2.5 percentage points with effect from May 1, 2004.

5.15 The mid-term Review of October 2002 had mooted deregulation of interest rate on rupee export credit in phases to encourage greater competition in the interest of exports. A view was that in the light of competitive lending rates in the economy, it is important to ensure that regulated interest rates should not restrict credit flow to all segments of exporters with different risk profiles. However, the Annual Policy Statement for 2005-06 released in April 28, 2005 proposed to continue with *status quo* as various issues pertaining to above regulations on interest rates were being debated.

5.16 The Working Group to review export credit (Chairman: Shri Anand Sinha), which submitted its report in May 2005, had noted that under the deregulated interest rate regime, the small exporters have been at disadvantage, while large corporate exporters got the benefit. It was practically very difficult for exporters to shift from one bank to another bank, which charged lower rates of interest. As a result they were unable to take advantage of the competition among banks in lowering the interest rates. Therefore, the Working Group recommended that the present interest rate prescription by Reserve Bank for the first slabs of the rupee export credit (both pre and post shipment) may continue for the time being in the interest of the small and medium exporters.

5.17 In view of the difficulties being faced by exporters on account of the weakening of external demand, the Reserve Bank on November 15, 2008 extended the period of entitlement of the first slab of pre-shipment rupee export credit, which was available at a concessional interest rate ceiling of BPLR minus 2.5 percentage points, from 180 days to 270 days. Furthermore, on November 28, 2008 the period of entitlement of the first slab of post-shipment rupee export credit was extended from 90 days to 180 days for availing concessional interest rate ceiling of the BPLR minus 2.5 percentage points. Further, on December 8, 2008, the Reserve Bank extended the concessional interest rate ceiling of BPLR minus 2.5 percentage points to overdue bills up to 180 days from the date of advance. The validity of the reduction in the interest rate ceiling to 250 basis points below BPLR on pre-shipment rupee export credit up to 270 days and post-shipment rupee export credit up to 180 days is extended up to October 31, 2009.

5.18 The export sector is an important segment of the economy and it is important that the export sector also obtains adequate credit at competitive rates. As in the case of small borrowers, the Group feels that administered lending rates on export credit may also be deregulated. As the tenure of both pre and post shipment rupee export credit is less than one year, interest rates charged to exporters can now be without reference to the Base Rate. In fact, under the Base Rate system proposed by the Group, it should be possible for exporters to obtain credit at rates lower than Base Rate when there is a surplus liquidity in the system. However, recognising that not all exporters may be able to obtain lower and competitive rates on export credit, the Group recommends that the interest rates charged to exporters should not exceed the Base Rate of individual banks. This is based on the logic that export credit is of short-term in nature, exporters are generally wholesale borrowers and would need incentive to be globally competitive. Under the proposed system, the Base Rate is envisaged to be significantly lower than the existing BPLR. An illustrative estimate of the Base Rate based on the methodology suggested in Section 3 works out to 8.55 per cent (refer Table 12 in Chapter 3). The Base Rate based on the methodology suggested by the Group is thus comparable with the present lending rate of 9.5 per cent (PSBs modal BPLR of 12 per cent as on June 2009 minus 2.5 per cent) charged by the banks to most exporters. Going by the actual lending rates charged to exporters, the export credit provided under the proposed Base Rate system would continue to remain more competitive (Table 14). The Group is of the view that the proposed system of providing export credit under the proposed system will be more flexible and competitive. If any special dispensation is considered necessary it should come explicitly from the Government in the form of interest rate subvention.

Table 14: Interest Rate on Pre-Shipment Rupee Export Credit up to 180 days June 2009

(per cent)

Bank Categories	Advances at which at least 60 per cent of the business has been contracted	
	Actual Rate	Median Rate
1	2	3
Public Sector Banks	7.00-10.50	9.25-9.50
Private Sector Banks	7.50-14.00	10.38-10.50
Foreign Banks	6.00-13.50	8.75-9.88

Education Loans

5.19 At present, BPLR serves as the ceiling rate for interest rate on education loans up to Rs. 4 lakh. Interest rates on educational loans in excess of Rs. 4 lakh are prescribed as BPLR+1 per cent. Education loans are intended to enable the borrowers, *i.e.*, students to develop their skills so that they are employed gainfully and able to service the loans easily. In view of the critical role played by education loans in developing human resource skills, the Group felt that interest rates on education loans may continue to 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 interest rate on all education loans may not exceed the Base Rate plus 200 basis points. Illustratively, based on the proposed methodology, loans above Rs. 4 lakh will be available at 8.55 per cent plus a maximum of 200 basis points as against the existing rate of 13 per cent (Modal BPLR of PSBs plus 1 per cent). In order to provide greater uniformity in the lending rates across banks, the Base Rate for pricing educational loans by all banks may be set as the average Base Rate of the five largest banks. Even with this stipulation, the actual lending rates for education loans would be lower than the current rates prevailing. In this regard, the Reserve Bank may require IBA to (i) collect the information on the base rates of five largest banks based on the size of deposits; and (ii) disseminate the information on the average base rate of these five banks on a quarterly basis for ensuring uniformity in base rates charged by all banks.