6. Recommendations of the Working Group

6.1 The findings, views and major observations/recommendations of the Working Group are summed up below:

Findings of the Working Group

6.2 The bank group-wise trends in the modal BPLR since March 2004 show three distinct phases. In the first phase between March 2004 and March 2006, the modal BPLRs of public sector banks and private sector banks remained almost steady and range bound, though the modal BPLRs of private sector banks were about 100 bps higher than those of public sector banks. Modal BPLRs of foreign banks showed some variations, but converged to modal BPLR of public sector banks by March 2006. During March 2006 to June 2007, modal BPLRs of all three bank groups showed sharp upward movement in line with the general tightening of monetary conditions. Even in this phase, modal BPLRs of private sector banks remained at around 100 bps higher than those of public sector bank. Modal BPLRs of foreign banks remained close to those of public sector banks. In the next phase from June 2007 to September 2008, the divergence in the modal BPLRs of public sector banks and private sector banks widened somewhat; modal BPLRs of foreign banks converged to the modal BPLR of private sector banks. However, since September 2008, modal BPLRs of private and public sector banks have diverged significantly. The modal BPLRs of public sector banks have shown a significant decline since September 2008, while those of private banks' after showing an upward movement till March 2009, have exhibited a downward movement (Para 2.16).

6.3 An empirical exercise carried out to ascertain the responsiveness of modal BPLR to the changes in the Reserve Bank's policy rates (repo rate) for the period from Q1:2004 to Q1:2009 suggests a mixed picture across the bank groups and interest rate cycles. An increase in the repo rate was observed to bring about a contemporaneous change in modal BPRLs of private sector banks and major foreign banks and a lagged response in the case of public sector banks. A decrease in the repo rate had a significant contemporaneous impact only in the case of public sector banks. This asymmetric response shows that while public sector banks were slow to respond to an increase in policy rate, they were quick on the reverse. This could be attributed to the ownership structure of public sector banks which makes them more amenable to moral suasion by the authorities. Apart from the policy rate, the weighted average call money rate was also used to assess the impact on modal BPLRs. An increase in the weighted average call money rate, an indication of tightness of liquidity, was observed to have a significant contemporaneous effect across all bank groups. A decline was seen to have a significant impact, albeit with a lag in the case of public sector banks and contemporaneous as well as lagged impact in the case of private banks while in the case of five major foreign banks, no significant impact was seen (Para 2.17).

6.4 An analysis of the interest rate spreads around modal BPLR for the period March 2004 to 2009 revealed considerable variations among different bank groups. Minimum interest rates, in particular, showed relatively subdued movements suggesting that they were rather insensitive to the overall movements in BPLRs (Para 2.18).

6.5 The movements in BPLR, however, do not capture a true picture of lending interest rates in the country as banks resort to sub-BPLR lending to a varying degree. It is observed that in the case of all scheduled commercial banks, except foreign banks, periods of increase in share of sub-BPLR lending were also associated with high BPLR rates (Para 2.22).

6.6 An empirical analysis of the relationship between changes in BPLRs and sub-BPLR lending rates for select major banks showed that they were positively related. As established by the empirical results above, the co-movements in BPLR and sub-BPLR lending could be for the reason that banks are unable to reduce their BPLRs, which are worked out based on the average cost of funds, when the marginal costs declines. This resulted in incremental lending at sub-BPLR. True movements in lending interest rate of banks, therefore, are better captured in the weighted average lending rate of banks. Though there was considerable divergence in weighted average lending rates in 2004 among the various bank groups, the weighted average lending rates have tended to converge in the recent period. Furthermore, the weighted average lending rate kept coming down beginning 2002 before rising in 2008. However, the weighted average lending rate was lower in 2008 than in 2005. In 2009, the weighted average lending rates have registered a significant decline, expect in the case of private banks (Para 2.23).

Major Observations/Recommendations of the Working Group

6.7 The BPLR system was expected to be a step forward from the PLR system, which more or less represented the minimum lending rates, to that of one which stood as a benchmark or a reference rate around which most of the banks' lending was expected to take place. However, over a period of time, several concerns have been raised about the way the BPLR system has evolved. These relate to large quantum of sub-BPLR lending, lack of transparency, downward stickiness of BPLRs and perception of cross-subsidisation in lending (Paras 2.24 to 2.34).

6.8 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. More importantly, perhaps, in the present system, the BPLR has tended to be out of sync with market conditions and does not adequately respond to changes in monetary policy. The Working Group was of the opinion that until the system was modified and/or replaced with some other system, the tendency to extend loans at sub-BPLR rates on a large scale in the market would continue raising concerns on transparency. The Working Group also noted that on account of competitive pressures, banks were lending a part of their portfolio at rates which did not make much commercial sense (Para 3.15).

Need to Replace the Present BPLR System with the Base Rate System

6.9 After carefully examining the views expressed by trade and industry associations and others and international best practices, the Group is of the view that there is merit in introducing a system of Base Rate. The proposed Base Rate will include all those cost elements which could clearly be identified and are common across borrowers (Para 3.22).

6.10 The constituents of the Base Rate would include (a) the card interest rate on retail deposit (deposits below Rs.15 lakh) with 1-year maturity adjusted for current account and savings account (CASA) deposits; (b) adjustment on account of negative carry in respect of CRR and SLR; (c) unallocatable overhead cost for banks; and (d) average return on net worth. The final lending rates would include the Base Rate plus variable or product specific operating expenses, credit risk premium and tenor premium (Paras 3.23 to 3.27).

6.11 In order to make the lending rates responsive to the Reserve Bank’s policy rates, the Group recommends that banks may review and announce their Base Rate at least once in a calendar quarter with the approval of their Boards. The Base Rate alongside actual minimum and maximum lending rates may be placed in public domain (Para 3.30).

Sub-Base Rate Lending to be Allowed within Limits

6.12 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 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 liquidity adjustment facility (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 and not as a rule on a regular and long-term basis. 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. That is, short-term loans with less than one year could technically be priced below 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 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 (Para 3.31).

6.13 The Group recommends that the Base Rate could also serve as the reference rate for floating rate loan products (Para 3.32).

Categories to be Excluded from the Base Rate

6.14 The recommendation of Base Rate will necessitate amendments in the extant provisions contained in the Master Circular on ‘Interest Rate on Advances’ (Section 2.4 of the Master Circular on Interest Rate on Advances). Under the proposed system, all the above categories of loans referred to in the Master Circular be linked to the Base Rate, except interest rates on (a) loans relating to selective credit control; (b) credit card receivables; and (c) loans to banks' own employees. The Group recommends that DRI scheme, which constitutes a very small part of banks' lending, should continue in its existing form for the benefit of the deprived sections of the society. Furthermore, the Working Group also suggests that the proposed 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 (Paras 3.33-3.35).

Dissemination of the Base Rate and Range of Actual Lending Rates

6.15 It is possible that some banks charge unduly high product specific operating expenditure, credit risk and term premia from some borrowers. In order to avoid such unhealthy practices, 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. This would give both existing and prospective borrowers an idea of variable operating cost, credit risk and term premia charged by different banks. The Group is of the view that greater dissemination of information on lending rates would enhance the transparency of the loan pricing system (Para 3.36).

Scrupulous Adhering to the Two Codes Prescribed by BCSBI

6.16 On this issue of reference rates and transparency in lending rates, it may be noted that the Banking Codes and Standards Board of India (BCSBI) has evolved two Codes, *viz.,* the Code of Bank's Commitment to Customers (Code) and the Code of Bank's Commitment to Micro and Small Enterprises (MSE Code). The Group recommends that all the banks should follow both the commitment codes 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 (Paras 3.37 and 3.44).

Benchmarks for Floating Rate Loans in the Retail Segment

6.17 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 (Para 4.3).

Administered Lending Rates for Small Loans up to Rs. 2 lakh to be Deregulated

6.18 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 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 (Para 5.11).

Credit to Exporters to be Extended at the Base Rate

6.19 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. The Group feels that under the proposed system, there will not be any need to extend any concessional export credit. If any special dispensation is considered necessary it should come explicitly from the Government in the form of interest rate subvention (Para 5.18).

Education Loans to be Provided at Rates not Exceeding Base Rate Plus 200 Basis Points

6.20 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. 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 information, 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 (Para 5.19).