Report of the
Working Group on Pricing of Credit

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Abbreviations

ABS	Association of Banks in Singapore	HKAB	Hong Kong Association of Banks
ALM	Asset Liability Management	HKMA	Hong Kong Monetary Authority
APR	Annual Percentage Rate	HKMC	Hong Kong Mortgage Corporation Limited
APRA	Australian Prudential Regulation Authority	HMDA	Home Mortgage Disclosure Act
ASIC	Australian Securities and Investments Commission	HOEPA	Home Ownership and Equity Protection Act
BCSBI	Banking Codes and Standards Board of India	IBA	Indian Banks' Association
BPLR	Benchmark Prime Lending Rate	IBBR	Indian Banks Base Rate
CARRP	Credit Agreements Relating to Residential immovable Property	IGIDR	Indira Gandhi Institute of Development Research
CASA	Current Account-Savings Account	IIM	Indian Institute of Management
CBFA	Banking, Finance and Insurance Commission	IRR	Interest rate restrictions
CBRT	Central Bank of Republic of Turkey	IRS	Interest Rate Swaps
CCD	Consumer Credit Directive	KYC	Know Your Customer
CCPA	Consumer Credit Protection Act	LIBOR	London Interbank Offered Rate
CFPB	Consumer Financial Protection Bureau	LPR	Loan Prime Rate
CIR	Cox Ingersoll Ross Model	MAS	Monetary Authority of Singapore
CoBP	Code of Banking Practice	MCD	Mortgage Credit Directive
COFI	Cost of Funds Index, USA	MIBOR	Mumbai Inter-bank Offered Rate
COFIX	Cost of Funds Index, Korea	NCA	National Credit Act
CRR	Cash Reserve Ratio	NCC	National Credit Code
CSD	Customer Service Department	NCCPA	National Consumer Credit Protection Act
DBOD	Department of Banking Operations & Development	NCR	National Credit Regulator
DEPR	Department of Economic and Policy Research	OECD	Organisation for Economic Co-operation and Development

Dodd-Frank Act	Dodd–Frank Wall Street Reform and Consumer Protection Act
DRI	Differential Rate of Interest
DTCA	Deposit Taking Companies Association
EC	European Commission
ECOA	Equal Credit Opportunities Act
EIR	Effective Interest Rate
EMI	Equated Monthly Instalment
EU	European Union
FACTA	Fair and Accurate Credit Transactions Act
FCA	Financial Conduct Authority
FCAC	Financial Consumer Agency of Canada
FCRA	Fair Credit Reporting Act
FDCPA	Fair Debt Collection Practices Act
FDMC	Financial Data Management Centre
FHA	Fair Housing Act
FOMC	Federal Open Market Committee
FPC	Financial Policy Committee
FRA	Financial Redressal agency
FSA	Financial Services Authority
FSB	Financial Stability Board
FSLRC	Financial Sector Legislative Reforms Commission
FTC	Federal Trade Commission
OFT	Office of Fair Trading
OSFI	Office of the Superintendent of Financial Institutions
PCGM	Principal Chief General Manager
PDS	Product Disclosure Statement
PLR	Prime Lending Rate
PRA	Prudential Regulation Authority
PSU	Public Sector Unit
PTLR	Prime Term Lending Rate
RAROC	Risk Adjusted Return on Capital
RBA	Reserve Bank of Australia
RMB	Renminbi
ROA	Return on Assets
ROE	Return on Equity
SARB	South African Reserve Bank
SLR	Statutory Liquidity Ratio
SME	Small and Medium Enterprises
TCF	Treating the Customer Fairly
TILA	Truth in Lending Act
TPLR	Tenor Linked Prime Lending Rate
WALR	Weighted Average Lending Rate
WG	Working Group
WSJ	Wall Street Journal

Executive Summary and Recommendations

0.1 In the dynamic world of finance the demand for credit is one of the constants. In India, banks are the most important channel to meet this demand. Banks connect the surplus and deficit economic agents through their primary activity of financial intermediation, and generate profits largely from the difference between the interest paid to the depositor and charged to the borrowers.

0.2 At the time of lending funds, banks are expected to carry out necessary credit appraisal and due diligence and thereafter, charge interest accordingly. The interest rates charged to borrowers can be determined by banks based on fixed rules or discretion. Under rules based lending, banks may use models to arrive at the interest rate that may be charged to the customers. A number of research papers have endeavoured to model the factors that determine the lending rates by banks. While rule based lending leads to interest rates that are based on pre-defined factors, lending based on discretion allows flexibility to banks in terms of considering customer specific attributes as well. Notwithstanding the method followed, it is in the interest of all stakeholders that pricing is kept efficient and fair.

0.3 Efficient and fair pricing of credit by banks, within the ambit of policy of the Central Bank, is assumed to be serving the following three objectives:

a. Flexibility to the lenders, enabling them to adjust the rates quickly to the dynamic economic scenario so that they remain competitive and profitable.
b. Effectiveness to the monetary policy so that the policy signals are quickly and adequately transmitted to the financial system to achieve the objectives of the monetary policy.
c. Protection to customers from the unfair practices of lenders, by being transparent and non-discriminatory.

0.4 In India, interest rate regulation has traversed a long path from the days of administered regime in vogue till the early 1990s to the deregulated regime prevailing now. As part of the deregulation, banks have been permitted to set their own lending and deposit rates except for a very few segments such as DRI scheme where administered rates still prevail. To ensure that such flexibility is judiciously

deployed and the borrower interests are taken care of, the BPLR system was replaced by the Base Rate system in 2010 which has largely addressed the gaps noticed in the erstwhile BPLR regime.

0.5 Despite the policy efforts to usher in transparency and fairness to the credit pricing framework, there have been certain concerns from the customer service perspective. These mainly relate to the downward stickiness of the interest rates, discriminatory treatment of old borrowers vis-à-vis new borrowers, and arbitrary changes in spreads, etc. In response, the Reserve Bank of India had announced in the Second Quarter Review of October 2011 that a Working Group will be constituted to examine the issues related to discrimination in pricing of credit and recommend measures for transparent and appropriate pricing of credit under a floating rate regime. Accordingly, a Group was constituted under the Chairmanship of Shri Anand Sinha, Deputy Governor, Reserve Bank of India comprising members from banks, IBA, Academia and the Reserve Bank of India, with the following terms of reference:

- to review the current international practices and the practice in India for pricing of floating rate loan products and determination of the credit spreads;
- to suggest the components of credit spread and appropriate pricing of floating rate loan products;
- to suggest measures to improve transparency in pricing and loan documentations; and
- to consider any other issue relating to pricing of floating rate loan products.

0.6 A study of available literature provided useful insight on the models/approaches that are used for pricing of loans. It emerged that banks use both rules and discretion based pricing strategies, or even a hybrid strategy containing elements of discretion in a rule based approach. Pricing depends on various factors like the type of model used, availability of information, competition, size of the loan, and switching cost, etc. The papers also provided information on factors that may have a bearing on pricing of the spread of a floating rate loan such as concentration of banks, ownership, collateral, etc. It also became evident that there is no one uniform or best way for

pricing of credit and that the pricing by banks is often dependent on the strategy pursued.

0.7 Typically, the pricing of credit is done on a cost plus approach, i.e., a benchmark rate *plus* a spread. The benchmark used for the purpose can be inter-bank market rate or the overnight money market rates or a cost of funds index. The spread comprises various factors that include product specific operating cost, credit risk premium, tenor premium, competition, strategy and customer relationship, etc. While the lending rate remains fixed in the case of a fixed rate loan, in the case of floating rate loans, the lending rate is dynamically reset at specified intervals based on the movements in the benchmark rates.

0.8 Ideally for floating rate loans, the interest rate charged to a customer should not change at the time of reset unless (a) there is a change in Base Rate or (b) there is a change in credit profile of the customer thereby leading to change in credit spread charged. Further, in case there is a change in policy rate by the central bank, it should impact the benchmark, albeit with a lag, and not the spread component of the interest rate.

0.9 Banks with lower cost of funds aided by higher CASA may not necessarily increase the lending rates when the policy rate is increased as long as their margin expectations are fulfilled. These banks can leverage this advantage to maximise their respective market shares. On the other hand, such banks can reduce the Base Rate as soon as the policy rate is moderated (as they already enjoy lower cost of funds) to maximize their market share before waiting for the full impact of reduction in policy rate to be fully felt on their cost of funds.

0.10 In the Indian markets, movement of Base Rates of banks vis-à-vis the policy rate has been asymmetric. While the increase in policy rate led to a corresponding increase in the Base Rate of banks, the Base Rate has exhibited “stickiness” by not coming down quickly enough whenever there has been a reduction in the policy rate.

0.11 The stickiness in Base Rate can be attributed to the deposit profile of banks. Banks with considerable reliance on interest bearing deposits, which are fixed in

nature, do not have the flexibility to pass on the impact of accommodative policy action immediately as their cost of funds represented by the cost of fixed deposits does not decrease immediately. By and large, banks in India are computing their Base Rate based on the weighted average cost of deposits, and hence, their Base Rate does not lend itself to immediate downward adjustment. The full impact can be seen only after the bulk of the existing fixed rate deposits gets rolled over at lower rates on maturity.

0.12 The liquidity conditions in the market may also impact the behaviour of the Base Rate. At times of tight liquidity in the market, the inter-bank call rates are generally above the policy rate. Any easing of the policy rate may not impact the Base Rate in such a scenario. However, under the same scenario, significant injection of liquidity say through a cut in the Cash Reserve Ratio (CRR) will infuse substantial liquidity in the system that may lead to the lowering of the interest rates. Further, the interest rates can also be influenced due to the predominance of the public sector banks.

0.13 In India, the deposit profile is predominantly fixed rate, while the loans, especially the home loans, are predominantly under floating rate regime. Hence, the effects of stickiness in the Base Rate of banks can be mitigated if the loans and advances are funded by similar liability, i.e., longer term floating rate deposits, thereby making assets and liabilities symmetrical to sensitivity in policy rate. The WG noted that though the regulations do not impede floating rate deposits, these are virtually non-existent as the depositors have the implicit option of replacing a low yielding deposit with a higher yielding one.

0.14 As the Base Rate is computed primarily using the average cost of funds, it does not move in tandem with the policy rate. One of the ways to make the Base Rate more responsive to the policy rate is by banks computing their Base Rates on the basis of the marginal cost of funds. Under this approach, the pricing of other facilities based on Base Rate will more quickly align with the changes in the policy rate. The WG deliberated at length the appropriateness and feasibility of the use of marginal cost of funds by banks in computing their Base Rate. However, taking into

account the difficulties involved in migrating to marginal cost of funds for computing Base Rate for majority of banks due to the maturity profile of deposits, it may not be appropriate to mandate it at this juncture.

0.15 Where banks choose to use the historical cost of funds for computing the base rate, it would be unrealistic to expect that they would not pass on the benefit of lower marginal cost of funds to the new customers by operating on the spreads.This can lead to differentiation amongst customers who enter into borrowal relationship with a bank at different points of time. However, the WG wishes to emphasise that no bank can discriminate among borrowers who get into borrowing relationship with a bank at the same time, i.e., in identical or similar funding conditions. Any difference in pricing in such cases must be based on objective and transparent criteria for determining the mark up or spread over the base rate. It is important to be clear about what these criteria might be. In other words, on what grounds does a bank distinguish between customers who enter into a relationship with it at the same time and also have the same credit risk profile? The WG has sought to address this question.

0.16 At the time of pricing of floating rate loans, banks add a spread to the benchmark rate to arrive at the interest rate charged to the borrower. In terms of the guidelines on Base Rate, the spread should be a function of product specific operating cost, credit risk premium and the tenor premium. This apart, there are other behavioural factors such as competition, customer relationship and business strategy that also get factored in while determining the lending rates. In any formulation on this issue, these factors need to be considered. Banks have contended that parameters such as future business potential of a customer, value of the relationship and business strategy are some 'soft' parameters which are difficult to quantitatively establish but surely form a part of their pricing. However, arbitrary inclusion of these factors into pricing can lead to discrimination among customers.

0.17 The WG agreed that while price differentiation among old and new customers would remain where the Base Rate is calculated on the basis of weighted average cost of deposits, price discrimination cannot be accepted. Price differentiation will

imply different pricing for customers with identical credit profile due to varying conditions. One reason for difference in pricing that has been highlighted earlier is that customers may establish borrowing relationships at different point of time when the marginal cost of funding has declined due to lowering of policy rate (while the base rate remains unaffected because it is computed using historical cost of funds). To this, other factors need to be added that could result in differences in pricing between customers with identical risk profiles. Illustratively, a bank may pursue a business strategy whereby it wishes to acquire a greater share of a product market or wants to enter into a new segment where there are established players by making loans to new customers at a lower rate. Value of relationship would be another factor resulting in concession in the interest rates when bank expects to gain fee-based business or deposit accounts or more business in future. On the other hand, price discrimination would occur if a bank offers different prices on loans to two customers with identical credit profile and without any of the other factors mentioned above entering the picture. Such price discrimination cannot be accepted.

0.18 The Board of banks must ensure through a laid down policy that customers are not discriminated against and the differentiation in pricing of credit is occurring only due to specified factors such as competitive conditions, customer relationship and business strategy. In order to ensure that these factors are not used arbitrarily, the Boards of banks must ensure that the interest rates charged to customers are consistent with bank's target for Risk Adjusted Return on Capital (RAROC).

Recommendation 1

The WG recommends that it would be desirable that banks, particularly those whose weighted average maturity of deposits is on the lower side, move towards computing the Base Rate on the basis of marginal cost of funds as this may result in more transparency in pricing, reduced customer complaints, better transmission of changes in the policy rate and improved asset liability management at banks. If banks are using weighted average cost of funds

because of their deposits profile or any other methodology that may result in differentiation between old and new customers, the Boards of banks should ensure that this differentiation does not lead to any discrimination amongst borrowers. Discrimination would occur if a bank offers different prices on loans to customers with identical credit profile, every other factor being the same.

(Paragraph 4.31)

Recommendation 2

The WG acknowledges that apart from factors like specific operating cost, credit risk premium and tenor premium, broad factors like competition, business strategy and customer relationship are also used to determine the spread. Banks should have a Board approved policy delineating these components. The Board of a bank should ensure that any price differentiation is consistent with bank's credit pricing policy factoring RAROC. Banks should be able to demonstrate to the Reserve Bank of India the rationale of the pricing policy.

(Paragraph 4.32)

0.19 The WG observed that competition, customer relationship and business strategy are very broad factors that encompass a number of components and that it would not be practical to prepare an exhaustive list of factors that may be clubbed under business strategy and customer relationship. Further, it is possible in this framework for a bank to arbitrarily bring in some factor as strategy or competition to price the spread, and this could put some customers at a disadvantage. Moreover, each bank may use a different combination of such factors to price the spread for relationship, strategy or competition. The WG, therefore, felt that the Board of a bank would be in the best position to assess the optimal bouquet of such factors that it determines should be clubbed under these parameters to price the spread.

Recommendation 3

The WG recommends that banks' internal policy must spell out the rationale for, and range of, the spread in the case of a given borrower, as also, the delegation of powers in respect of loan pricing.

(Paragraph 4.34)

0.20 Arbitrary change in contracted spread has also resulted in complaints by the customers. It is understood that likely reasons for change in contracted spread is to adjust the impact of changes in policy rate, or any other factor like liquidity in the system, etc. The WG felt that for a given customer, once a spread has been determined after looking at all factors including customer's credit profile, customer relationship with bank, strategy, etc., such spread should not be increased except on account of deterioration in the credit risk profile of the customer. There should be a loan covenant to this effect. Apart from this, the WG felt that other externalities should not impact the contracted spread for a given customer.

Recommendation 4

The WG recommends that the spread charged to an existing customer cannot be increased except on account of deterioration in the credit risk profile of the customer. The customer should be informed of this at the time of contract. Further, this information should be adequately displayed by banks through notices/website.

(Paragraph 4.35)

0.21 The WG observed that any change in Base Rate need not result in an immediate change in the floating interest rate on the existing loans. The covenant of the floating rate loan may have mandatory reset dates (monthly, quarterly, half-yearly, etc.) and the existing loans may be reset on the date agreed upon in the covenant. This will improve transparency with respect to the customer, who would know upfront when the rates are due for change. It will also aid in better risk management by banks.

Recommendation 5

The WG recommends that the floating rate loan covenant may have interest rate reset periodicity and the resets may be done on those dates only, irrespective of changes made to the Base Rate within the reset period.

(Paragraph 4.36)

One member, State Bank of India, however is of the view that whenever there is a change in the Base Rate, such changes should be passed on to the customers.

0.22 Though the Base Rate system has replaced the BPLR system with effect from July 1, 2010, and is applicable for all new loans and for those old loans that come up for renewal, some of the existing loans based on the BPLR system continue to be in the system and may run till their maturity. Continuation of contracts under the BPLR regime leaves an element of operational inconvenience for banks. Moreover, the intended benefit of the Base Rate regime, viz., shifting of the old BPLR linked borrowers to the base rate system could not manifest itself in the true sense. Apparently, customers who shifted from BPLR to the Base Rate regime were charged a spread different / higher than the borrowers who entered newly / directly under the Base Rate system leading to issues of discrimination between old and new customers.

Recommendation 6

The WG recommends that there may be a sunset clause for BPLR contracts so that all the contracts thereafter are linked to the Base Rate. Banks may ensure that these customers who shift from BPLR linked loans to Base Rate loans are not charged any additional interest rate or any processing fee for such switch-over.

(Paragraph 4.38)

0.23 Apart from the Base Rate, Indian banks have been allowed to use external benchmarks to facilitate pricing of floating rate interest rates. A number of external benchmarks are available in the Indian markets, viz., MIBOR, G-Sec yields, Repo Rate, CP and CD rates, etc. However, these benchmarks have drawbacks - they are mainly driven by liquidity conditions in the market, as also, they do not reflect the

cost of funds of banks. Further, these benchmarks are volatile and may lead to frequent changes in the floating rate.

0.24 A number of countries have benchmark indices over which the floating interest rates are priced. The WG considered benchmarks available in various countries that are being used for pricing of floating rate loans. The major advantage of using such benchmarks is that it makes comparison between similar loan products offered by competing banks easier and more efficient.

0.25 To improve transparency in the pricing of floating rate loans, the WG proposes a new benchmark, viz., Indian Banks Base Rate (IBBR) Index which is a Benchmark derived from the Base Rates of some large banks. The use of IBBR would facilitate all floating rate loan pricing to move in tandem and an individual bank's specific funding advantages /disadvantages and changes in funding profile may not affect the customers. Further, as the IBBR will be based on major banks across the system, changes in base rate of few banks will have limited impact on the index. Being an industry-wide index, it is likely to find better acceptance than market benchmarks like MIBOR, T-bill, etc. By design, the IBBR should meet the standards for benchmarks set by the Committee on Financial Benchmarks (Chairman: Shri P Vijaya Bhaskar, Executive Director, RBI)[1]. These standards include, *inter-alia,* well-defined hierarchy of data inputs, code of conduct for submitters, minimum number of submitters, and a well-defined methodology for calculation of the benchmark. Moreover, there should be a governance structure in place for benchmark administrators, benchmark calculation agents and benchmark submitters.

Recommendation 7

The WG recommends that IBA may develop a new benchmark for floating interest rate products, viz., the Indian Banks Base Rate (IBBR), which may be collated and published by IBA on a periodic basis. Banks may consider offering floating rate products linked to the Base Rate, IBBR or any other

[1] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=761#C7

floating rate benchmark ensuring that at the time of sanction, the lending rates should be equal to or above the Base Rate of bank. To begin with, IBBR may be used for home loans. By design, the IBBR should meet the standards for benchmarks set by the Committee on Financial Benchmarks (Chairman: Shri P Vijaya Bhaskar, Executive Director, RBI).

(Paragraph 4.44)

0.26 Apart from the issues underlying pricing of credit, the WG studied international standards and regulations on consumer protection. Many international bodies and regulators have focused attention on consumer protection and conducted studies and surveys as well as published reports and issued guidance. It is observed that consumer protection measures in various jurisdictions broadly focus on disclosure and transparency, regulations for equality and against unfair trade practices. Protection in this regard is enforced either through Laws/Statutes/Acts or stipulations by regulators. In addition, industry associations have also developed self-regulatory codes of practices. In India, banks are guided on consumer credit protection and customer service by instructions/ regulations/directions from the RBI and guidance from BSCBI, apart from protection under the Customer Protection Act 1986.

0.27 The Consumer Protection Act, 1986 which provides the statutory framework for consumer protection, also covers the banking services and provides a dispute resolution framework. However, there is anecdotal evidence that in this framework, the entire process may be time consuming.

0.28 The directives, guidelines and advisories issued by the Reserve Bank of India enumerate the regulatory measures regarding consumer protection / customer service. They cover individual products / services as also the grievances redressal mechanism that each bank is mandated to put in place.

0.29 Banks have also adopted fair practices code / lenders liability code and codes of the Banking Codes and Standards Board of India (BCSBI) which are in the nature of self-regulatory measures which each bank is expected to adopt with the approval of the Board of Directors and place in the public domain.

0.30 With respect to grievance redressal, the Banking Ombudsman Scheme (2006) of the RBI serves as an alternate dispute resolution mechanism for deficiencies in banking services that have been clearly delineated. This is a cost free service aimed at helping the common person / small enterprises who may have limited means to approach a court of law or a consumer court for resolution of their grievances.

0.31 Thus it may be seen that for handling disputes, institutional and structural arrangements are in place. However, the WG felt that the grievances redressal systems in banks should be made robust and responsive to customers' needs.

0.32 In the area of consumer protection, the WG has following recommendations to make:

Recommendation 8

The WG reiterates that banks should publish their interest rates, fees and charges on their websites for transparency, comparability across banks and informed decision making by customers. In addition, it is recommended that the banks should disclose the interest rate range of contracted loans for the past quarter for different categories of loans along with the mean and median interest rates charged.

- **Fees and charges must be clearly disclosed at the time of account opening and made available to the customers at all times through various communication channels.**

(Paragraph 6.23)

Recommendation 9

The WG recommends that banks may provide a range of Annual Percentage Rate (APR) or such similar other arrangement of representing the total cost of credit on a loan on annualized basis that will allow customers to compare the costs associated with borrowing across products and / or lenders. However, the applicable APR should get crystallized in the loan covenant with the customer.

(Paragraph 6.24)

Recommendation 10

The WG recommends that the terminology used by all banks must be standardized so as to enhance/ facilitate comparability. A glossary/ list of terms standardised for all banks and for all bank accounts offered to customers may be drawn up and mandatorily be included at the end of the loan offer documents and sanction letters. These may be displayed on the websites of banks. The initiative for creating a standardised terminology may be taken by IBA.

(Paragraph 6.27)

Recommendation 11

(i) The WG recommends that the Reserve Bank may clearly specify the information to be included in credit agreements, including a standard format for a summary box to be displayed on the credit agreement. Besides banks may be mandated to provide a clear, concise, one-page key facts statement/fact sheet to all retail/mortgage borrowers at every stage of the loan processing as well as in case of change in any terms and conditions. This would give customers a simple summary of the important terms and conditions (tenor / fees/ interest rate / reset dates) of the financial contract.

(ii) The WG also recommends that a standardized loan format may be prepared by IBA for retail customers covering terms and conditions including *inter-alia* the periodicity of reset and provisions for re-fixation of spread in an unambiguous and simplified language

(Paragraph 6.28)

Recommendation 12

The WG recommends that the benefit of interest reduction on the principal on account of pre-payments should be given on the day the money is received by bank without waiting for the next EMI cycle date to effect the credit.

(Paragraph 6.29)

Recommendation 13

The WG recommends that both banks and the RBI may impart Financial Education through consumer education drives.

(Paragraph 6.30)

Recommendation 14

(i) The WG recommends that for the retail loans, the customers should have a choice of "with exit" and "sans exit" options at the time of entering the contract. The exit option can be priced differentially but reasonably. The exit option should be easily exercisable by the customer with minimum notice period and without impediments. This would address issues of borrowers being locked into contracts, serve as a consumer protection measure and also help enhance competition.

(ii) The WG also recommends that IBA should evolve a set of guidelines for easier and quicker transfer of loans, particularly mortgage/housing loans. There could also be penalties for banks which do not cooperate with borrowers in this regard.

(Paragraph 6.31)

Recommendation 15

The WG recommends that the industry association, IBA, should do the following:

- **a. Develop case studies and examples of best practices for customer service;**
- **b. Conduct studies to identify areas of best market conduct practices for improvement;**
- **c. Conduct training for industry representatives.**

(Paragraph 6.32)

Recommendation 16

The WG reiterates that the grievances redressal systems in banks should be made robust and responsive to customers' needs. The senior management of

banks should pay particular attention in this regard. Banks which do not put in place adequate measures, as evidenced by repeated complaints, may be penalized by the RBI.

(Paragraph 6.25)

CHAPTER 1

Introduction

1.1 The price of credit, as reflected in lending rates, plays a significant role in encouraging economic activity. As per economic theory, lower interest rates spur economic activity and propel growth while higher interest rates help to contain exuberance and moderate credit and, eventually, economic growth. Policy makers, therefore, attach a lot of importance to the interest rate channel of transmission of monetary policy and endeavour to improve the effectiveness of such transmission.

1.2 Fair pricing of credit is very critical for both lenders as well as borrowers. In fact it has a direct bearing on earnings and profits of a lending bank. Pricing of credit should be done in such a way so as to generate adequate return (return on equity (ROE) and return on assets (ROA)) for banks, as also, ensuring optimal Risk Adjusted Return on Capital (RAROC). The effectiveness of loan pricing ultimately impinges the prudential aspects of bank in terms of capital adequacy, asset quality, management, and earnings, etc.

1.3 According to Stiglitz and Weiss (1981)[2], in a world with perfect and costless information, a bank would stipulate precisely all actions which a borrower could undertake (which might affect the return to the loan). However, bank is not able to directly control all actions of the borrower; therefore it will formulate the terms of the loan contract in a manner designed to induce the borrower to take actions which are in the interest of bank as well as to attract low risk borrowers.

1.4 Efficient and fair pricing of credit could be assumed to be serving the following three objectives:

a. Flexibility to lenders enabling them to adjust the rates quickly to the dynamic economic scenario so that they remain competitive and profitable.

b. Effectiveness of the monetary policy so that the policy signals are quickly and adequately transmitted to the financial system to achieve the objectives of the monetary policy.

[2] Joseph E. Stiglitz and Andrew Weiss (1981) “Credit Rationing in Markets with Imperfect Information”.

c. Protection to consumers from unfair practices of lenders, by being transparent and non-discriminatory.

1.5 Interest rate regulation in India has traversed a long path (as explained in Chapter 3) from the days of the administered regime till the early 1990s to the deregulated regime prevailing now. Banks have been permitted to set their own lending and deposit rates excepting a few segments such as DRI scheme where administered rates still prevail. To ensure, however, that such flexibility is judiciously deployed and borrower interests are taken care of, certain guidelines have been prescribed from time to time. The Prime Lending Rate (PLR) system gave way to the Benchmark Prime Lending Rate (BPLR) system which is recently replaced by the Base Rate system.

1.6 The Base Rate system was expected to bring in more transparency and consistency to the interest rate framework and also enhance the effectiveness of the monetary policy. While it is too early to assess its success in enhancing the effectiveness of the monetary policy, the Base Rate regime seems to have addressed the gaps noticed in the erstwhile regime of BPLR.

1.7 There have however been some concerns from the customer service perspective which needed a review of the pricing of credit by banks. Customer complaints essentially arose on the following:

a. ***Downward stickiness of the interest rates***: Banks have been quicker in increasing their interest rates in response to policy tightening than in decreasing interest rates when the policy turned more accommodative. This asymmetric response to policy rate not only impinges on the effectiveness of the monetary policy but also leads to borrower dissatisfaction.

b. Discriminatory treatment of old borrowers vis-à-vis new borrowers: Borrowers have represented that banks have been more generous with the new borrowers in offering them lower rates in comparison to the rates charged for the old borrowers.

1.8 There have also been other complaints regarding administrative issues such as delay in sanctions, non-communication of the decision of non-sanction, inadequate dissemination of information to the borrowers, and lack of standardized procedures, etc.

1.9 Reserve Bank announced in the Second Quarter Review of Monetary Policy in October 2011 that a Working Group will be constituted to examine the issues related to discrimination in pricing of credit and recommend measures for transparent and appropriate pricing of credit under a floating rate regime. Accordingly, a Group was constituted under the Chairmanship of Shri Anand Sinha, Deputy Governor, Reserve Bank of India comprising members from banks, IBA, Academia and the Reserve Bank of India. The constitution of the Group is as follows:

Sr. No.	Name and Designation	Bank / Institution
1.	Shri Anand Sinha, Deputy Governor	RBI
2.	Shri B. B. Joshi, Executive Director*	Bank of Baroda
3.	Shri Supriyo Chaudhuri, Chief General Manager**	State Bank of India
4.	Shri Sashi Jagdishan, Country Head- Finance	HDFC Bank
5.	Shri Badri Nivas, Director	Citibank N.A.
6.	Shri Manish Dhameja, Regional Head	Standard Chartered Bank
7.	Dr. Rajendra Vaidya, Professor	IGIDR
8.	Dr. T. T. Ram Mohan, Professor	IIM, Ahmedabad
9.	Shri K. Unnikrishnan, Deputy Chief Executive	IBA
10.	Shri Amitava Sardar, Adviser@	DEPR, RBI
11.	Shri D G Kale	GM, CSD
12.	Shri, Chandan Sinha, PCGM+, Member Secretary Of the Working Group	DBOD, RBI

* Shri Rajiv Kumar Bakshi was replaced by Shri B. B. Joshi

** Shri Bhaskar Niyogi was replaced by Shri Supriyo Chauduri

+ Shri Deepak Singhal was replaced by Shri Chandan Sinha

@ Dr. Janak Raj was replaced by Shri Amitava Sardar

1.10 The terms of reference to the Group are as under:

a. to review the current international practices and the practice in India for pricing of floating rate loan products and determination of the credit spreads

b. to suggest the components of credit spread and appropriate pricing of floating rate loan products

c. to suggest measures to improve transparency in pricing and loan documentation and

d. to consider any other issue relating to pricing of floating rate loan products.

1.11 The Report is organised as follows. Chapter 2 reviews the current international practices for pricing of floating rate loan products and determination of credit spreads. Chapter 3 studies the evolution of lending rates regulation in India. Chapter 4 enumerates various issues underlying consumer complaints vis-à-vis pricing of loans by banks and the measures suggested by the Group to improve transparency in pricing of loan. Chapter 5 details the international best practices in consumer protection adopted by various regulators. Chapter 6 lists the existing consumer protection framework in India and suggestion for improvement therein.

CHAPTER 2

Floating Rate Loans Pricing and Credit Spreads - International Practices

2.1 Banks are the most important entities in the financial system and contribute significantly to the economic development of a country. Through their primary activity of financial intermediation, they connect the surplus and deficit economic agents. Banking business primarily pivots around accepting deposits and lending funds, thereby profiting from the difference between the interest paid to the depositors and charged to the borrowers. For a bank to make profit, this difference should be positive.

2.2 The principle of demand and supply applies to the pricing of credit by banks. The interest rate that is charged by a bank depends on the extent of demand from borrowers as also, on the lendable funds available with a bank.

2.3 Though it may appear to be simple, the dynamics of managing asset and liability by a bank are quite tedious. The liabilities or the source of funds for a bank can be manifold. Apart from deposits which form the largest source of funds for banks, they also rely on the money, capital and foreign exchange markets to source funds for lending. However, it is the CASA or Current Account-Savings Account deposits that form the bulk of as well as the cheapest source of funds for banks.

2.4 On the other hand, banks lend funds to borrowers after carrying out necessary credit appraisal and due diligence and thereafter, charge them interest accordingly. The interest rate charged to the borrowers can be determined by banks based on fixed rules or discretion. Under rules based lending, banks may use models to arrive at the interest rate that may be charged to the customers. A number of research papers have endeavoured to model the factors that may determine the lending rates. Some of these studies have been annexed at Annex I.

2.5 While rule based lending leads to interest rates that are based on pre-defined factors, lending based on discretion allows flexibility to banks in terms of considering customer specific attributes also. These factors may include the size of loan, size of

company, predictive power of model, riskiness of firm, and switching cost for a firm, etc.

2.6 Discretion based lending can result in subjective decision making and may lead to discrimination amongst customers in pricing of loans. Banks may also adopt a hybrid strategy by adding an overlay of discretion to the outputs generated by the credit pricing models. At any point in time, there is always a trade-off between rule based lending as against discretion based lending. There have been some studies that have identified situations where discretion based lending may be practiced.

2.7 Depending upon the size of loan, relationship, competition, etc., a bank may decide whether a loan needs to be priced on the basis of rules using statistical models (Cerqueiro, Degryse and Ongena, 2007)[3]. Transactions lending (or rule based lending) is based on quantitative data whereas relationship lending (or discretion based lending) is based on qualitative information.

2.7.1 Banks may use rule based lending where their loan-pricing models have higher predictive powers. Else, they may be constrained to use discretion.

2.7.2 Discretionary lending practices may also stem from market imperfections, such as information asymmetry, imperfectly competitive credit market structures, regulatory constraints, etc. These market imperfections allow unfair advantage to banks over borrowers.

2.7.3 Larger firms with better information have a comparative advantage in rule based lending, while smaller institutions have a comparative advantage in discretion based lending. Size of a loan is dependent on the size of business and has an immediate bearing on the pricing of the loan. It is generally accepted that smaller loans attract higher interest rates (Benston, 1964)[4]. The inverse relationship between interest rates and the size of loans may be construed as a discrimination against small loans and hence, against smaller businesses. This may be due to the fact that in most cases, demand curves of loans for small

[3] Geraldo Cerqueiro, Hans Degryse, Steven Ongena, [2007], 'Rules versus Discretion in Loan Rate Setting'.
[4] George J. Benston, [1964], 'Commercial Bank Price Discrimination Against Small Loans: An Empirical Study'

businesses are likely to be inelastic as compared to large businesses that have multiple options to raise funds.

2.7.4 Further, it has been observed that switching costs are proportional to the size of the firm. Larger firms are likely to be well audited, have copious public information and multiple creditors, and hence are likely to have lower switching costs. Borrowers with low switching costs face rule based prices, while those with high switching costs face discretion in pricing (Bester, 1993)[5].

2.7.5 Higher the risk in the firm, and greater the opaqueness, there would be more "discretion" in loan pricing.

2.7.6 Stronger ties of a bank with a firm imply less uncertainty for a lender, and hence less "discretion". This correlation stems from the informational advantage a lending bank may have over its competitors.

2.8 Interest rate on a floating rate loan has two components – a benchmark rate and a spread.

Benchmark

2.9 For pricing of a loan, a benchmark or a perfectly competitive rate is required, against which deposit and loan rates can be compared. Globally, the London Interbank Offered Rate (LIBOR) has been the rate banks quoted to each other for overnight deposits and loans. Being an international rate to which all banks have access, LIBOR used to be treated as a proxy for the perfectly competitive loan rate, though the recent turn of events have undermined its popularity.

2.10 A floating interest rate is expected to move synchronously with the benchmark rate on which it has been priced. However, Heffernan (2006)[6] has shown that there is likely to be a lag in price adjustment to changes in LIBOR. Even the deposit and loans rates are unlikely to respond to changes in LIBOR immediately.

[5] Helmut Bester [1993], 'Bargaining versus Price Competition in markets with Quality uncertainty'.
[6] Shelagh Heffernan, [2006], 'UK bank services for small business: How competitive is the market?'

2.11 Globally, the pricing of loans is done on a cost plus approach, i.e., a benchmark rate *plus* a spread. The benchmark used for the purpose can be the interbank market rate (Brazil, Poland and South Africa) or the overnight money markets rates. In US, it can be based on US prime rate, which is broadly determined as a 300 bps spread over the Fed Funds rate or any other benchmark such as the Cost of Funds Index or the Wall Street journal (WSJ) prime rate. The PLRs in these countries tended to have moderate to high correlation with central bank policy rate. A list of various benchmarks used globally is annexed at Annex II.

Spread

2.12 Under the cost plus approach, interest rates are determined by adding a spread over the benchmark rate. The spread comprises product specific operating cost, credit risk premium, tenor premium, etc. Several research papers are available in the public domain that have endeavoured to identify the components that have a bearing on the spread as also, to develop a model for pricing the spread.

2.13 According to standard economic theory, presence of a dominant bank or financial institution may lead to higher costs for the customers which may get accentuated in the absence of perfect competition. This in turn may also lead to reduced access of borrowers to loans. If the dynamics of informational asymmetries and agency costs are considered, there is a possibility of adverse selection, thereby benefitting a borrower in terms of easy (and cheaper) access to loans.

2.14 Petersen and Rajan (1995)[7] show that "…banks with market power have more incentives to establish long-term relationships with young borrowers, since they can share in future surpluses". Further, "…small firms are more likely to receive financing at a lower cost in more concentrated local banking markets in the U.S".

2.15 Cetorelli and Peretto (2000)[8] show that though the aggregate amount of loanable funds may get reduced due to concentration of banks, lending may get

[7] Mitchell A. Petersen and Raghuram G Rajan [1995], The Effect of Credit Market Competition on Lending Relationships.

[8] Cetorelli Nicola, and Pietro F. Peretto, [2000], Oligopoly banking and capital accumulation.

efficient due to better screening of the borrowers as banks have advantage of better availability of information. Therefore an oligopolistic market may be an optimal banking market structure if compared with monopolistic market or a perfect competition market, offering better prices to the customers. However, Hannan (1991) has shown that that there is a great association between concentration and higher interest rates in the US banking markets.

2.16 Beck, Demirgüç-Kunt and Maksimovic (2003)[9] have shown that restricting banks' activities might increase competition in an area. They also worked on the ownership structure of banks and have indicated that ownership structure influences access to and costs of external financing. Government owned banks may be mandated to lend to certain sector or a set of borrowers as such banks do not intend to maximize their profits. As compared to foreign banks, domestically owned banks may be more willing to do business with 'opaque borrowers' as they have superior information gathering system and better enforcement mechanisms. Hence, the ownership structure also has a say in access to loans and can influence the cost of loan.

2.17 In a research paper by Sumon C. Mazumdar and Partha Sengupta[10], the spread is shown as a function of a number of factors including the size of a loan, its maturity, and collateral, etc.

2.18 In another research paper by Maria Soledad, Martinez Peria and Ashoka Mody[11] on Latin American countries, spreads were studied vis-à-vis foreign participation and market concentration. According to the study, foreign banks charge lower spreads, possibly due to lower cost of operations. New establishments or *de novo* banks operate with particularly low spreads. The authors feel that the possible reason for cost reduction may be a manifestation of demonstration effect and potential competition where banks may be targeting the competing banks' customers, thereby benefiting bank clients. In the case of domestic banks, greater

[9] Thorsten Beck, Asli Demirgüç-Kunt, and Vojislav Maksimovic, World Bank Policy Research Working Paper 2996, March 2003

[10] Sumon C. Mazumdar and Partha Sengupta, [2005], Disclosure and the Loan Spread on Private Debt.

[11] Maria Soledad Martinez Peria and Ashoka Mody, [2004], How Foreign Participation and Market Concentration Impact Bank Spreads: Evidence from Latin America.

concentration raises spreads, as higher concentration may increase administrative costs.

2.19 Study of various research papers provided useful insight into the models that are used for pricing of loans. Further, it emerged that banks use both rules and discretion based pricing strategies, or even a hybrid strategy containing elements of discretion in a rule based approach. Pricing depends on various factors like the type of model used, availability of information, competition, size of the loan, and switching cost, etc. Further, the papers also provided information on factors that may have a bearing on pricing of the spread of a floating rate loan such as concentration of banks, ownership, collateral, etc. However it is evident that there is no one uniform or best way for pricing of credit and that the pricing by banks is dependent on the strategy pursued.

CHAPTER 3

Evolution of Regulation of Lending Rates in India

3.1 Pricing of credit is regulated by the RBI in terms of the powers vested with it under Section 21 of the Banking Regulation Act, 1949 which deals with the power to control advances made by banking companies. Prior to financial sector reforms of the 1990s, the regulation of pricing of credit was by way of prescription of sector-specific quantum and tenor based interest rates. The exact modalities for arriving at the amount of loan that can be granted were also indicated during the administered interest rate regime, regulated by the Reserve Bank of India till the late 1980s.

3.2 In October 1994, as a major step towards deregulation of lending rates, banks were permitted to determine their own lending rates for credit limits over ₹ 2 lakhs. The rates were to be determined with reference to a Board approved benchmark. The benchmark was the Prime Lending Rate (PLR) of a bank. The PLR was the minimum rate charged by banks for credit limit of over ₹ 2 lakhs.

3.3 In February 1997, banks were allowed to charge interest rate on loan and cash credit components separately, based on PLRs and spreads (over PLRs), as approved by their Boards.

3.4 Further, to distinguish between the tenor of loans, a separate Prime Term Lending Rate (PTLR) was introduced in October 1997 for term loans of three years and above and PLR was used for granting short-term loans. In April 1998, to ensure that the small borrowers are not charged at the same rate, PLR was prescribed as a ceiling rate on loans below ₹ 2 lakh.

3.5 In April 1999, the concept of Tenor Linked Prime Lending Rate (TPLR) was prescribed to operate as different PLRs for different maturities. Banks were also given the additional freedom to charge certain categories of loans without reference to the PLR in October 1999 and in 2000-01, banks were permitted to charge fixed/ floating rates on all loans with credit limit of more than ₹ 2 lakh with PLR as the reference rate.

3.6 The Mid-Term Review of the Monetary and Credit Policy for the year 2002-03 observed that both PLR and spread varied widely across banks/bank-groups. Since in a competitive market, PLRs among various banks/bank-groups should converge to reflect credit market conditions and the spreads around the PLR should be reasonable, banks were asked to review both their PLRs and spreads and to align spreads within reasonable limits around PLRs. However, the divergence in PLR and the widening of spreads between bank borrowers continued to persist. Moreover, the prime lending rates continued to remain rigid and inflexible in relation to the overall direction of interest rates in the economy.

3.7 In order to enhance the transparency in banks' pricing of their loan products as also to ensure that the PLR truly reflects the actual costs, banks were advised to price their advances with reference to a new benchmark- Benchmark PLR (BPLR). The BPLR was determined by taking into account the (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirement of provisioning / capital charge and profit margin.

3.8 Since all lending rates could be determined with reference to the BPLR by taking into account term premia and / or risk premia, the system of tenor-linked PLR was discontinued. These premia could be factored in the spread over or below the BPLR.

3.9 The above prescriptions led to a situation whereby banks could lend below BPLR. By December 2009, sub-BPLR lending was about 65.8 per cent of aggregate lending. There were several complaints from borrowers regarding levying of excessive interest on certain loans and advances like credit card dues. The benchmark prime lending rate (BPLR) system had, thus, fallen short of expectations in its original intent of enhancing transparency in lending rates charged by banks.

3.10 More importantly, the BPLR tended to be out of sync with market conditions and did not adequately respond to changes in monetary policy. On account of competitive pressures, banks were lending a part of their portfolio at rates which did not make much commercial sense. This tendency to extend loans at sub-BPLR rates

on a large scale in the market continued to raise concerns on transparency and cross-subsidisation in lending (large borrowers cross subsidized by retail and small borrowers).

3.11 To address the drawbacks in the BPLR system, the Base Rate system was introduced on July 1, 2010 to make the lending rates transparent, forward looking and sensitive to the Reserve Bank's policy rate. Since the system of pricing under the Base Rate will invariably be at a rate which is 'cost plus', it would make more commercial sense. The Base Rate system is considered more transparent since the borrower knows that there cannot be any sub-Base Rate lending except for the exempted categories and any change in the Base Rate will equally affect all the borrowers with floating rate.

3.12 Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. Banks may choose any benchmark to arrive at the Base Rate for a specific tenor that may be disclosed transparently. One of the ways this can be done is that the base rate may comprise a bank's cost of deposits / funds, negative carry on CRR and SLR, unallocatable overhead cost and average return on net worth. However, banks are free to use any other methodology, as considered appropriate, provided it is consistent, and is made available for supervisory review/scrutiny, as and when required.

3.13 Banks may determine their actual lending rates on loans and advances with reference to the Base Rate and by including such other customer specific charges as considered appropriate. The actual lending rates charged should be transparent and consistent and be made available for supervisory review/scrutiny, as and when required.

3.14 Changes in the Base Rate shall be applicable in respect of all existing loans linked to the Base Rate, in a transparent and non-discriminatory manner.

3.15 The methodology of computing the floating rates should be objective, transparent and mutually acceptable to counter parties. The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from 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. This methodology should be adopted for all new loans. In the case of existing loans of longer / fixed tenure, banks should reset the floating rates according to the above method at the time of review or renewal of loan accounts, after obtaining the consent of the concerned borrower/s.

CHAPTER 4

Pricing of Floating Rate Loans in India - Underlying Issues

4.1 The existing regulatory framework allows banks to offer all categories of loans on fixed or floating rates, subject to conformity to their Asset-Liability Management (ALM) guidelines. The methodology of computing the floating rates should be objective, transparent and mutually acceptable to counter parties. The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from 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 [12].

4.2 For floating rate loans, banks add a spread reflecting the product specific operating cost together with term premium and credit risk premium to a benchmark. While using Base Rate as the benchmark, ideally the interest rate charged to a customer should not change at the time of reset unless (a) there is a change in the Base Rate or (b) there is a change in the credit profile of a customer thereby leading to change in credit spread charged. Further, in case there is a change in the policy rate by the Reserve Bank, it should impact the Base Rate, albeit with a lag, and not the spread component of the interest rate. Any deviations from these may lead to customer dissatisfaction, which may accentuate if there is a lack of transparency in pricing of loans by banks.

4.3 A general rise in customer awareness and improvements in the Banking Ombudsman Scheme has encouraged customers to raise issues affecting them. One of the oft repeated queries is the interest rate charged on advances. There have been instances where the spread charged to a customer had been revised upward frequently during the tenure of a floating rate loan, despite no adverse change in the credit profile of the customer. Customers did not have adequate information about the working of a floating rate loan and felt that they had to pay a higher rate due to upward revision of the benchmark in a rising interest rate scenario but banks were very slow in adjusting the base rate and extended loan at a lower rate to new

[12] Master Circular - Interest Rates on Advances

customers. Hence, the existing customers did not get the same benefit in a falling interest rate cycle. This has resulted in the existing customers finding themselves at a disadvantage as compared to the new customers with the same credit profile, resulting in existing customers complaining about discrimination.

4.4 Discrimination between new and existing home loan customers with floating rate of interest is a long standing issue of discontent with the customers of banks. The dissatisfaction is more pronounced in longer tenure loans with floating interest rates. Since interest rates on long term retail loans, like home loans, are based primarily on the quantum of loan and involve less of individual credit rating, the rationale for charging different spread in similar loans is not apparent.

4.5 Apart from the issue of arbitrary change in the spread for existing customers, there have been instances of customers with similar credit profile being charged different spreads at a given point in time. Moreover, customers with similar credit profile coming to a bank at different points in time have been charged different floating interest rates, with no change in either the RBI policy rate or the credit profile of the customers.

4.6 Ideally, any change in the policy rate should impact the benchmark rate but not the spread charged to the customer. However, any change in the credit profile of the customer may alter the spread charged. A change made in the spread due to change in policy rate is likely to be perceived as discriminatory.

Pricing of loan - Benchmark Rate

4.7 In the context of floating rate loans, it is important to assess the effectiveness of the transmission of the RBI policy rate to the benchmark. A good lending rate benchmark should be responsive to changes in the policy rate of the central bank. It is only then that the central bank can achieve the desired objectives through monetary policy actions. The success of conduct of monetary policy eventually depends on the strength and speed of the transmission of monetary policy impulses.

4.8 The WG studied the experience on transmission of monetary policy of some countries. Cross-country study on the transmission of monetary policy impulses to bank deposit and lending rates across USA and major European countries reveals

that the pass-through to both short- and long-term interest rates is far from complete and presents evidence of heterogeneity across various retail products and banks. Importantly, the study has also thrown factors that are conducive for faster and stronger pass-through as also, those factors that are likely to impede the pass-through.

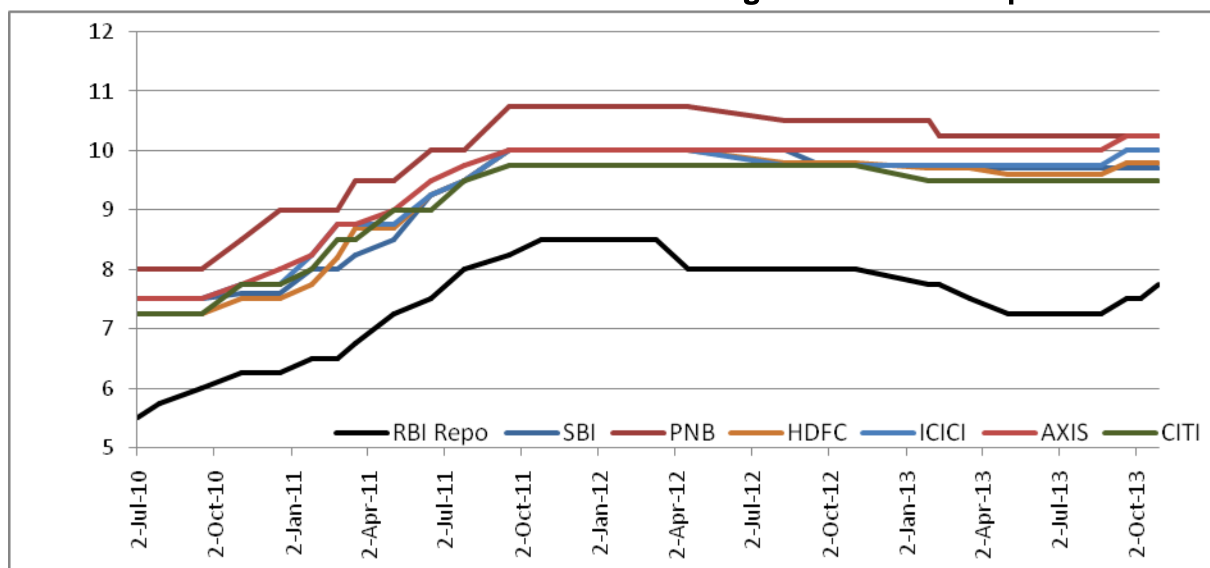
Conducive factors	Impeding factors
Better asset quality in the banking system	Large fiscal dominance
Stronger competition in the banking system	Higher share of core deposits in total liability
Lower volatility in money market	Excess liquidity in the system
Higher overhead costs	Well capitalised banking system
Higher inflationary environment	
Larger mobility of capital	

4.9 Ideally, banks with lower cost of funds aided by higher CASA may not necessarily increase the lending rates when the policy rate is increased as long as their margin expectations are fulfilled. These banks can leverage this advantage to maximise their respective market shares. On the other hand, such banks may try to reduce the Base Rate as soon as the policy rate is moderated (as they already enjoy lower cost of funds) and hence, to maximize their market share, they may not want to wait till the impact of reduction in policy rate is fully felt on their respective cost of funds.

4.10 It can also be argued that the RBI policy rate is at best, a signal/ symbolic rate that indicates where the interest rates are headed in the economy and hence, individual banks may take the necessary judgement call on changes in their interest rates in response to the change in the policy rate depending upon their cost of funds and strategy, etc.

4.11 However, the movement in the Base Rate of a few banks vis-à-vis the RBI repo rate indicates that while the increase in policy rate led to a corresponding increase in the Base Rate of banks, the Base Rate showed “stickiness” and did not come down quickly enough when there was reduction in the policy rate (Chart 1).

Chart 1: Base rate of select banks against the RBI Repo rate



4.12 Further, looking at the responsiveness of the Indian banks in terms of change of their Base Rate in response to changes in the policy rate by the Reserve Bank of India, it could be seen (Table 1) that the pace of increase in the Base Rate relative to that of the repo rate slowed down as larger banks kept their Base Rates unchanged, possibly due to gradual moderation in the growth of economic activity and the resultant slowdown in the growth of non-food credit, in particular from end-May 2011 to end-March 2012. Subsequently, as the RBI reduced its repo rate in phases by 125 bps during April 17, 2012-September 19, 2013, 33 banks accounting for around 75 per cent of aggregate credit reduced their Base Rates by, on average, 40 bps during the period. On an average, these banks revised their Base Rates with a longer gap of 591 days, indicating downward rigidity during the reverse cycle of interest rates. Banks reduced their modal base rate by 50 bps and the weighted average lending rates (WALR) by 37 bps during the same period (Table 1). During September 20-October 29, 2013, when the Reserve Bank raised the repo rate in two steps of 25 bps each to 7.75 per cent, 7 banks accounting for around 14 per cent of aggregate credit increased their Base Rates by, on average, 2 bps during the period. On an average, these banks revised their Base Rates with a relatively lower gap of 206 days than that during reverse cycle of interest rates. The modal base rate though remained unchanged at 10.25 per cent during the period, WALR reduced marginally by 6 bps

Table 1: Extent of Change in both Deposit Rate and Base Rate and Time Taken by Public/Private Sector Banks in effecting these changes consequent to change in the policy rate

Period (Month-end over Month-end)	Change in Repo Rate (bps)	Change in Cash Reserve Ratio (CRR) (bps)	Change in deposit rate (bps)	Average change in Base Rate (bps)	Average no. of days taken to change Base Rate*	No. of banks changed the Base Rate	Share of credit of banks that changed their Base Rate (%) #
Jul 10 - Dec 10	75	-	25-325	58	141	41	93.1
Dec 10 - Mar 11	50	-	25-450	73	96	47	96.5
Mar 11 - May 11	50	-	10-275	55	85	38	89.0
May 11 - Oct 11	125	-	05-425	95	129	46	94.5
Oct 11 - Mar 12	-	-125	05-500	29	93	13	9.7
Mar 12 - Sept 13	-125	-75	(-)10-(-410)	-40	591	33	74.9
Sept 13 - Dec 13	50	-	05-150	2	206	7	14.0
Memo Item							
July 10/Dec 11	300	-	25-500	270			
Dec 11/Sept 13	-125	-200	(-)10-(-)425	-41			

- : Indicates no change. *: Since the date of last change in Base Rate. #: As at end-Period.

4.13 It may be said that stickiness in the Base Rate may be attributable, primarily, to the deposit profile of banks. Banks with considerable reliance on interest bearing deposits which are fixed in nature do not have the flexibility to pass on the impact of accommodative policy action as the cost of funding represented by the cost of fixed deposits does not decrease immediately with the policy rate cut. It is understood that generally, banks are computing their Base Rate based on the weighted average cost of deposits, and hence, their Base Rate does not lend itself to immediate downward adjustment. The full impact can be seen only when existing fixed rate deposits get rolled over to new lower rates on maturity.

4.14 From a behavioural point of view, depositors enjoy the upside of higher rates (when the policy rate increases) as they have an option of premature withdrawal and reinvestment. On the other hand, under a falling interest rate scenario, depositors benefit by continuing till maturity, with the earlier contracted higher rate deposits.

Regulations[13] allow withdrawal of rupee term deposits of less than ₹ one crore before completion of the period of the deposit agreed upon at the time of making the deposit. Banks have the freedom to determine own penal interest rates for premature withdrawal of term deposits. Banks have to inform the depositors of the applicable penal rate upfront.

4.15 However, banks do not have the same freedom as depositors have. This is because deposits form the largest source of funding and the maturity pattern is largely concentrated in fixed tenor deposits. Moreover the distribution of term deposits is tilted in favour of deposits with tenor of 1 year and above. When the policy rate goes up, the cost of deposits is likely to go up due to competition from other banks, thereby forcing banks to increase their lending rates to maintain margins. However, when the policy rate goes down, the average cost of deposits does not go down correspondingly till the existing high interest rate deposits complete their term, leading to a downward stickiness in the interest rates. It is understood that banks are unable to lower their Base Rates since the cost of funds (represented by deposit rates) does not come down.

4.16 Apart from the policy rate changes, there could be other factors that may influence Base Rate. International studies[14] have shown that banks' responses to changes in the policy rate (or market rates) in the short run depend on their size, their capital base, their recourse to funding options, etc. Well capitalized banks are observed to be reacting slowly to the policy changes as compared to banks with lesser capital.

4.17 The Working Group is of the view that the liquidity conditions in the market may also impact the behaviour of the Base Rate. At times of tight liquidity in the market, the interest rates are under pressure and the inter-bank call rates are generally above the policy rate. Under such a scenario, any easing of the policy rate may not impact the Base Rate. However, under the same scenario significant injection of liquidity say through a cut in CRR will infuse substantial liquidity into the system that

[13] In respect of bulk deposits of ₹1 crore and above, banks have the discretion to disallow premature withdrawal of a term deposit *vide* DBOD circular DBOD.No.Dir.BC.74/13.03.00/2012-13 dated January 24, 2013

[14] Leonardo Gambacorta, [2008], How do Banks set interest rates?

will lead to lowering of the interest rates, *ceteris paribus* resulting in faster transmission of policy rate. This way Banks can pass on the benefits to the customers in a more discernible manner.

4.18 The WG also looked at an important feature of the Indian banking structure, viz., pre-dominance of public sector banks whose ownership lies with the Government. These banks have been pivotal to the growth of the Indian economy and have been critical conduits to promote financial inclusion and facilitate credit to agriculture, weaker sections, SMEs, etc. Due to their sheer size and presence, the government as owner can also influence the interest rates in the markets through these banks, which may lead to stickiness in the rates.

4.19 The liability profile of the Indian banks where most of the funding is through fixed interest bearing deposits inhibits quick pass through of policy rate. Table-2 enumerates the maturity pattern of term deposits of Scheduled Commercial Banks in India.

TABLE 2: Maturity pattern of term deposits of scheduled commercial banks - 2011 to 2013

(Amount in ₹ Billion)

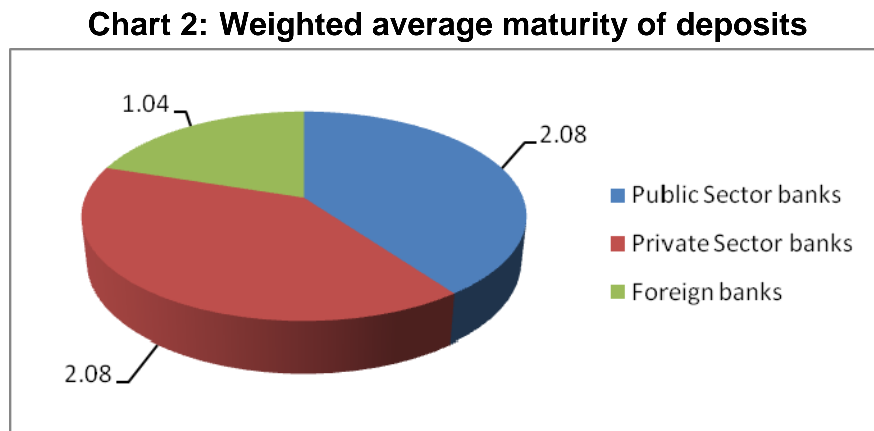
	2011	2012	2013
Deposits	**SCBs**	**SCBs**	**SCBs**
1-14 Days	4,520	4,504	5,654
Per cent to total	(8.1)	(7)	(7.6)
15-28 Days	1,760	1,762	2,071
Per cent to total	(3.1)	(2.7)	(2.8)
29 Days-3 Months	6,390	7,521	7,687
Per cent to total	(11.4)	(11.7)	(10.3)
3 Months to 6 Months	5,060	6,757	6,804
Per cent to total	(9)	(10.5)	(9.2)
6 Months to 1 Year	9,512	11,701	13,102
Per cent to total	(16.9)	(18.1)	(17.6)
1-3Years	17,043	16,986	19,741
Per cent to total	(30.4)	(26.3)	(26.6)
3-5Years	4,355	5,168	6,944
Per cent to total	(7.8)	(8)	(9.3)
Over 5 Years	7,507	10,126	12,279
Per cent to total	(13.4)	(15.7)	(16.5)
Total	**56,146**	**64,524**	**74,283**
Per cent to total	(100.0)	(100.0)	(100.0)
Weighted average maturity (in years)	**1.86**	**1.94**	**2.04**

Note : Figures in brackets represent per cent share in total.

Source : Basic Statistical Returns of Scheduled Commercial Banks in India, Volumes 39-41.

Chart-2 represents the weighted average maturity of deposits.

Chart 2: Weighted average maturity of deposits



4.20 Given the higher weighted average maturity of deposits and their being on fixed rate basis, banks compute Base Rate primarily using the average cost of funds which does not move in tandem with the policy rate. The changes in the weighted average rate would obviously be lesser than the changes to the policy rate. Illustratively, if a bank having Rs.100 liabilities at a cost of 8%, mobilizes additional wholesale liabilities of ₹ 10 at 7% (lower rate due to softening of policy rate), it has two alternatives of pricing its credit. If it adopts marginal cost, it would lend the new loans based on the cost of funds of 7%. Alternatively, it can spread the benefit of lower cost of new liabilities over the entire loan portfolio and revise its Base Rate lower (if that is computed on average cost basis) so that it can lend based on the cost of funds of 7.9%. If the older liabilities (assuming they are contracted at fixed rates like in the case of term deposits) constitute a significant portion, bank will have to wait for all such old liabilities to mature and get rolled over for overall cost to come down significantly below 8%. It appears that some banks find it competitively more attractive to change the spreads and offer the benefit of lower cost of new liabilities to new borrowers rather than effecting Base Rate revision which would impact all borrowers but the impact would be negligible because as illustrated above the Base Rate would be left virtually unchanged. Banks may perceive greater strategic value in extending new loans at lower rates due to lower marginal cost of funds.

4.21 Currently, the deposit profile is predominantly fixed rate, while the loans, especially the home loans are predominantly floating rate. The effect of stickiness in

the floating rate loans can be mitigated if such loans are funded by similar liability, i.e. longer term floating rate deposits, thereby making it symmetrical to sensitivity in policy rate. The WG noted that though the regulations do not impede floating rate deposits, these are not popular, and in fact these are virtually non-existent as there is already an implicit option available to the depositors in the form of premature withdrawal of low yielding deposit and replacing it with a higher yielding one (except in cases mentioned in paragraph 4.14).

4.22 Another way to achieve the convergence of profile of deposits and advances is for banks to compute their Base Rates on the basis of the marginal cost of funds. This approach would enhance the response of Base Rate to the policy rate and lead to quicker and more symmetric transmission of monetary policy signals. The pricing of other facilities based on such a Base Rate will get more quickly aligned with changes in the policy rate. Changes in pricing would be more transparent and banks will be less exposed to criticism or complaints than they are now. The WG felt that banks, particularly those whose weighted average maturity of deposits is on the lower side, may consider moving from using the weighted average cost of funds on a historical basis to using the marginal cost of funds while computing the Base Rate.

4.23 Banks whose weighted average maturity of deposits is relatively low (say, around 1 year) may find it relatively easy to migrate to marginal cost of funds to compute their Base rate and pass the benefit of lower policy rate by lowering Base Rate more quickly and thus benefit all customers – both existing as well as the new ones.

4.24 For banks whose weighted average maturity of deposits is on the high side, there would be difficulties in migrating to marginal cost of funds to compute their Base Rate.

4.25 The WG deliberated at length the appropriateness and feasibility of the use of marginal cost of funds by banks in computing their Base Rate. The WG is cognizant

of the difficulties involved in migrating to marginal cost of funds for computing Base Rate for majority of banks due to the maturity profile of deposits.

4.26 Where banks choose to continue using the historical cost of funds for computing the base rate, it would be unrealistic to expect that they would not pass on the benefit of lower marginal cost of funds to the new customers by operating on the spreads.This would imply that there could be differentiation amongst customers who enter into borrowal relationship with a bank at different points of time. However, the WG wishes to emphasise that no bank can discriminate among borrowers who get into borrowing relationship with a bank at the same time, i.e., in identical or similar funding conditions. Any difference in pricing in such cases must be based on objective criteria for determining the mark up or spread over the base rate while determining lending rate for the borrowers. It is important to be clear about what these criteria might be. In other words, on what grounds does a bank distinguish between customers who enter into a relationship with it at the same time and also have the same credit risk profile? In what follows, the WG seeks to address this question.

4.27 At the time of pricing of floating rate loans, banks add spreads to the benchmark rate to arrive at the interest rate charged to the borrower. In terms of the guidelines on Base Rate, the spread should be a function of product specific operating cost, credit risk premium and the tenor premium.

4.28 Apart from the aforesaid components of the spread, there are other behavioural factors such as competition, customer relationship and business strategy that also get factored in while determining the lending rates. In any formulation on this issue, these factors need to be considered. Banks contend that parameters such as future business potential of a customer, value of the relationship and business strategy are some ‘soft’ parameters which are difficult to quantitatively establish but surely form a part of their pricing. However, arbitrary inclusion of these factors into pricing may lead to discrimination among customers.

4.29 The WG agreed that while price differentiation among old and new customers would remain where the Base Rate is calculated on the basis of weighted average cost of deposits, price discrimination cannot be accepted. Price differentiation will imply different pricing for customers with identical credit profile due to varying conditions. One reason for difference in pricing that has been highlighted earlier is that customers may establish borrowing relationships at different point of time when the marginal cost of funding has declined due to lowering of policy rate (while the base rate remains unaffected because it is computed using historical cost of funds). To this, other factors need to be added that could result in differences in pricing between customers with identical risk profiles. At a given point in time, a bank may pursue a business strategy whereby it wishes to acquire a greater share of a product market or wants to enter into a new segment where there are established players. It may adopt an aggressive strategy and make loans to new customers at a lower rate. Value of relationship would be another factor resulting in concession in the interest rates on loans given where bank expects to gain fee-based business or deposit accounts or more business in future. Price discrimination would occur if a bank offers different prices on loans to two customers with identical credit profile and without any of the other factors mentioned above entering the picture.

4.30 WG is of the view that it will be the responsibility of the Board of bank to ensure that the customers are not being discriminated against and the differentiation in pricing of credit is occurring only due to specified factors, such as competitive conditions, customer relationship and business strategy. In order to ensure that these factors are not used arbitrarily, the Board of a bank must ensure that pricing is consistent with bank's target for Risk Adjusted Return on Capital (RAROC).

4.31 **The WG recommends that it would be desirable that banks, particularly those whose weighted average maturity of deposits is on the lower side, move towards computing the Base Rate on the basis of marginal cost of funds as this may result in more transparency in pricing, reduced customer complaints, better transmission of changes in the policy rate and improved asset liability management at banks. If banks are using weighted average cost of funds because of their deposits profile or any other methodology that may result in**

differentiation between old and new customers, the Boards of banks should ensure that this differentiation does not lead to any discrimination amongst borrowers. Discrimination would occur if a bank offers different prices on loans to customers with identical credit profile, every other factor being the same.

4.32 **The WG acknowledges that apart from factors like specific operating cost, credit risk premium and tenor premium, broad factors like competition, business strategy and customer relationship are also used to determine the spread. Banks should have a Board approved policy delineating these components. The Board of a bank should ensure that any price differentiation is consistent with bank's credit pricing policy factoring RAROC. Banks should be able to demonstrate to the Reserve Bank of India the rationale of the pricing policy.**

4.33 It was felt that these factors, viz., competition, business strategy and customer relationship, are very broad factors that may encompass a number of components. Strategy may incorporate a number of factors such as position/strategy of other banks, stage of economic cycle, bank concentration in an area, etc. Customer relationship may include factors like customers' business with bank, size of loan, size of the business of the customer and duration of ties of the customer with a bank, etc. The WG realised that it would not be practical to prepare an exhaustive list of factors that may be clubbed under business strategy and customer relationship.

4.34 Further, it is possible in this framework for a bank to arbitrarily bring in any factor as strategy or competition to price the spread, and this could put some customers at a disadvantage. Moreover, each bank may use a different combination of such factors to price the spread for relationship, strategy or competition. The WG therefore felt that the Board of a bank would be in the best position to assess the optimal bouquet of such factors that it determines should be clubbed under these parameters to price the spread. **The WG recommends that banks' internal policy must spell out the rationale for, and range of, the spread in the case of a given borrower, as also, the delegation of powers in respect of loan pricing.**

4.35 Arbitrary change in contracted spread has also resulted in complaints by the customers. It is understood that likely reasons for change in contracted spread is to adjust the impact of changes in policy rate, or any other factor like liquidity in the system, etc. The WG felt that for a given customer, once a spread has been determined after looking at all factors including customer's credit profile, customer relationship with bank, strategy, etc., such spread should not be increased except on account of deterioration in the credit risk profile of the customer. There should be a loan covenant to this effect. Apart from this, the WG felt that other externalities should not impact the contracted spread for a given customer. **The WG recommends that the spread charged to an existing customer cannot be increased except on account of deterioration in the credit risk profile of the customer. The customer should be informed of this at the time of contract. Further, this information should be adequately displayed by banks through notices/website.**

4.36 Under the current system, when the Base Rate changes, the interest rates on credit are adjusted simultaneously. This has implications for Asset-Liability management. The WG considered this aspect and is of the opinion that any change in the Base Rate need not result in an immediate change in the floating interest rates on the existing loans. The covenant of the floating rate may have mandatory reset dates (monthly, quarterly, half-yearly, etc.) and the existing loans may be reset on the dates agreed upon in the covenant. Hence, the benefit of reduction in the Base Rate shall be passed on to the customer on the reset date, whereas the new borrowers would get the reduced rate at the time of entering into the agreement. However, if the rates are increased, then the existing loan holders get the advantage of the period till the next reset date, whereas the new borrower would have to pay higher rate prevailing at that point in time. In any case, banks get benefited in terms of better risk management as they would know upfront when the rates are likely to be changed while the customers know when to expect changes in interest rates on the existing loans. **The WG recommends that the floating rate loan covenant may have interest rate reset periodicity and the resets may be done on those dates only, irrespective of changes made to the Base Rate within the reset period.**

One member, State Bank of India, however is of the view that whenever there is a change in the Base Rate, such changes should be passed on to the customers.

4.37 Though the Base Rate system has replaced the BPLR system with effect from July 1, 2010, and is applicable for all new loans and for those old loans that come up for renewal, some of the existing loans based on the BPLR system continue to be in the system and may run till their maturity. In case existing borrowers wanted to switch to the Base Rate system before expiry of the existing contracts, an option was given to them, on mutually agreed terms.

4.38 Continuation of contracts under the BPLR regime leaves an element of operational inconvenience for banks. Moreover, the intended benefit of the Base Rate regime, viz., shifting of the old BPLR linked borrowers to the Base Rate system could not manifest itself in the true sense as it is understood that those customers who shifted from BPLR to the Base Rate regime were charged a spread different / higher than the borrowers who entered newly / directly under the Base Rate system thereby again leading to discrimination between old and new customers. **The WG recommends that there may be a sunset clause for BPLR contracts so that all the contracts thereafter are linked to the Base Rate. Banks may ensure that these customers who shift from BPLR linked loans to Base Rate loans are not charged any additional interest rate or any processing fee for such switch-over.**

4.39 Apart from the Base Rate, Indian banks have been allowed to use external benchmarks to facilitate pricing of floating rate interest rates. A number of external benchmarks are available in the Indian markets, viz., Mumbai Inter-bank Offered Rate (MIBOR), G-Sec yields, Repo Rate, CP and CD rates, etc. However, these benchmarks have drawbacks - they are mainly driven by liquidity conditions in the market, as also, these do not reflect the cost of funds of banks. Further, these benchmarks are volatile and may lead to frequent changes in the floating rate.

4.40 It has been discussed in the previous paragraphs that the legacy deposits structure at some banks may prevent them from changing the Base Rate in response to the changes in the RBI policy rate. To obviate the constraints in using a bank's Base Rate as benchmark, the WG studied the benchmark indices used in different countries over which the floating interest rates loans are priced.

4.40.1 People's Bank of China on October 25, 2013, has introduced one-year Loan Prime Rate (LPR). The LPR shall be a weighted average rate based on quotes from a group of panel of nine commercial banks and would be weighted by the share of each panel bank's RMB loans in the total outstanding RMB loans. The rate shall be published daily by National Inter-bank Funding Centre. LPR is expected to further promote the market-based interest rate reform, improve the base interest rate system in the financial market, and guide credit product pricing. It will be offered by a commercial bank to its prime clients, and other lending rates can be offered by adding and subtracting basis points based on the LPR.

4.40.2 The Wall Street Journal arrives at the WSJ Prime Rate by polling Base Rate on corporate loans from 10 banks in the US. When at least 7 out of these 10 banks change their Prime rate, the WSJ updates its published WSJ Prime Rate. The loan products are priced at a spread above this prime rate. Some financial institutions use Prime rate for pricing of time-deposit products like variable-rate Certificates of Deposit. But at times loans may be offered below the prime rate such as when the loan product in question is secured, etc. US lending institutions like banks, thrifts, etc. use it as an index / base for pricing loan products. It is also offered to their preferred customers with highest credit ratings. The major advantage of using this rate is that it makes comparison between similar loan products offered by competing banks easier and more efficient. It is a single rate that is accepted across all states and is listed in the Eastern print edition of the Wall Street Journal.

4.40.3 Cost of Funds Index or COFIX reflects Korean banks' costs of funding. COFIX is announced once a month by the Korea Federation of Banks and the average maturity of loans linked to COFIX is nine to ten months. Two separate

rates, viz., COFIX on outstanding balances and COFIX on monthly acquired new funds are published separately. The short-term COFIX, introduced later reflects banks' average funding costs for short term lending with a three-month maturity, and is announced every week. The Korean COFIX was first introduced to replace the certificate of deposit (CD) rate in loan markets. The COFIX rate on outstanding balances reflects the market interest rate changes in a gradual manner, while the COFIX rate on monthly acquired new funds tends to change quickly in tandem with market rates since it is calculated based on newly financed funds.

The WG considered benchmarks available in various countries that are being used for pricing of floating rate loans (Annex II).

4.41 To improve transparency in the pricing of floating rate loans, the WG proposes a new benchmark, viz., Indian Banks Base Rate (IBBR) Index which is a Benchmark that may be derived from the Base Rates of some large banks. The details of construction and working of IBBR are annexed (Annex III). By design, the IBBR should meet the standards for benchmarks set by the Committee on Financial Benchmarks (Chairman: Shri P Vijaya Bhaskar, Executive Director, RBI)[15]. These standards include, *inter-alia,* well-defined hierarchy of data inputs, code of conduct for submitters, minimum number of submitters, and a well-defined methodology for calculation of the benchmark. Moreover, there should be a governance structure in place for benchmark administrators, benchmark calculation agents and benchmark submitters.

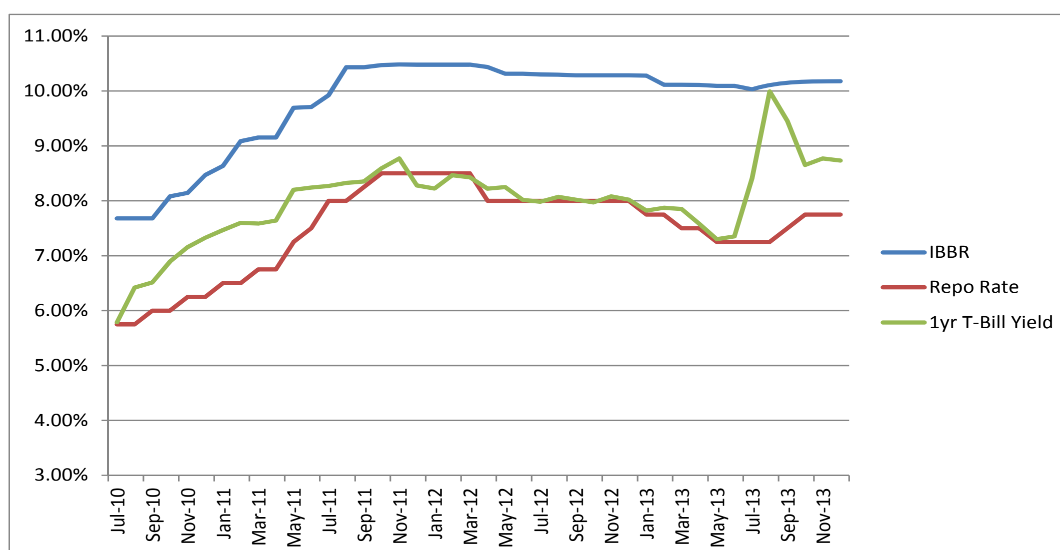
4.42 The advantage of using IBBR is that all floating rate loan pricing may move in tandem and an individual bank's specific funding advantages /disadvantages and changes in funding profile are not passed onto the customers. Further, as the IBBR will be based on major banks across the system, changes in base rate of few banks will have limited impact on the index. Being an industry-wide index, it is likely to find better acceptance than market benchmarks like MIBOR, T-bill, etc.

[15] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=761#C7

4.43 The WG observed that during the period July 2010 (Base Rate was introduced from July 1, 2010) to December 2013, the IBBR has a reasonable correlation with the RBI Repo rate (0.94) and more modest correlation of 0.77 with 1-year T-Bill. In the same period, the mean spread to Repo rate is 2.29% and to 1-year T-bill is 1.81%, with a standard deviation of 0.29% and 0.56% respectively.

IBBR vs	Repo Rate	1Y T-Bill
Correlation	**0.94**	**0.77**
Mean of spread	2.29%	1.81%
Std Dev of spread	0.29%	0.56%

Chart 3: Changes in IBBR vis-à-vis the RBI Repo Rate and 1-yr T-bill yields



4.44 **The WG recommends that IBA may develop a new benchmark for floating interest rate products, viz., the Indian Banks Base Rate (IBBR), which may be collated and published by IBA on a periodic basis. Banks may consider offering floating rate products linked to the Base Rate, IBBR or any other floating rate benchmark ensuring that at the time of sanction, the lending rates should be equal to or above the Base Rate of bank. To begin with, IBBR may be used for home loans. By design, the IBBR should meet the standards for benchmarks set by the Committee on Financial Benchmarks (Chairman: Shri P Vijaya Bhaskar, Executive Director, RBI).**

CHAPTER 5

Consumer Credit Protection – International Experience

5.1 In order to have a background of global best practices in respect of consumer protection, legislations and regulations on consumer credit in some major financial jurisdictions as well as in India, were studied, with an attempt to focus particularly on the issue of discrimination in credit pricing.

5.2 Consumer protection measures in various jurisdictions focus on disclosure and transparency, regulations for equality and against unfair trade practices. Protection in this regard is enforced either through Laws/Statutes/Acts or stipulations by regulators. In addition, industry associations have also developed self-regulatory codes of practices.

5.3 In the aftermath of the global financial crisis, many international bodies and regulators focused attention on consumer protection. Several studies and surveys have been conducted, reports published, and guidelines issued by bodies such as the Financial Stability Board (FSB), the Organisation for Economic Co-operation and Development (OECD), and the World Bank, apart from regulators of various jurisdictions such as the European Union and federations of consumer credit providers. OECD published the G20 High-Level Principles on Financial Consumer Protection in October 2011, designed to assist G20 countries and other interested economies in enhancing financial consumer protection. These principles cover the equitable and fair treatment of consumers; disclosure and transparency; financial education and awareness; responsible business conduct of financial services providers and intermediaries; the protection of consumer assets against fraud and misuse; the protection of consumer data and privacy; and complaints handling and redressal. The international measures and studies have also been drawn upon for guidance. A brief drawn from the above literature is given below.

5.4 According to a Report on Consumer Finance Protection in the area of consumer credit, including mortgages, credit cards, and secured and unsecured

loans published by the Financial Stability Board (FSB) on October 26, 2011[16], the most common elements of consumer finance protection frameworks across jurisdictions include disclosure and transparency, financial education, fair treatment and dispute resolution mechanisms. A common feature of these frameworks is the focus on responsible lending practices, with varying degrees of emphasis on preventing over-indebtedness as well as strengthening disclosure guidelines. Some jurisdictions also aim to protect consumers from over-indebtedness by placing a floor on minimum household earnings to qualify for an unsecured loan or a credit card. Generally there are binding rules for the disclosure of product features and risks to borrowers. The FSB report indicates that financial education, financial literacy and consumer protection policies should form the foundation of any regulatory and supervisory framework for protecting consumers particularly amid efforts to expand financial inclusion by reaching "unbanked" customers.

5.5 The FSB report concludes that an international organisation with a clear mandate and adequate capacity could help maintain the international momentum on consumer protection, strengthen the connection with domestic developments, facilitate engagement with consumer advocacy groups and other relevant stakeholders, and steer the work in a productive direction. It also observes that providing a global platform for consumer protection authorities to exchange views on experiences as well as lessons learnt from the crisis would help to progress the strengthening of consumer protection polices across the FSB membership and beyond. Further, potential gaps in regulatory and supervisory frameworks could be more readily identified and explored, such as the increasing use of the internet to sell credit products where jurisdictional issues exist.

Institutional architecture for consumer protection

5.6 Countries have adopted different institutional architectures for consumer protection. These could involve a single agency responsible for both financial conduct and prudential matters, a "twin peaks" model of separate financial conduct

[16]FSB report on Consumer Finance Protection with particular focus on credit dated October 26, 2011.

and prudential regulators or multiple agencies responsible for covering consumer protection. Countries like Australia, Netherlands, Belgium, France, etc., have a "twin peaks" model with a consolidated regulator of markets, conduct and consumer/investor protection separate from the (consolidated) prudential supervisor for banking and insurance. In the UK, the Financial Services Authority was (FSA) split into the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Spain, Italy and Portugal also have twin peaks features in their regulatory structure. The government is also involved in many countries, especially by way of legislative frameworks for consumer protection. The financial conduct regulators are usually responsible for enforcing consumer protection laws, handling consumer complaints, conducting financial education, enhancing disclosure etc. In general, responsible lending is outlined in regulations, consumer protection laws and industry codes of conduct e.g., Canada, Hong Kong, Russia, and Turkey.

5.7 As per the FSB report, in some jurisdictions, financial consumer protection is not an explicit goal; rather, prudential supervisory measures are seen as protecting consumers indirectly and implicitly (e.g., in Germany, the Federal Financial Supervisory Authority (BaFin) is responsible for ensuring financial institutions are in compliance with banking regulations which include the interests of investors and consumers, but consumer protection is not an explicit objective. BaFin's primary objective is to ensure the proper functioning, stability and integrity of the German financial system).

5.8 Prudential tools such as credit underwriting standards are also used in a number of jurisdictions to indirectly influence consumer credit providers to lend responsibly, e.g., Australia, Canada, Hong Kong, and Switzerland. Often consumer credit providers are also required to conduct checks with credit registers to assess the credit worthiness of borrowers e.g., China, Germany, Hong Kong, Singapore.

Engagement of consumer groups

5.9 According to the FSB Report[17], countries like France, Russia, UK, and US have established a formal process for engaging consumer groups to understand the consumer perspective so as to maintain effective and robust consumer protection framework. The process also helps in regulation by offering an early warning of potential risks to consumer protection. In the US, consumer advocacy organisations have a formal advisory role in at least three ways: (i) under federal rulemaking procedures, proposed regulations issued by the Consumer Finance Protection Bureau (CFPB) as well as by other federal agencies are published in the Federal Register for a formal comment period (ii) the CFPB has established an Office of Community Affairs which meets regularly with consumer groups, civil rights organisations, and other stakeholders to discuss the spectrum of relevant consumer financial protection issues (iii) As mandated by the Dodd-Frank Act, the CFPB has set up a Consumer Advisory Board, which will include consumer protection experts, to advise, consult with, and provide information to the CFPB.

Inter-agency coordination mechanisms

5.10 The FSB report indicates that where multiple agencies are responsible for consumer finance protection, the agencies have established coordination mechanisms. E.g., in Brazil, the various agencies have entered into an agreement for the exchange of information and technical and institutional support, with the objective of promoting coordinated actions regarding consumer protection. In the US, the CFPB has entered into information-sharing agreements with the federal prudential supervisors, as well as a number of state banking and financial regulators. The Dodd-Frank Act also requires additional agreements with respect to the overlapping authorities of the CFPB and Federal Trade Commission (FTC). The CFPB and the prudential regulators are also required to coordinate and consult with one another regarding examination, enforcement, and rulemaking matters.

Consumer Awareness

5.11 Many countries pay attention to consumer education as a means of consumer protection. This includes providing consumers with information in clear and simple

[17] FSB report on Consumer Finance Protection with particular focus on credit dated October 26, 2011.

language about the features including the risks and costs of the various types of credit products (e.g., Canada) or with clear, timely and accurate information (e.g., Singapore). In Turkey, both the Central Bank (CBRT) and other regulatory bodies pay special attention to increase awareness about risks on financial products, and provide warnings not only with press releases but also by regular reports, such as Financial Stability Report, Financial Markets Report and presentations to public by heads of regulatory bodies.

Glossaries

5.12 In Italy, the law provides that a glossary of terms used has to be included at the end of the list of fees, with the same 15 terms, standardised for all banks and for all bank accounts offered to consumers. The glossary has been drafted in cooperation with experts in communications, to ensure that the explanation be clear, understandable and user friendly. With respect to credit, in the U.S, Regulation Z which implements the Truth in Lending Act mandates that all creditors must use the same credit terminology and expressions of rates and provides for a uniform system for disclosures. These initiatives highlight the desirability of standardised glossaries (one per country) to be used by all banks in the presentation and explanation of their tariffs so as to enhance comparability between the products offered by different banks.

Disclosure and transparency

5.13 It is observed from various international practices and the FSB report[18] that banks are generally required to disclose loan features including effective costs, loan tenors and amortisation methods for mortgages. The disclosure requirements for borrowers' risks usually cover the penalties for pre-payment of mortgages, risks of repossession of underlying goods/property being financed and interest rates changing over time, and liabilities regarding unauthorised use of credit cards. E.g., in Brazil, for residential mortgages, disclosure requirements include detailed information on the outstanding debt balance and remaining term of the contract, contractual interest rates (nominal and effective), value of insurance premiums

[18]FSB report on Consumer Finance Protection with particular focus on credit dated October 26, 2011.

detailed by type of insurance, the total effective cost of the loan, which should take into account all costs incurred by the borrower, including fixed or floating interest rates, taxes, fees and other related expenses. In Canada, the Cost of Borrowing Regulations require financial institutions to provide clear information in mortgage contracts through a “summary box” that sets out key product features, such as the annual percentage rate, the amortization period and a description of pre-payment penalty charges.

5.14 International experience reveals that regulations on pricing vary across jurisdictions. Some countries, e.g., Greece, France, Italy, etc.,[19] have fixed interest rate ceilings/restrictions/caps to protect against imposition of usurious rates However, regulations regarding fixing of spread over the base rate are not observed in any of the countries.

5.15 The consumer protection architecture and measures available in a few specific jurisdictions as well as interest rate restrictions are furnished in detail in Annex IV.

[19]iff/ZEW (2010): Study on interest rate restrictions in the EU, *Final Report for the EU Commission DG Internal Market and Services*.

CHAPTER 6

Consumer Protection – Position in India and Way Forward

In India, though the Customer Protection Act, 1986, also covers banking transactions, banks are mainly guided on consumer credit protection and customer service by instructions/regulations/directions from the RBI as well as guidance from BCSBI.

6.1 The existing bank consumer protection measures in India can be broadly categorized as follows:

- Statutory measures
- Regulatory measures
- Voluntary or self – regulatory measures

6.2 The Consumer Protection Act, 1986, covers banking services, and depending upon the amount at stake, a consumer could approach the District Consumer Forum, the State Consumer Forum, or the National Consumer Dispute Resolution Forum. A perceived problem in this regard is that this Act does not address consumer issues specific to the banking sector. Further, according to anecdotal evidence, consumers find that not only is the process time consuming but they are disadvantaged by the institutions engaging the services of lawyers / advocates, even though it is not mandatory to do so under the provisions of the Act.

Regulatory measures

6.3 The regulatory measures are enshrined in the directives, guidelines, and advisories issued by the Reserve Bank of India which have been codified by way of master circulars that are in the public domain and are annually updated. The Guidelines mainly encompass non-discriminatory levy of charges, reasonableness of charges, transparency and disclosure regarding all charges levied to enable customers to take informed decisions, timely disbursal, use of recovery agents and putting in place a grievance redressal mechanism.

6.4 More details regarding the guidelines / directives which are of importance in relation to consumer protection matters are given in Annex V.

Voluntary / Self – regulatory measures

6.5 The voluntary / self-regulatory measures are by way of bank level and banking industry level initiatives. Bank level initiatives are in the nature of policies / codes of banking practices which each bank is expected to adopt with the approval of the Board of Directors and place in the public domain. An important component of these measures is the fair practices code / lenders liability code that each bank is expected to formulate. The RBI has indicated the broad contents and parameters on which the code should be framed. An effective, well-functioning and transparent fair practices code / lenders liability code may help resolve many consumer protection issues upfront.

6.6 The second set of voluntarily adopted self-regulation measures arises from banks' membership of the Banking Codes and Standards Board of India (BCSBI). The BCSBI has come up with two sets of codes addressed directly by individual member-banks to their customers, viz., Code of Banks' Commitment to Customers and Code of Banks' Commitment to Micro and Small Enterprises. The codes are affirmation of actions that a bank would take while dealing with its customers. The affirmation is not only by way of declaration but also in the way a bank would communicate with its customers and keep them informed of changes to products / services, service charges, and interest rates, etc. The thrust of the codes is on ensuring that banks keep their customers informed upfront about every aspect of the relationship including the availability of a grievances redressal system. Further, the codes are an initial step towards evolving a well-defined "treating the customer fairly" (TCF) framework. The availability of the two sets of codes may help resolve many customer issues only if the adoption and implementation of the codes is effective starting from the Board level to the branch level. The lack of awareness about the codes both among the customers and among bank staff is the major hurdle that needs to be overcome at the earliest.

6.7 Among the other voluntary initiatives are the various model codes / policies evolved by India Banks Association (IBA) for adoption by member banks.

Dispute resolution mechanism

6.8 In retail/individual banking relationships, especially those involving low income individuals, power imbalances between providers and users of banking services are substantial. An individual is unlikely to initiate and go through a legal process when subjected to unfair treatment due to insufficient resources and/or understanding. A modern banking consumer protection framework relies on two key mechanisms to address this concern. Firstly, it involves banks establishing an effective mechanism to receive and resolve customer complaints. Secondly, in case the complaint is not resolved within a reasonable time or the customer is not satisfied with the outcome, the complainant may approach a third party independent dispute resolution mechanism such as an ombudsman or a mediation service. In India we have all these institutional and structural arrangements in place. However, the grievances redressal systems in banks should be made robust and responsive to customers' needs.

6.9 Banking Ombudsman Scheme (2006) of the RBI – Notified under Section 35A of the Banking Regulation Act, 1949: The Scheme is in the nature of an alternate dispute resolution mechanism for deficiencies in banking services that have been clearly delineated. This is a cost free service aimed at helping the common person / small enterprises who may have limited means to approach a court of law or a consumer court for resolution of their grievances. By prescribing a pecuniary limit of ₹ 1.00 million, the Banking Ombudsman Schemes tries to ensure that the service is available mostly to common persons / small enterprises.

Recent Developments - Financial Sector Legislative Reforms Commission (FSLRC):

6.10 The Report of the Financial Sector Legislative Reforms Commission submitted to the Government of India on March 2013 has emphasised the need for strengthening the consumer protection and grievance redressal mechanism in the financial sector. This is considered particularly important given the low level of

financial literacy, low penetration of financial services, absence of clear regulatory mandate on composite and complex products and on the roles of product distributors and financial advisers. The report indicates that there were arguments that the Consumer Protection Act framework, as it exists today, is insufficient to deal with the growing complexities in the financial sector. There was also a suggestion for consolidating the consumer redressal mechanism by means of a single redressal agency for the financial sector.

6.11 The Commission found that the current strategy of caveat emptor ('buyer beware' approach) is not adequate in finance; regulators must place the burden upon financial firms of doing more in the pursuit of consumer protection. This perspective shapes interventions aimed at prevention (ensuring fair play) and cure (redressal of grievances).

6.12 The draft Indian Financial Code (IFC) envisaged in the Report first establishes certain basic rights for all financial consumers. In addition, the Code defines what an unsophisticated consumer is, and an additional set of protections are defined for these unsophisticated consumers. The basic protections are:

1. Financial service providers must act with professional diligence;
2. Protection against unfair contract terms;
3. Protection against unfair conduct;
4. Protection of personal information;
5. Requirement of fair disclosure;
6. Redressal of complaints by financial service providers.

Three additional protections defined for unsophisticated consumers are:

1. The right to receive suitable advice;
2. Protection from conflicts of interest of advisors;
3. Access to the redressal agency for redressal of grievances.

6.13 The regulator will also be able to impose a range of requirements on financial service providers, ranging from disclosure, suitability and advice requirements,

regulation of incentive structures, to more intrusive powers such as recommending modifications in the design of financial products and services, etc.

Financial Redressal Agency (FRA)

6.14 The Commission has recommended the creation of a new statutory body, viz, the Financial Redressal Agency (FRA) to redress complaints of retail consumers through a process of mediation and adjudication. The FRA will function as a unified grievance redressal system for all financial services. To ensure complete fairness and to avoid any conflicts of interest, it will function independently from the regulators.

6.15 The financial redressal mechanism proposed by the Commission will replace the existing financial sector-specific ombudsman systems such as the banking ombudsman and the insurance ombudsman although retail consumers will continue to have the option to approach other available forums, such as the consumer courts established under the Consumer Protection Act, 1986 as well and regular courts. In future, if the Government is of the view that the FRA has acquired sufficient scale and expertise to be able to efficiently address all complaints from retail consumers, it will have the power to exclude the applicability of the Consumer Protection Act, 1986 to retail consumers covered by the redressal agency.

6.16 The draft Code seeks to ensure a feedback loop through which the FRA will use the proposed Financial Data Management Centre (FDMC) to share information on complaints with the regulators on an on-going basis and the regulators will analyse the information received from it and utilise it for improved regulation-making and systemic improvement.

Financial Awareness

6.17 The draft Indian Financial Code also vests regulators with the duty to promote financial awareness among the members of the public including the

(*a*) benefits of financial planning;

(*b*) rights and protections available to consumers of financial products and financial services; and

(*c*) features, costs, risks and benefits of different financial products and financial services.

The regulator is also conferred power to make regulations in this regard and to establish a financial awareness body.

6.18 The Report advocates a fresh look over a horizon of five to ten years after the proposed laws come into effect. One possibility envisaged is the construction of a single unified financial regulatory agency, which would combine all the activities of the proposed Unified Financial Authority and also the work on payments and banking. Another possibility is to shift to a two-agency structure, with one Consumer Protection Agency which enforces the proposed consumer protection law across the entire financial system and a second Prudential Regulation Agency which enforces prudential regulation.

6.19 The Department of Economic Affairs, Ministry of Finance, Government of India has published a Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code on December 26, 2013. The handbook provides guidance on the adoption of a harmonised method of implementation of the recommendations of FSLRC by financial sector regulators.

Assessment of Consumer Credit Protection in India

6.20 The existing regulations for banks in India are fairly comprehensiveand encompass a range of consumer protection measures (as mentioned in paragraph 6.3 as also in Annex V). These are largely comparable with the global best practices. In the following paragraphs, the best practices prevalent in other jurisdictions that may be of relevance in India have also been considered while making recommendations.

6.21 The WG felt that the extant guidelines serve the purpose of consumer protection to a large extent. The Fair Practices Code based on guidelines issued by the RBI as well as the codes of commitment evolved and enunciated by the BCSBI both contain various measures that would ensure a robust and sound consumer

protection mechanism. Accordingly, banks are encouraged to follow them and the various model policies for customer care indicated by IBA.

6.22 Banks must further declare and undertake to adhere to the following best practices:

6.22.1 Banks will undertake to lend money in a responsible way. They should ensure that there is proper assessment of credit applications from borrowers. They should not use margin and security as a substitute for due diligence on the credit worthiness of the borrower.

6.22.2 Banks should consider carefully whether the purpose of a customer communication is operational or promotional.

6.22.3 Advertising and promotional literature should be fair, clear and not misleading

6.23 To enhance comparability to enable customers to make a choice between different banks, **the WG reiterates that banks should publish their interest rates, fees and charges on their websites for transparency, comparability across banks and informed decision making by customers. In addition, it is recommended that the banks should disclose the interest rate range of contracted loans for the past quarter for different categories of loans along with the mean and median interest rates charged.**

- **Fees and charges must be clearly disclosed at the time of account opening and made available to the customers at all times through various communication channels.**

6.24 Annual Percentage Rate: In many jurisdictions, an annual percentage rate of charge (APR), the effective interest rate (EIR) or the total effective cost of the loan taking into account all costs incurred by the borrower, including fixed or floating interest rates, taxes, fees and other related expenses are to be disclosed to the borrower at all stages of loan processing. In India, the Reserve Bank of India has

asked banks to disclose all the charges upfront. Further, banks must inform 'all-in-cost' to the customer to enable him to compare the rates charges with other sources of finance. **The WG recommends that banks may provide a range of Annual Percentage Rate (APR) or such similar other arrangement of representing the total cost of credit on a loan on annualized basis that will allow customers to compare the costs associated with borrowing across products and / or lenders. However, the applicable APR should get crystallized in the loan covenant with the consumer.**

6.25 In order to ensure that customer dissatisfaction is quickly addressed, **the WG reiterates that the grievances redressal systems in banks should be made robust and responsive to customers' needs. The senior management of banks should pay particular attention in this regard. Banks which do not put in place adequate measures, as evidenced by repeated complaints, may be penalized by the RBI.**

New measures to be put in place

6.26 Modern consumer protection regulation aims to empower consumers by allowing them to compare offers and thus enhance / encourage competition. As such, the disclosure rules must focus on requiring banks to disclose information on the terms of loans in a standardized manner to enable comparison at various stages, viz., at the time of advertising or promoting a product, at the time of signing a contract (account opening) and during the period of the contractual relationship (periodic through regular statements, and occasional when terms of service are likely to undergo a change).

6.27 The WG felt that there is a need to reduce all aspects of the credit process in writing to ensure clarity in communication and transparency, so that the complaints against banks may come down. **The WG recommends that the terminology used by all banks must be standardized so as to enhance/ facilitate comparability. A glossary/ list of terms, standardised for all banks and for all bank accounts offered to customers may be drawn up and mandatorily be included at the end**

of the loan offer documents and sanction letters. These may be displayed on the websites of banks. The initiative for creating a standardised terminology may be taken by IBA.

6.28 Documentation in respect of loans should reflect all details and terms and the legal framework should be strengthened. The WG felt the need for a standardized loan contract / covenant for retail customers so that there is no ambiguity regarding periodicity of reset, and the provisions for re-fixation of the spread. Moreover, the terms and conditions in the loan covenant should be presented in a clear and simplified language. In its report on Financial Literacy and Consumer Protection: Overlooked Aspects of the Crisis in June 2009, OECD has named recommendations on good practices on financial education and awareness relating to credit. One of the recommendations is to promote the use of a 'box' by all lenders for all types of credit products. The 'box' should be prominently displayed on the credit agreement and clearly summarize the important terms and conditions of the credit product. This summary box should capture in brief the amount of loan, tenor, rate of interest, repayment details etc. Further, considering the complaints in respect of housing/ retail loans, it is felt desirable to provide retail/mortgage borrowers clarity by way of a simple summary of the important terms and conditions (tenor / fees/ interest rate / reset dates) of the financial contract at every stage of the loan processing.

(i) **The WG recommends that the Reserve Bank may clearly specify the information to be included in credit agreements, including a standard format for a summary box to be displayed on the credit agreement. Besides banks may be mandated to provide a clear, concise, one-page key facts statement/fact sheet to all retail/mortgage borrowers at every stage of the loan processing as well as in case of change in any terms and conditions. This would give customers a simple summary of the important terms and conditions (tenor / fees/ interest rate / reset dates) of the financial contract.**

(ii) The WG also recommends that a standardized loan format may be prepared by IBA for retail customers covering terms and conditions including inter-alia

the periodicity of reset and provisions for re-fixation of spread, etc., in an unambiguous and simplified language.

6.29 Mortgage is a long term product and pre-payments during tenor of the loan may occur. **The WG recommends that the benefit of interest reduction on the principal on account of pre-payments should be given on the day the money is received by bank without waiting for the next EMI cycle date to effect the credit.**

6.30 Considering the significant role of financial awareness in decision making by customers, **the WG recommends that both banks and the RBI may impart Financial Education through consumer education drives.**

6.31 It is important to enable market forces to operate as freely as possible to ensure that each bank is providing the most competitive pricing to its clients, including existing clients. Accordingly, borrowers should have exit option from their contracts on reasonable terms which will serve as a consumer protection measure as well as enhance competition. A step in this direction has been the RBI circular whereby borrowers have been given the freedom to pre-pay their floating rate housing loans without penalty and to take a loan from other banks with lower rates. However, it has been found that in some cases banks do not co-operate in cases of such switchovers. It is felt that the onus should be on banks to assist the customer in the account transfer process. Extant RBI instructions and BCSBI code of commitment mandate conveyance of concurrence or otherwise for such transfers within 21 days of receipt of request by a bank. Further steps to help in this process may include:

6.31.1 Stipulation of guidelines on minimum service standards for banks to process a loan transfer request by clients;

6.31.2 Banks to share KYC documents directly with another bank to facilitate loan transfer, which documents may be independently verified by bank taking over the loan account;

6.31.3 Banks to formulate internal guidelines which may be issued to all branches for handling loan transfer requests including turnaround timings;

6.31.4 Banks to provide clients with their process and service standards for handling loan transfer at the time of loan disbursement, so that clients are aware of the process;

6.31.5 Banks may charge a fee for handling and facilitating this transfer, but the fees should be reasonable and disclosed upfront to clients.

(i) The WG recommends that for the retail loans, the customers should have a choice of "with exit" and "sans exit" options at the time of entering the contract. The exit option can be priced differentially but reasonably. The exit option should be easily exercisable by the customer with minimum notice period and without impediments. This would address issues of borrowers being locked into contracts, serve as a consumer protection measure and also help enhance competition.

(ii) The WG also recommends that IBA should evolve a set of guidelines for easier and quicker transfer of loans, particularly mortgage/housing loans. There could also be penalties for banks which do not cooperate with borrowers in this regard.

6.32 To sensitise bank staff on consumer protection and the importance of customer satisfaction and to reduce customer dissatisfaction, **the WG recommends that the industry association, IBA, should do the following**:

a. Develop case studies and examples of best practices for customer service;

b. Conduct studies to identify areas of best market conduct practices for improvement;

c. Conduct training for industry representatives.

Annex I

Models for Pricing Floating Rate Loans

Heffernan model[20]

A.1.1 Heffernan (1993) modelled the degree of competition in the banking market for pricing behaviour using cross-section, time-series data on UK banks and building societies for the period 1985–1989. The model considered various factors like interest deposit accounts, higher interest chequing accounts at high and low amounts, repayment mortgages, and personal loans. This study employed a monthly average of the daily 3-month LIBOR rate. Since retail rates are unlikely to respond to changes in current LIBOR immediately, the rate was lagged by 1, 2 and 3 months. The difference in pricing behaviour by type of bank suggests imperfect competition in the markets.

A.1.2 Using a generalised linear pricing model, the degree of competition for a given product was tested, for differences in behaviour among individual banks, and for different types of imperfect competition, such as the Cournot model of oligopoly[21] and the Salop–Stiglitz (1977) model of monopolistic competition with bargains and rip-offs[22]. On the left-hand side, the dependent variable is the ‘‘price’’ of the product, in this case the deposit or loan rate. On the right-hand side is a number of explanatory variables.

$$\mathrm{R1}_{it} = \alpha_0 + \sum_j \beta_j \mathrm{Libor}_{t-j} + \gamma t + \delta_i D_i + \varsigma n_t + \varepsilon_{it},$$

where $R1_{it}$ is the gross deposit rate paid by bank i at time t, j = 0, 1,2, 3 the monthly lags used on LIBOR, ‘n’ the number of banks offering the product, γt the time trend and D_i the dummy variable for each financial bank i - unity for bank i, 0 otherwise.

[20] Shelagh Heffernan, [1993], ‘Competition in British retail banking’.

[21] The Cournot model would predict that increased bank entry into a market lowers price.

[22] In the Salop–Stiglitz model, consumers face unseen information costs. Some know the distribution of prices and buy bargains, others buy randomly. A bank can survive either by charging a low price (bargain) or a high one (rip-off). Rip-off banks stay in business as long as there are enough purchases by the ill-informed consumers. Banks offering bargain products profit from a higher volume of sales, because well-informed customers buy their relatively cheaper product. Thus, the relative bargains and bad buys co-exist, and there is a twin-peak price distribution. In retail banking, some consumers are well informed; others are not, enabling the Salop–Stiglitz theory to be put to the test. The dummy variable captures the competitive behaviour of each individual bank, relative to a default bank.

A.1.3 The study shows that information asymmetries means banks' pricing behaviour differs depending on the product, ranging from competitive pricing in the new borrower mortgage market, to the existence of substantial pricing differences between relative bargain and rip-off products, especially in the personal loan and credit card markets. The policy implication is to require banks to produce comparable information for consumers, so it is more difficult for the relative rip-off products to survive.

Cox-Ingersoll-Ross (CIR) model[23]

A.1.4 It is one of the most popular models due to its intuitive appeal and its ease of implementation. It has three basic elements – the mean interest rate, μ, a parameter that determines the rate at which interest rate reverts back to the mean, k and a drift term, *dz* that depends upon the volatility, σ. The CIR model specifies that the interest rate, r follows the path defined by the following stochastic differential equation.

$$\partial r = k(\mu - r)\partial t + \sigma\sqrt{r}\,\partial z$$

A.1.5 The basic building blocks of a risk pricing model are (i) interest rates, (ii) default/ rating migration and (iii) recovery rates. Of these three, recovery in the event of a default is the most intriguing and difficult to model parameter. This is because recovery process elements are not easily quantifiable, e.g., uncertainties in the bankruptcy process, the outcome of which may be liquidation or reorganisation.

Other models / approaches

A.1.6 There are numerous structural or firm value approaches inspired by the classic Black and Scholes option pricing theory (1973)[24] formalised by Merton (1974)[25]. Merton's model has been refined over a period of time by addressing several simple and strict assumptions built into the model. In the structural models, company specific factors affecting debt value are considered. Critics of the structural

[23] John C. Cox, Jonathan E. Ingersoll, Jr. and Stephen A. Ross, [1980], 'An Analysis of Variable Rate Loan Contracts'.
[24] Fischer Black and Myron Scholes, [1973], 'The Pricing of Options and Corporate Liabilities Author'.
[25] Robert C. Merton, [1973], "Theory of Rational Option Pricing".

approach argue that firm value is difficult to measure, especially if the company's securities are thinly traded or private.

A.1.7 The reduced form approaches bypass the company's financial fundamentals and deal directly with market spreads or prices. The price or spread of a defaultable bond is directly linked to a risk free bond though default and recovery rates are specified exogenously[26].

A.1.8 In Risk Factor Premium approach credit spreads are allowed to be considered as compensation for various risks in a linear relationship. Credit fundamentals approach uses company's fundamentals to estimate default probabilities over a period of time. In Macroeconomic Approach the systematic risk is separated from the company specific risk

A.1.9 Pricing of credit can be done by using Risk-Adjusted Return on Capital (RAROC)

$$RAROC = \frac{Risk\ Adjusted\ Return}{Economic\ Capital}$$

A.1.10 Alternately, pricing of credit can also be done by using Return on Risk-Adjusted Capital (RORAC)

$$RORAC = \frac{Return}{Economic\ Capital}$$

$$\text{RORAC} = \frac{\text{net interest income} + \text{income from credit products} + \text{fees} - \text{operating expenses}}{\text{Risk adjusted capital}}$$

$$= \frac{(\text{loan price} - \text{cost of funds}) * \text{volume} + \text{income from credit products} + \text{fees} - \text{operating expenses}}{\text{Risk adjusted capital}}$$

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[26] In the reduced form approach, analysts either imply default probabilities from the observable values of traded securities or estimate them from a historical data base of defaults and the relevant explanatory variables. There are two types of inputs to a reduced form model. The first type of inputs is a set of macro-economic factors that affect some or all risky counterparties. The second type of input is counterparty specific.

Annex II

Pricing of credit - Benchmarks

Sr No	Index	Description	Usage
1.	US Prime Rate[27]	Prime rate is invariably tied to US Fed Funds Target Rate which is set by FOMC. When the Fed Funds Target Rate changes, prime rate is invariably changed by banks. Since 1994, a rule of thumb for the US Prime Rate has been: US Prime Rate = (The Fed Funds Target Rate + 300bps)	US Prime Rate is used to price products such as credit card, an education loan, a car loan, a business loan, a personal loan, mortgages etc.
2.	Wall Street Journal Prime Rate (US)	• WSJ arrives at the Prime Rate by polling base rate on corporate loans from 10 banks in the US. • When at least 7 out of these 10 banks have changed their Prime, the WSJ will update its published Prime Rate. • The loan products are priced at a spread above this prime rate. • Some financial institutions use Prime rate for pricing of time-deposit products like variable-rate Certificates of Deposit. • But at times loan may be offered below prime rate such as cases when the loan product in question is secured, etc.	US lending institutions like banks, thrifts, etc., use this index for pricing loan products and it is offered to their preferred customers with highest credit ratings. The major advantage of using this rate is that it makes comparison between similar loan products offered by competing banks easier and more efficient. It is a single rate that is accepted across all states and is listed in the Eastern print edition of the Wall Street Journal (WSJ).
3.	Cost of Funds Index, COFI[28] (US)	• COFI is the 11th District Monthly Weighted Average Cost of Funds Index published by Federal Home Loan Bank of San Francisco. • The COFI index is the ratio of monthly interest expenses to total funds, adjusted for variation in the number of days in that month, annualized and expressed as a percentage. • Interest expenses include the total amount of interest reported for the month on all Deposit Accounts (including chequing and savings	COFI is one of many indices used by mortgage lenders to adjust the interest rate on adjustable rate mortgages. Depository institutions use swaps, caps and floors linked to COFI to hedge their funding costs.

[27] http://www.federalreserve.gov/faqs/credit_12846.htm
[28] http://www.fhlbsf.com/

		accounts, certificates of deposit, money market deposit accounts, transaction accounts, and passbook accounts), Federal Home Loan Bank advances, and other borrowings. • Total funds, consists of the simple average of the two most recent month-end balances of Deposit Accounts, Federal Home Loan Bank advances, and other borrowings. • COFI is published on the last business day of the following month.	
4.	Cost of Funds Index, COFIX (Korea)[29]	• COFIX reflects banks' costs of funding. • COFIX is initially announced only once a month by Korea Federation of Banks and an average maturity of loans linked to COFIX is nine to ten months. • Two separate rates, viz., COFIX on outstanding balances and COFIX on monthly acquired new funds is published separately. • The short-term COFIX, introduced later reflects banks' average funding costs for short term lending with a three-month maturity, and is announced every week.	The Cost of Funds Index (COFIX) was first introduced to replace the certificate of deposit (CD) rate in loan markets. The COFIX rate on outstanding balances reflects the market interest rate changes in a gradual manner, while the COFIX rate on monthly acquired new funds tends to change quickly in tandem with market rates since it is calculated based on newly financed funds.
5.	Loan Prime Rate[30]	• People's Bank of China on October 25, 2013, has introduced the Loan Prime Rate (LPR). • The LPR shall be for one-year and would be a weighted (by the share of each panel bank's RMB loans in the total outstanding RMB loans) average of the quotes provided by the panel banks as the average LPR rate. • The rate shall be published daily by National Inter-bank Funding Centre based on quotes from a group of panel of 9 commercial banks.	• LPR is expected to further promote the market-based interest rate reform, improve the base interest rate system in the financial market, and guide credit product pricing. It will be offered by a commercial bank to its prime clients, and other lending rates can be offered by adding and subtracting basis points based on the LPR.
6.	Singapore Prime	Singapore Prime Lending rate refers to a simple average of annualized interest rates compiled from that quoted by 10 leading banks and	It is used as one of the financial Indicators by the MAS. This rate is evaluated by the

[29] http://www.kfb.or.kr/eng/cofix/cofix02.php
[30] http://www.pbc.gov.cn/publish/english/955/2013/20131107102844337520397/20131107102844337520397_.html

	Lending rate[31]	finance companies on new loans, denominated in the national currency, to their most credit-worthy customers. It is published by the Monetary Authority of Singapore (MAS) in its official website and can be culled out from 1983 till December 2013 on a monthly basis.	MAS to see how banks respond to changes in the domestic inter rate market.
7.	Hong Kong Prime Rate[32]	Hong Kong Prime Rate means the interest rate in respect of the Hong Kong Dollar announced by the Hong Kong Mortgage Corporation Limited (HKMC), which is based on the prime rates quoted by the approved banks and financial companies. This rate is announced from time to time by the HKMC, and it is the arithmetic mean of the prime rate quoted by 12 reference banks specified by the HKMC from time to time, eliminating the highest prime rate (or, in the event of equality, one of the highest) and the lowest prime rate (or, in the event of equality, one of the lowest) and rounded to the nearest 2 decimal places (i.e. 0.01%).	The HKMC effective rates are available from March 2006 onwards. These rates are primarily used for floating rate mortgages in Hong Kong.
8.	Japan prime rate[33]	Bank of Japan publishes the short term prime lending rate of banks as the highest and lowest interest rates and the rate adopted by the greatest number of city banks. From January 23, 1989, banks (principal banks) independently set the rate taking funding costs, etc., into consideration. The data is available for all the effective dates of the implementation of the rates from January 1966 till October 2013. However, the long term prime lending rate is the interest rate adopted and released by Mizuho Bank.	Bank lending rate, also called prime rate, refers to a reference interest rate used by banks to lend money to companies or individuals. The rate is not changed every month and is revised only when the original rates are revised.

[31] https://secure.mas.gov.sg/msb/InterestRatesOfBanksAndFinanceCompanies.aspx
[32] http://www.hkma.gov.hk/eng/key-information/press-releases/2011/20110711-3.shtml and http://www.hkmc.com.hk/eng/pcrm/toolbox/rm-calc/rmcalc_input.php
[33] https://www.boj.or.jp/en/statistics/dl/loan/prime/prime.htm/

Annex III

Indian Banks Base Rate (IBBR)

A.3.1 The simplest way to improve transparency in pricing floating rate retail loans will be to link the loans to external traded benchmarks. However, there are 3 issues in using external benchmarks in India :

a) Absence of appropriate term money market benchmarks like tenor LIBOR;

b) Even if some external benchmark is used, absence of large, liquid market instruments for banks to hedge the re-pricing risks based on such external benchmark (like Euro-dollar Futures, IRS, etc.); &

c) Limited ability of retail clients to understand market benchmarks (like T-bills or MIBOR) especially if they vary widely v/s popular expectations;

A.3.2 In the Indian context, banks will be more comfortable to have the floating rate loans linked to a cost of funds index rather than money market benchmarks. Hence the Base Rate of banks may continue to be used as one of the indices for floating rate loans. However, for better transparency, the interest rates on floating rate retail loans may be linked to a representative Base Rate (rather than specific Base Rate of individual bank). The Indian Banks Base Rate (IBBR) may be based on the Base Rate of the top 20-25 Banks (after removing outliers).

A.3.3 Banks will have the choice of offering floating rate retail loans either linked to external benchmarks or IBBR. While Banks have the choice to price the loans at any spread to the IBBR at inception (subject to floor of their own base rate), subsequently all re-pricing of the loan will be based on changes to IBBR. Banks may also specify upfront, the re-pricing frequency to the customer (i.e., monthly, quarterly, semi-annual, annual, etc.) depending on their ALM profile.

A.3.4 The IBBR will be constructed as a simple average of the prevailing Base rates of a representative set of banks. The choice of the representative banks should ensure there is adequate and reasonably proportionate representation of PSU Banks, Private Banks and Foreign Banks in the IBBR construction.

A.3.5 The IBA (Indian Banks' Association) or any other suitable body may be given the responsibility of calculating and publishing the IBBR each month. The publishing frequency may be set as monthly, either on the last day of each month or the 1st day of the next month. In computing the IBBR, outliers may be removed to smoothen the data and reduce volatilities.

A.3.6 As the Base Rates of banks change, the IBBR will capture the change and all clients of floating rate retail loans across the market will have a consistent and transparent change in their floating rate pricing. This process will bring in the much required transparency in re-pricing of floating rate retail loans. The recommendations to further strengthen the Base Rate computation process will add more credence to the IBBR.

A.3.7 The simplest way to select the representative banks is by looking at the relative size of deposits or advances. Secondly, given the diverse business models of different categories of Banks, it is important to have adequate representation of 3 categories of Banks (PSUs, Private & Foreign).

A.3.8 For the purpose of construction of the IBBR model top 14 PSU Banks, 7 Private Banks and 3 Foreign Banks have been selected based on size of deposits.

Annex III
Indian Banks Base Rate (IBBR)

Rs. In Crore

Sl No	Name of Bank	Category	As on	Deposits	Advances
1	St Bk of India	PSU	201303	1,202,740	1,045,617
2	Bank of Baroda	PSU	201303	473,883	328,186
3	Punjab Natl.Bank	PSU	201303	391,560	308,725
4	Bank of India	PSU	201303	381,840	289,368
5	Canara Bank	PSU	201303	355,856	242,177
8	Union Bank (I)	PSU	201303	263,762	208,102
10	IDBI Bank	PSU	201303	227,116	196,306
11	Central Bank	PSU	201303	226,038	171,936
12	I O B	PSU	201303	202,135	160,364
13	Syndicate Bank	PSU	201303	185,356	147,569
14	Allahabad Bank	PSU	201303	178,742	129,490
15	Oriental Bank	PSU	201303	175,898	128,955
16	UCO Bank	PSU	201303	173,431	128,283
17	Corporation Bank	PSU	201303	166,005	118,717
18	Indian Bank	PSU	201303	141,980	105,643
19	Andhra Bank	PSU	201303	123,796	98,373
20	St Bk of Hyderab	PSU	201303	113,324	89,857
24	Bank of Maha	PSU	201303	94,337	75,471
25	St Bk of Patiala	PSU	201303	88,672	73,800
23	Vijaya Bank	PSU	201303	97,017	69,766
21	United Bank (I)	PSU	201303	100,652	68,909
26	S B T	PSU	201303	84,624	67,484
22	Dena Bank	PSU	201303	97,207	65,781
27	St Bk of Bikaner	PSU	201303	72,116	57,535
28	Pun. & Sind Bank	PSU	201303	70,642	51,431
34	St Bk of Mysore	PSU	201303	56,969	44,933
33	Federal Bank	PSU	201303	57,615	44,097
31	J & K Bank	PSU	201303	64,221	39,200
38	South Ind.Bank	PSU	201303	44,262	31,816
40	Karur Vysya Bank	PSU	201303	38,653	29,480
41	Karnataka Bank	PSU	201303	36,056	25,208
7	ICICI Bank	PRIVATE	201303	292,614	290,249
6	HDFC Bank	PRIVATE	201303	296,247	239,721
9	Axis Bank	PRIVATE	201303	252,614	196,966
37	Kotak Mah. Bank	PRIVATE	201303	51,029	48,469
29	Yes Bank	PRIVATE	201303	66,956	47,000
36	IndusInd Bank	PRIVATE	201303	54,117	44,321
39	ING Vysya Bank	PRIVATE	201303	41,334	31,772
43	Lak. Vilas Bank	PRIVATE	201303	15,619	11,703
46	Dhanlaxmi Bank	PRIVATE	201303	11,202	7,777
48	Dev.Credit Bank	PRIVATE	201303	8,364	6,586
49	Ratnakar Bank	PRIVATE	201303	8,341	6,376
32	Stand.Chart.Bank	FOREIGN	201303	62,002	61,954
30	Citibank N. A.	FOREIGN	201303	66,559	52,036
35	Hongkong & Shang	FOREIGN	201303	56,866	35,709
42	Deutsche Bank	FOREIGN	201303	20,794	22,374
44	DBS Bank	FOREIGN	201303	15,488	13,858
45	Royal Bank	FOREIGN	201303	12,749	12,534
51	Barclays Bank	FOREIGN	201303	5,063	8,472
50	BNP Paribas	FOREIGN	201303	5,580	7,737
47	J P Morgan Chase	FOREIGN	201303	10,369	5,345

(Source: Capitaline Databases)

A.3.9 After identifying these 24 banks, the Base Rate of these 24 banks from July 2010 at quarterly frequency is tabulated below –

BASE RATE OF BANKS	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Bank of Baroda	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
Punjab National Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
Canara Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
State Bank of India	7.50%	7.50%	7.50%	7.60%	7.60%	7.60%
Union Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
Bank of India	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
Central Bank of India	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
IDBI Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
I O B	8.25%	8.25%	8.25%	8.50%	8.50%	9.00%
Syndicate Bank	8.25%	8.25%	8.25%	8.50%	8.50%	9.00%
Allahabad Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
Oriental Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
UCO Bank	8.00%	8.00%	8.00%	8.50%	8.50%	9.00%
Corporation Bank	7.75%	7.75%	7.75%	7.75%	8.25%	8.25%
HDFC Bank	7.25%	7.25%	7.25%	7.50%	7.50%	7.50%
ICICI Bank	7.50%	7.50%	7.50%	7.75%	7.75%	7.75%
Kotak Mahindra Bank	7.25%	7.25%	7.25%	7.75%	7.75%	8.00%
Axis Bank	7.50%	7.50%	7.50%	7.75%	7.75%	8.00%
ING Vysya Bank	7.25%	7.25%	7.25%	7.75%	7.75%	7.75%
Yes bank	7.00%	7.00%	7.00%	7.50%	8.00%	8.00%
IndusInd Bank	7.00%	7.00%	7.00%	7.50%	7.75%	8.00%
HSBC	7.00%	7.00%	7.00%	7.50%	7.50%	7.50%
Standard chartered	7.25%	7.25%	7.25%	7.50%	7.50%	8.00%
Citibank	7.25%	7.25%	7.25%	7.75%	7.75%	8.00%

BASE RATE OF BANKS	Jan-11	Feb-11	Mar-11	Apr-11	May-11	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11
Bank of Baroda	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
Punjab National Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.00%	10.75%	10.75%	10.75%	10.75%	10.75%
Canara Bank	9.00%	9.50%	9.50%	9.50%	9.50%	9.50%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
State Bank of India	8.00%	8.25%	8.25%	8.25%	9.25%	9.25%	9.50%	10.00%	10.00%	10.00%	10.00%	10.00%
Union Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.65%
Bank of India	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.00%	10.75%	10.75%	10.75%	10.75%	10.75%
Central Bank of India	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.00%	10.75%	10.75%	10.75%	10.75%	10.75%
IDBI Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.00%	10.75%	10.75%	10.75%	10.75%	10.75%
I O B	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
Syndicate Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
Allahabad Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
Oriental Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
UCO Bank	9.00%	9.50%	9.50%	9.50%	10.00%	10.00%	10.25%	10.75%	10.75%	10.75%	10.75%	10.75%
Corporation Bank	8.90%	9.40%	9.40%	9.40%	9.90%	9.90%	10.25%	10.65%	10.65%	10.65%	10.65%	10.65%
HDFC Bank	7.75%	8.20%	8.70%	8.70%	9.25%	9.25%	9.50%	10.00%	10.00%	10.00%	10.00%	10.00%
ICICI Bank	8.25%	8.75%	8.75%	8.75%	9.25%	9.25%	9.50%	10.00%	10.00%	10.00%	10.00%	10.00%
Kotak Mahindra Bank	8.25%	8.75%	8.75%	8.75%	9.25%	9.25%	9.50%	9.75%	9.75%	9.75%	10.00%	10.00%
Axis Bank	8.25%	8.75%	8.75%	8.75%	9.50%	9.50%	9.75%	10.00%	10.00%	10.00%	10.00%	10.00%
ING Vysya Bank	8.25%	8.50%	8.90%	8.90%	9.45%	9.70%	9.70%	10.20%	10.20%	10.45%	10.45%	10.45%
Yes bank	8.50%	8.50%	8.50%	8.50%	9.50%	9.50%	9.75%	10.25%	10.25%	10.50%	10.50%	10.50%
IndusInd Bank	8.25%	8.75%	9.25%	9.25%	9.75%	9.75%	10.00%	10.50%	10.50%	10.75%	10.75%	10.75%
HSBC	8.00%	8.00%	8.50%	8.50%	9.00%	9.00%	9.25%	9.75%	9.75%	9.75%	9.75%	9.75%
Standard chartered	8.00%	8.50%	8.50%	8.50%	9.25%	9.25%	9.50%	9.50%	9.75%	9.75%	9.75%	9.75%
Citibank	8.00%	8.50%	8.50%	8.50%	9.00%	9.00%	9.50%	9.75%	9.75%	9.75%	9.75%	9.75%

BASE RATE OF BANKS	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12
Bank of Baroda	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Punjab National Bank	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Canara Bank	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
State Bank of India	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	9.75%	9.75%	9.75%	9.75%
Union Bank	10.65%	10.65%	10.65%	10.65%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Bank of India	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Central Bank of India	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
IDBI Bank	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
I O B	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Syndicate Bank	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Allahabad Bank	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Oriental Bank	10.75%	10.75%	10.75%	10.65%	10.50%	10.50%	10.50%	10.40%	10.40%	10.40%	10.40%	10.40%
UCO Bank	10.75%	10.75%	10.75%	10.75%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
Corporation Bank	10.65%	10.65%	10.65%	10.65%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
HDFC Bank	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	9.80%	9.80%	9.80%	9.80%	9.80%	9.80%
ICICI Bank	10.00%	10.00%	10.00%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%
Kotak Mahindra Bank	10.00%	10.00%	10.00%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%
Axis Bank	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
ING Vysya Bank	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%
Yes bank	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
IndusInd Bank	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%
HSBC	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%
Standard chartered	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.50%	9.50%	9.50%
Citibank	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%

Annex III
Indian Banks Base Rate (IBBR)

BASE RATE OF BANKS	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13
Bank of Baroda	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
Punjab National Bank	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
Canara Bank	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	9.95%	9.95%	9.95%	9.95%	9.95%	9.95%
State Bank of India	9.75%	9.70%	9.70%	9.70%	9.70%	9.70%	9.70%	9.70%	9.70%	9.70%	10.00%	10.00%
Union Bank	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.00%	10.00%	10.25%	10.25%	10.25%	10.25%
Bank of India	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.00%	10.00%	10.25%	10.25%	10.25%	10.25%
Central Bank of India	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.00%	10.25%	10.25%	10.25%	10.25%	10.25%
IDBI Bank	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
I O B	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
Syndicate Bank	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
Allahabad Bank	10.50%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%
Oriental Bank	10.40%	10.25%	10.25%	10.25%	10.25%	10.25%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
UCO Bank	10.50%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%	10.20%
Corporation Bank	10.50%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
HDFC Bank	9.70%	9.70%	9.70%	9.60%	9.60%	9.60%	9.60%	9.80%	9.80%	9.80%	10.00%	10.00%
ICICI Bank	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	10.00%	10.00%	10.00%	10.00%	10.00%
Kotak Mahindra Bank	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	10.00%	10.00%	10.00%	10.00%	10.00%
Axis Bank	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.25%	10.25%	10.25%	10.25%	10.25%
ING Vysya Bank	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%	10.45%
Yes bank	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%	10.75%	10.75%	10.75%	10.75%	10.75%
IndusInd Bank	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	10.75%	11.00%	11.00%	11.00%	11.00%	11.00%
HSBC	9.75%	9.75%	9.75%	9.75%	9.45%	9.45%	9.45%	9.75%	9.75%	10.00%	10.00%	10.00%
Standard chartered	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.75%	10.25%	10.25%	10.25%	10.25%
Citibank	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.75%	9.75%	9.75%	9.75%	10.00%

(Source: Reuters)

A.3.10 The IBBR has been computed as a simple average of the above base rates for each month, after removing the top 2 and bottom 2 data points as outliers.

	Avg Base Rate	IBBRI (removing top & bottom 2 outliers)
Jul-10	7.67%	7.68%
Aug-10	7.67%	7.68%
Sep-10	7.67%	7.68%
Oct-10	8.07%	8.08%
Nov-10	8.12%	8.14%
Dec-10	8.43%	8.47%
Jan-11	8.60%	8.63%
Feb-11	9.04%	9.08%
Mar-11	9.11%	9.15%
Apr-11	9.11%	9.15%
May-11	9.66%	9.69%
Jun-11	9.67%	9.71%
Jul-11	9.90%	9.92%
Aug-11	10.39%	10.43%
Sep-11	10.40%	10.43%
Oct-11	10.43%	10.47%
Nov-11	10.44%	10.48%
Dec-11	10.44%	10.48%
Jan-12	10.44%	10.48%
Feb-12	10.44%	10.48%
Mar-12	10.44%	10.48%
Apr-12	10.40%	10.43%
May-12	10.29%	10.31%
Jun-12	10.29%	10.31%
Jul-12	10.28%	10.30%
Aug-12	10.28%	10.30%
Sep-12	10.27%	10.28%
Oct-12	10.26%	10.28%
Nov-12	10.26%	10.28%
Dec-12	10.26%	10.28%
Jan-13	10.24%	10.28%
Feb-13	10.10%	10.11%
Mar-13	10.10%	10.11%
Apr-13	10.10%	10.11%
May-13	10.09%	10.09%
Jun-13	10.09%	10.09%
Jul-13	10.03%	10.03%
Aug-13	10.14%	10.10%
Sep-13	10.18%	10.15%
Oct-13	10.19%	10.16%
Nov-13	10.21%	10.18%
Dec-13	10.22%	10.18%

A.3.11 IBBR was compared with the Base Rates of all the selected banks and it had a large correlation and reasonable consistency in variance (except for a few banks) with the Base Rates of those banks.

	Base Rate vs IBBR (July-2010 to Dec 2013)		
Banks	**Correlation**	**Average of spread**	**Std dev of spread**
Bank of Baroda	0.995	0.25%	0.10%
Punjab National Bank	0.994	0.25%	0.10%
Canara Bank	0.973	0.19%	0.20%
State Bank of India	0.980	-0.45%	0.18%
Union Bank	0.992	0.23%	0.12%
Bank of India	0.991	0.23%	0.12%
Central Bank of India	0.993	0.24%	0.11%
IDBI Bank	0.994	0.24%	0.11%
I O B	0.995	0.27%	0.13%
Syndicate Bank	0.995	0.27%	0.13%
Allahabad Bank	0.992	0.24%	0.12%
Oriental Bank	0.983	0.20%	0.17%
UCO Bank	0.992	0.24%	0.12%
Corporation Bank	0.994	0.16%	0.11%
HDFC Bank	0.989	-0.47%	0.15%
ICICI Bank	0.986	-0.40%	0.15%
Kotak Mahindra Bank	0.986	-0.43%	0.14%
Axis Bank	0.979	-0.25%	0.18%
ING Vysya Bank	0.982	0.00%	0.29%
Yes bank	0.973	0.03%	0.39%
IndusInd Bank	0.980	0.25%	0.45%
HSBC	0.982	-0.59%	0.18%
Standard chartered	0.962	-0.54%	0.24%
Citibank	0.989	-0.56%	0.13%

A.3.12 The IBBR has a reasonable correlation v/s RBI Repo rate (0.94) and more modest correlation of 0.77 v/s 1 year T-Bill. The mean spread to Repo rate is 2.29% and to 1 year T-bill is 1.81%, with a standard deviation of 0.29% and 0.56% respectively.

A.3.13 The above correlation, mean and standard deviation compare favourably v/s the same data for individual banks –

Annex III
Indian Banks Base Rate (IBBR)

	Base Rate vs Repo Rate (July-2010 to Dec 2013)		
Banks	**Correlation**	**Average of spread**	**Std dev of spread**
Bank of Baroda	0.951	2.55%	0.25%
Punjab National Bank	0.947	2.54%	0.26%
Canara Bank	0.949	2.48%	0.26%
State Bank of India	0.933	1.84%	0.32%
Union Bank	0.952	2.52%	0.25%
Bank of India	0.953	2.53%	0.25%
Central Bank of India	0.950	2.54%	0.25%
IDBI Bank	0.947	2.54%	0.26%
I O B	0.957	2.57%	0.23%
Syndicate Bank	0.957	2.57%	0.23%
Allahabad Bank	0.954	2.53%	0.24%
Oriental Bank	0.954	2.50%	0.24%
UCO Bank	0.954	2.53%	0.24%
Corporation Bank	0.938	2.45%	0.32%
HDFC Bank	0.934	1.82%	0.34%
ICICI Bank	0.912	1.89%	0.34%
Kotak Mahindra Bank	0.901	1.86%	0.37%
Axis Bank	0.884	2.04%	0.41%
ING Vysya Bank	0.895	2.29%	0.52%
Yes bank	0.882	2.33%	0.60%
IndusInd Bank	0.881	2.55%	0.67%
HSBC	0.910	1.70%	0.39%
Standard chartered	0.884	1.75%	0.40%
Citibank	0.921	1.73%	0.32%

	Base Rate vs 1 yr T-Bill (July-2010 to Dec 2013)		
Banks	**correlation**	**Mean of spread vs rep**	**std dev of spread vs r**
Bank of Baroda	0.758	2.07%	0.54%
Punjab National Bank	0.756	2.06%	0.55%
Canara Bank	0.673	2.00%	0.63%
State Bank of India	0.740	1.36%	0.60%
Union Bank	0.737	2.04%	0.56%
Bank of India	0.733	2.05%	0.57%
Central Bank of India	0.752	2.06%	0.55%
IDBI Bank	0.757	2.06%	0.54%
I O B	0.747	2.09%	0.54%
Syndicate Bank	0.747	2.09%	0.54%
Allahabad Bank	0.752	2.05%	0.55%
Oriental Bank	0.709	2.02%	0.59%
UCO Bank	0.752	2.05%	0.55%
Corporation Bank	0.752	1.97%	0.61%
HDFC Bank	0.775	1.34%	0.59%
ICICI Bank	0.800	1.41%	0.50%
Kotak Mahindra Bank	0.810	1.38%	0.50%
Axis Bank	0.793	1.56%	0.54%
ING Vysya Bank	0.749	1.81%	0.72%
Yes bank	0.780	1.85%	0.75%
IndusInd Bank	0.782	2.07%	0.81%
HSBC	0.779	1.22%	0.58%
Standard chartered	0.828	1.27%	0.48%
Citibank	0.795	1.25%	0.50%

Annex IV

Consumer Protection Architecture and Measures as well as Interest Rate Restrictions Available in a few Specific Jurisdictions

A. United States (US)

A.4.1 In the world's largest economy, bank regulation is highly fragmented. Depending on the type of charter a banking organization has, and its organizational structure, it may be subject to numerous federal and state banking regulations. Some individual cities also enact their own financial regulation laws. Consequently there is a plethora of statutes and regulatory bodies governing consumer credit. The aspects that are broadly looked into by them include: a) equality and prevention of discrimination b) fairness in lending c) appropriate disclosures and consumer information. In addition, there are exclusive laws governing housing loans/mortgages.

A.4.2 Consequent to the enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act in July 2010, the Consumer Financial Protection Bureau (CFPB) is the lead regulator for consumer finance protection (including institutions that are not regulated financial institutes).The Federal Trade Commission (FTC) has enforcement jurisdiction over consumer transactions that do not involve a regulated financial institution. There is some overlap in the powers of the CFPB and the FTC and they are instructed to coordinate on their concurrent jurisdiction.

A.4.3 Significant legislations in the US are briefly mentioned below:

Legislations for Equality and fairness in lending:

A.4.3.1 **Equal Credit Opportunities Act (ECOA) (12CFR 202) – Regulation B:** It is designed to prevent any form of discrimination during all phases of the credit process. ECOA prohibits credit discrimination on the basis on nine principles called characteristics of discrimination viz., Sex, marital status, race, religion, colour, ethnicity, age (applicant must be able to enter into a legal contract), receipt of public assistance income, or the individual's good faith use of his or her rights under the Consumer Credit Protection Act (CCPA). The

ECOA requires a written adverse action notice to a consumer applicant who is turned down for credit. Such notification must be sent within 30 days of receiving the completed application.

A.4.3.2 **Fair Housing Act (FHA):** The FHA prohibits discrimination on the basis of race, colour, sex, religion, handicap, familial status, national origin with respect to real estate loans. Advertisements for any loan for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling or any loan secured by a dwelling shall include the FHA logo and legend (Equal Housing Lender).

A.4.3.3 **Regulation C- Home Mortgage Disclosure Act (HMDA):** Regulation C is part of the civil rights law that enforces data maintenance and disclosure requirements. HMDA was passed to counter any home lending practices that denied or limited the extensions of credit on such prohibited bases as race, colour, and national origin. The Act covers virtually all mortgage lenders.

Legislation for transparency and consumer information:

A.4.3.4 **Regulation Z - Truth in Lending Act:** It implements the federal Truth in Lending and Fair Credit Billing Acts. Truth in Lending (TIL) was signed into law in May 1968 as Title 1 of the Consumer Credit Protection Act and became effective on July 1, 1969. The purpose of the regulation is to promote the informed use of "consumer credit" by requiring disclosures about terms and costs, ensure that credit terms are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably. All creditors must use the same credit terminology and expressions of rates. In addition to providing a uniform system for disclosures, the Act protects consumers against inaccurate and unfair credit billing and credit card practices. It provides consumers with rescission rights, provides for rate caps on certain dwelling-secured variable rate loans, imposes limits on home equity lines of credit and certain closed-end home mortgages and delineates and prohibits unfair or deceptive mortgage lending practices. The TILA and Regulation Z do not, however, tell banks how much interest they may charge or whether they must grant loans to consumers.

A.4.3.5 **Consumer Leasing Act/Regulation M (12 CFR 213):** Banks engaged in advertising consumer leasing are subjected to Regulation M advertising rules. The requirements of Regulation M are similar to those of Regulation Z including the standard of being accurate and not misleading; no bait-and-switch advertising; and disclosure of specific terms when triggering terms are included in the advertisement.

A.4.3.6 **Regulation AA- Unfair and Deceptive Practices Act:** This regulation is designed to prevent unfair or deceptive acts or practices with respect to extensions of credit to consumers, other than for the purchase of real estate, prohibits certain credit practices and requires disclosure to clarify the liability of co-signors and guarantors on loans. Specifically, it prohibits unfair provisions in consumer credit contracts, unfair or deceptive practices involving co-signers or unfair late charges.

A.4.3.7 **Home Ownership and Equity Protection Act of 1994 (HOEPA):** It amends the Truth in Lending Act (TILA) and establishes requirements for certain loans with high rates and/or high fees. The rules for these loans are contained in Section 32 of Regulation Z, which implements the TILA, so the loans are also called "Section 32 Mortgages." It addresses certain deceptive and unfair practices in home equity lending.

A.4.3.8 **Regulation N - Part 1014—Mortgage Acts and Practices—Advertising:** This relates to prohibited representations and states that it is a violation of this part for any person to make any material misrepresentation, expressly or by implication, in any commercial communication, regarding any term of any mortgage credit product.

A.4.3.9 **The Fair Credit Reporting Act** (**FCRA**): It regulates the collection, dissemination, and use of consumer information, including consumer credit information. Along with the Fair Debt Collection Practices Act (FDCPA), it forms the base of consumer credit rights in the United States. Consumer Reporting Agencies have a number of responsibilities under FCRA, including the following:

(i) Provide a consumer with information about him or her in the agency's files and to take steps to verify the accuracy of information disputed by a consumer. Under the Fair and Accurate Credit Transactions Act (FACTA), an amendment to the FCRA passed in 2003, consumers are able to receive one free credit report a year (ii) If negative information is removed as a result of a consumer's dispute, it may not be reinserted without notifying the consumer within five days, in writing.

A.4.3.10 **Fair and Accurate Credit Transactions Act of 2003:** This act was enacted to amend the Fair Credit Reporting Act, to prevent identity theft, improve resolution of consumer disputes, improve the accuracy of consumer records, make improvements in the use of, and consumer access to, credit information, and for other purposes. The final rules generally require a creditor to provide a risk-based pricing notice to a consumer when the creditor uses a consumer report to grant or extend credit to the consumer on material terms that are materially less favourable than the most favourable terms available to a substantial proportion of consumers from or through that creditor.

A.4.3.11 **Dodd-Frank Wall Street Reform and Consumer Protection Act** (Dodd-Frank Act): The Dodd–Frank Wall Street Reform and Consumer Protection Act, which was enacted in July 2010 consolidated consumer financial protection authorities that had existed across seven different federal agencies. The act provided for a United States Consumer Financial Protection Bureau (bureau/CFPB) to regulate credit practices. The bureau, which began operations on July 21, 2011 is a new federal consumer financial regulator with broad rulemaking, supervisory and enforcement powers and holds primary responsibility for regulating consumer protection in the United States. The Dodd-Frank Act has not prescribed any interest rate limit for credit.

Usury statutes in the United States

A.4.3.12 Each US state has its own statute which dictates how much interest can be charged before it is considered usurious or unlawful. If a lender charges above the lawful interest rate, a court will not allow the lender to sue to recover the debt because the interest rate was illegal anyway. In some states such loans are voided *ab initio*. However, separate rules applied to most banks. In 1980,

Congress passed the Depository Institutions Deregulation and Monetary Control Act to exempt federally chartered savings banks, instalment plan sellers and chartered loan companies from state usury limits. This effectively overrode all state and local usury laws. The 1968 Truth in Lending Act does not regulate rates, except for some mortgages, but requires uniform or standardized disclosure of costs and charges. The Supreme Court in its verdicts further limited states' power to regulate interest rates and credit card fees. The court held that the word "interest" used in the 1863 banking law included fees and, therefore, states could not regulate fees.

B. United Kingdom (UK)

A.4.4 In the United Kingdom, the Financial Services Authority (FSA) had first charge on Consumer credit protection and Office of Fair Trading (OFT) had second charge. With the passage of the Financial Services Act 2012 on December 19, 2012 FSA is now disbanded to establish a new system comprising of more specialised and focused regulators:

(i) The Prudential Regulation Authority (PRA): a subsidiary of the Bank of England, responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. One of its two statutory objectives is to promote the safety and soundness of these firms.

(ii) The Financial Conduct Authority (FCA): responsible for regulating conduct in retail and wholesale markets, supervising the trading infrastructure that supports those markets, and for the prudential regulation of firms not prudentially regulated by the PRA. The FCA is responsible for promoting effective competition, ensuring that relevant markets function well, and for the conduct regulation of all financial services firms. This includes acting to prevent market abuse and ensuring that consumers get a fair deal from financial firms. The responsibility for consumer credit regulation will transfer from the OFT, UK's consumer and competition authority, to the Financial Conduct Authority (FCA) from April 1, 2014.

(iii) The Financial Policy Committee (FPC): a macro-prudential regulator within the Bank of England to monitor and respond to systemic risks as also to support the economic policy of the Government. The FPC is a statutory sub-committee of Bank's Court of Directors. Its members are the Governor, the three Deputy Governors, the Chief Executive of the Financial Conduct Authority (FCA), the Bank's Executive Director for Financial Stability, four external members appointed by the Chancellor, and a non-voting representation of the Treasury.

A.4.4.1 By way of statutes, the **Consumer Credit Act 1974** (as amended by the Consumer Credit Act 2006) regulates consumer credit and consumer hire agreements. The Act lays down rules covering: the form and content of agreements, credit advertising, the method of calculating the Annual Percentage Rate (APR) of the Total Charge for Credit, the procedures to be adopted in the event of default, termination, or early settlement and the unfair relationships test.

A.4.4.2 **The Consumer Credit Act 2006** (which was fully implemented on October 1, 2008) established a fairer, clearer and more competitive market for consumer credit, updating consumer credit legislation and making it more relevant to today's consumers. It introduced a requirement for lenders to provide borrowers with much more information about their accounts on a regular basis, such as an annual statement and notices when consumers fall into arrears or incur a default sum. The OFT's regulation was extended to credit information and debt administration services - debt administration and credit information (repair) service providers need a consumer credit licence, and consumers can go to the courts asking for longer time to pay back their loan (a time order) when they receive an arrears notice (prior to October, consumers could only seek a time order when they received a default notice).

A.4.4.3 **The Enterprise Act of 2002** allows designated consumer bodies to submit 'super complaints' to the Office of Fair Trading (OFT), the competition regulator, where they consider whether the structure of a market or the conduct of those operating in it appears to be significantly harming the interests of

consumers. The OFT is required to respond within 90 days, setting out whether it agrees with the consumer group's analysis and setting out what action it intends to take.

A.4.4.4 UK also has a self-regulatory Lending Code prepared jointly by The British Bankers' Association, The Building Societies Association and The UK Cards Association.

C. Singapore

A.4.5 The Monetary Authority of Singapore (MAS) supervises banks as well as other categories of financial institutions (e.g. finance companies) that grant mortgages, secured personal loans and unsecured personal loans as part of their businesses. There are limits on the loans that financial institutions may give. For the personal loans market, there are other entities that are regulated by other government agencies, rather than MAS. For instance, moneylenders are licensed by the Registry of Moneylenders under the Singapore Law Ministry. By way of self-regulation, Singapore has a Code of Consumer Banking Practice by the Association of Banks in Singapore (ABS).

D. Hong Kong

A.4.6 One of the key statutory functions of the HKMA is to promote and encourage proper standards of conduct and sound and prudent business practices amongst authorized institutions. In April 2010, the HKMA established a Banking Conduct Department to provide greater focus to its work in this area. The guiding principle adopted by the HKMA is that authorized institutions are encouraged to treat their customers fairly. This is mainly achieved through authorized institutions' compliance with the recommended practices currently embodied in the Code of Banking Practice (CoBP) which was issued by the industry associations [Hong Kong Association of Banks (HKAB) and the Deposit Taking Companies Association (DTCA)] and endorsed by the HKMA, and circulars and guidelines issued by the HKMA from time to time.

A.4.6.1 The CoBP is intended to increase transparency in the provision of banking services so as to enhance customers' understanding of the services provided. Authorized institutions should make readily available to customers written terms and conditions of a banking service, including fees and charges, penalties and relevant interest rates and the customers' liabilities and obligations in the use of the banking service. All financial promotional materials should be fair, reasonable and not misleading. CoBP includes provisions that promote and provide relief against excessive interest charges and extortionate terms.

A.4.6.2 Authorized institutions are required to engage an independent internal party to conduct regular self-assessments on their compliance with the CoBP and report the results to the HKMA. The HKMA also conducts on-site examinations of authorized institutions to monitor their compliance with the CoBP. These monitoring measures are supplemented by the mystery shopping programme undertaken by the HKMA from time to time to assess authorized institutions' compliance with the CoBP. Any non-compliance will be taken seriously by HKMA.

A.4.6.3 On October 28, 2013, all the retail banks in Hong Kong signed up to the Treat Customers Fairly Charter which demonstrates the industry's commitment not only to treating customers fairly but fostering a stronger culture towards fair treatment of customers at all levels of banks and at all stages of their relationship with customers.

A.4.6.4 The HKMA has launched a Consumer Education Programme to help the public to be smart and responsible in the use of banking products and services. Smart tips on using different banking products and services are available. From time to time, the HKMA also publishes *inSight* articles to enhance consumers' awareness of their rights and obligations as well as their understanding in the key features and risks of certain financial products.

E. Australia

A.4.7 The responsibility for regulation and supervision of the Australian financial system is vested in four separate agencies: the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), the Reserve Bank of Australia (RBA) and the Australian Treasury. The co-ordinating body for these agencies is the Council of Financial Regulators, which is chaired by the RBA.

A.4.7.1 APRA is an integrated prudential regulator charged with regulating banks and other financial institutions and developing administrative practices and procedures (e.g. prudential standards) in a manner that balances financial safety and efficiency, competition, contestability and competitive neutrality. The Australian Securities and Investments Commission (ASIC) administers and enforces a range of legislative provisions relating to financial markets, financial sector intermediaries and financial products, including investments, insurance, superannuation and deposit-taking activities. The RBA, Australia's central bank sets the cash rate to meet a medium-term inflation target. The Australian Treasury provides advice to the Government on policy processes and reforms that promote a secure financial system and sound corporate practices, remove impediments to competition in product and services markets and safeguard the public interest in matters such as consumer protection and foreign investment.

A.4.7.2 The FSB report [34] attributes the architecture of the financial regulatory regime and oversight role of the ASIC and APRA as one of the several factors for the low impact of the global financial crisis. Australia has a strong regulatory regime and licensing system as well as a Product Disclosure Statement (PDS) which requires highlighting the downside of riskier product offerings. The disclosure laws may have acted as a deterrent for the marketing arms of global investment banks (many of which had extensive operations in Australia) to bring riskier products to consumers in Australia. Supervisors have undertaken 'shadow shopping' initiatives, development of a consumer education website, and

[34] FSB report on Consumer Finance Protection with particular focus on credit dated October 26, 2011.

formation of a specific compliance and surveillance directorate. As mentioned in the FSB report, *underscoring these supervisory activities is a significant record in law enforcement*.

A.4.7.3 The National Consumer Credit Protection Act 2009 (NCCPA), requires banks to make suitability assessments on consumers' abilities to repay and alignment of the product with the objectives of the consumer. The National Credit Code (NCC) enshrined in the NCCPA requires credit providers to include a comparison rate, inclusive of the interest rate and most fees and charges, when they advertise fixed term credit which is for, or mainly for, personal domestic or household purposes. NCC also mandates the matter that must be in the credit contract which includes the Annual percentage rate or rates, default rate (when payments are in default) and enforcement expenses. Copy of the contract must be provided to the debtor. NCC also prescribes the information to be contained in statements of account. Third party mortgages are prohibited.

A.4.7.4 The NCCPA treats disclosure of all consumer credit products, including leases, mortgage and guarantees, in the same way and does not distinguish between residential mortgages, personal loans and credit cards. Further amendments were made by enacting the Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2012. These amendments, interalia, enable debtors to request to negotiate to change the contract if the debtors consider themselves unable to meet their obligations under a credit contract due to hardship such as of illness or unemployment; provide for a remedy for unfair or dishonest conduct by credit service providers; restrict the use of particular phrases or words; expand the range of remedies available to consumers.

A.4.7.5 At present, for home loans, the Reserve Bank of Australia sets the 'cash' interest rate, which is reviewed every month. Credit providers set their own rates and can choose to increase or decrease the rates in line with the cash rate.

F. Canada

A.4.8 While the Office of the Superintendent of Financial Institutions (OSFI) is the prudential regulator of financial institutions, the Financial Consumer Agency of Canada (FCAC) oversees the consumer provisions as set out in the financial institution statutes, provides consumers with accurate and objective information about financial products and services, and informs consumers of their rights and responsibilities when dealing with financial institutions. It however does not determine specific product suitability issues for individual consumers. Consumers can avail of a free mechanism set up by the government for complaints handling and independent dispute resolution The authorities can intervene in the distribution of potentially harmful products, through Ministerial Directives, Cease and Desist orders, limitation of business powers.

G. South Africa

A.4.9 South Africa currently has an institutional approach to regulation, but is moving towards a Twin Peaks methodology. Currently regulation and supervision of the banking sector is the responsibility of the South African Reserve Bank, under the authority of the Registrar of Banks. The purpose is to achieve a sound, efficient banking system in the interest of the depositors of banks and the economy as a whole.

A.4.9.1 Credit law in South Africa was governed by the Usury Act (73 of 1968) and the Credit Agreements Act (75 of 1980). These two Acts were replaced by the National Credit Act, 2005 which codified several basic rights that the Consumer has with regard to the credit market. The National Credit Act (35 of 2005) is part of a comprehensive legislation overhaul designed to protect the Consumer in the credit market and make credit and banking services more accessible. The purpose of the Act enacted on March 15, 2006 is to promote a fair and non-discriminatory market place for access to consumer credit and for that purpose to provide for the general regulation of consumer credit and improved standards of consumer information; to promote black economic empowerment and ownership within the consumer credit industry; to prohibit

certain unfair credit and credit-marketing practices; to promote responsible credit granting and use and for that purpose to prohibit reckless credit granting; to provide for debt re-organisation in cases of over-indebtedness; to regulate credit information; to provide for registration of credit bureaux, credit providers and debt counselling services; to establish national norms and standards relating to consumer credit; to promote a consistent enforcement framework relating to consumer credit; to establish the National Credit Regulator and the National Consumer Tribunal; to repeal the Usury Act, 1968, and the Credit Agreements Act, 1980; and to provide for related incidental matters. With the enactment of NCA, the credit agreements and information disclosures are standardised by providing in simple language so that comparison of credit agreements from various providers of credit can be done easily. The act also has a provision for registering the Debt Counsellors who assist the consumers to restructure their debt, wherever required, and the act also provides for regulation of credit bureaux in terms of their consumer information and records.

A.4.9.2 The National Credit Regulator (NCR) is responsible for the regulation of the South African credit industry. It is tasked with carrying out education, research, policy development, registration of industry participants such as credit providers, credit bureaux and debt counsellors, investigation of complaints, and ensuring enforcement of the Act. It is responsible for enforcing compliance with the National Credit Act, and is focused on developing an accessible credit market to meet and promote the needs of people who are marginalized, especially economically. The National Credit Regulator is governed by a Board, which consist of members designated by cabinet members in the related ministries viz., finance, social development, housing matters etc.

A.4.9.3 National Consumer Tribunal is established to adjudicate on customer complaints, grants orders for cost and exercises any other powers conferred on it by law.

A.4.9.4 Further, the Banking Association of South Africa, which is an industry body representing all banks registered and operating in South Africa has

developed a Code of Banking Practice which sets out the minimum standards customers can expect from their bank in relation to services and products. Though the Code is a voluntary agreement by all major consumer lending banks, it formalised the standards of disclosure, conduct and fairness which is a valuable safeguard for South African bank customers.

H. European Union:

A.4.10 The European Commission (EC), the executive body of European Union (EU), has several departments known as Directorates-General (DG). The Internal Markets and Services DG and Health and Consumers DG are largely involved in financial services and consumer protection.

A.4.10.1 **Consumer Credit Directives (CCD)** are issued by EU for consumer protection and other measures for financial services. The first Directive on consumer credit was issued in 1987 after which new directives are issued or existing ones are amended. Credit agreements: Directive 2008/48/EC of the European Parliament and of the Council was issued on April 23, 2008 on credit agreements for consumers. The main objectives were further integration of the markets and a high level of consumer protection. The Directive focuses on transparency and consumer rights. It provides for a comprehensible set of information to be given to consumers in good time before the contract is concluded and also as part of the credit agreement. In order to enhance the comparability of different offers and to make the information better understandable, the pre-contractual information needs to be supplied in a standardised form (Standard European Consumer Credit Information), i.e. every creditor has to use this form when marketing a consumer credit in any Member State, and consumers will receive the Annual Percentage Rate of Charge (APR, a single figure, harmonised at EU level, representing the cost of the credit). The Directive foresees in addition two essential rights for consumers: they are allowed to withdraw from the credit agreement without giving any reason within a period of 14 days after the conclusion of the contract. They also will have the possibility to repay their credit early at any time, while the creditor can ask for a

fair and objectively justified compensation. Member States were asked to transpose the Directive into national law. The CCD fully harmonises throughout the EU, *inter alia,* the following: the elements of the total cost of the credit to the consumer, the methodology and assumptions used for calculating the Annual Percentage Rate of Charge (APR) and the obligations regarding disclosure of other relevant information to be provided to the consumer.

A.4.10.2 The APR is described as equating, on an annual basis, to "*the present value of all commitments (drawdowns, repayments and charges), future or existing, agreed by the creditor and the consumer*". The CCD also stipulates that the APR must be calculated in accordance with the mathematical formula set out therein. The CCD respects the diversity of methods used in practice for calculating interest charges, while imposing a unique method for calculating the APR. This requirement applies to all credit agreements within the scope of the CCD and at all three stages of the agreement: in advertising, at a pre-contractual and at a contractual stage.

A.4.10.3 **Distance Marketing of Financial Services:** To boost consumer confidence in distance marketing techniques - and in particular in internet transactions across borders - the EU adopted a Directive in 2002 laying down fundamental rights for consumers: an obligation to provide consumers with comprehensive information before a contract is concluded; a consumer right to withdraw from the contract during a cooling-off period; a ban on abusive marketing practices seeking to oblige consumers to buy a service they have not solicited ("inertia selling"); rules to restrict other practices such as unsolicited phone calls and e-mails ("cold calling" and "spamming").

A.4.10.4 **Mortgages:** In 2001 the Commission endorsed guidelines on harmonised information on "home loans" (mortgage or housing credit) to be made available by lenders to consumers. The guidelines were agreed in the form of a Voluntary Code of Conduct between the EU mortgage-lending industry and consumer groups. Their aim is to make it easier for consumers to compare loan products available from different lenders, including lenders from other Member

States and to allow consumers to make an informed choice. When signing up to the Code, mortgage lenders commit themselves to giving prospective borrowers two sets of information before they sign a contract: general information as to the different types of products offered including the types of interest rate (fixed, variable or combinations thereof) and all additional costs associated with taking up a mortgage credit; personalized information for the specific product the consumer is interested in, indicating for example the exact amounts to be paid over the full time span of the loan, as well as any possibility and conditions for early repayment.

A.4.10.5 In December 2013, the European Commission adopted the Directive on Credit Agreements Relating to Residential immovable Property (CARRP), referred to as Mortgage Credit Directive (MCD). The objectives are to create an efficient and competitive single market for consumers, creditors and credit intermediaries with a high level of consumer protection and to promote financial stability by ensuring that mortgage credit markets operate in a responsible manner. The Directive will foster consumer confidence and customer mobility, create a level playing field for operators and promote cross-border activity by creditors and credit intermediaries. The directive covers better information for consumers, more time to decide, heightened credit worthiness assessment standards, business conduct rules, early repayment, passport regime for credit intermediaries and arrears and foreclosures

Interest Rate Restrictions in the EU

A.4.10.6 Some of the 27 member states of the EU have stipulated certain restrictions on interest rates. In September 2010, European Commission services published a Study on Interest rate restrictions (IRR) in the EU[35] and invited the stakeholders to respond by March 22, 2011. The summary of responses was published on June 15, 2011. The study on the impacts of interest

[35]iff/ZEW (2010): Study on interest rate restrictions in the EU, *Final Report for the EU Commission DG Internal Market and Services*

rate restrictions in place in some Member States was considered important in order to fully understand the possible effects of interest rate restrictions on product diversity and cross-border activity as well as to assess their important social and consumer protection role. The objectives of the study were to identify the different types of interest rate restrictions, the Member States that apply them, and their reasons for doing so, and to analyse the economic, financial, and social impacts of interest rate restrictions on various stakeholders. The report observed that IRR in general do not affect ordinary car loans, mortgage loans, home improvement loans, ordinary overdraft for short-term liquidity because (a) Their interest rates are by definition far removed from the ceiling between 33% (France), 50% (Italy), 100% (Germany), 300% (Slovenia) because ceilings are defined by average interest rates for these products and (b) Borrowers can exercise a certain amount of choice (sufficient competition). Nevertheless, the findings of the study are reproduced below:

A.4.10.7 Fourteen of the EU member states had absolute (Greece, Ireland, Malta) or relative (Belgium, France, Estonia, Germany, Italy, Netherlands, Poland, Portugal, Slovenia, Spain, Slovakia) interest rate restrictions. The restrictions did not apply to banks in Greece, Ireland and Slovenia. Malta had many exemptions for banks. The ceilings were mostly by way of a cap of the average of rates found for different types of credit and amounts of credit. For example, in Italy, the ceiling was 50% above the calculations of the average charges while it was 33% in France.

The rate caps/ceilings/restrictions in some of the countries are as under:

I. France

A.4.11 Interest rates ceilings exist for all credit to consumers (including real estate loans). These are calculated quarterly by the National Bank on the basis of the market rates for different amounts of credits. It currently specifies (as on 2010) a relative maximum APR of 133% of the average of rates found for different amounts of credit. Sanctions in case of non-compliance are penal. The system is currently being reviewed by the French regulator.

J. Poland

A.4.12 Rate caps in Poland are subject to regulation in the Civil Code and in the Consumer Credit Act. The maximum interest rate in Poland is a relative rate ceiling for all types of credit, calculated by reference to the central Lombard rate multiplied by four. This mechanism for limiting interest rates was introduced in 2005 and set only on the interest rate, not the rate representing the total cost of the credit (ie. the APR). In addition, fees and additional charges related to the concluding of the credit contract are separately regulated as well, and cannot exceed 5% of the amount of the credit. The rule applies to all credit types, depending only on central bank decisions (Monetary Policy Council) and the rates are reviewed monthly. Decisions concerning changes are published in the statements of the Central Bank's Monetary Policy Committee.

K. Italy

A.4.13 Usury is a criminal offence in Italy and it provides a detailed system of usury ceilings based on 50% above calculations of the average charges in the market (APR or 'TEGM') for different types of credit and different credit amounts. The ceilings are effective for every kind of transaction or financial/credit operation, and for every kind of subject. Civil/contractual remedies, which include voiding the contract and/or substituting new interest rates into the contract, can also be combined with criminal sanctions. The types of credit are decided every year by Banca d'Italia, which collects data from all the credit providers. The rate ceilings are adjusted every three months by the Ministry of Economy and Finance, who approves the rates by decree and are published in the Italian Official Journal (Gazzetta Ufficiale).

L. Belgium

A.4.14 The maximum APR varies according to amount and type of credit. The reference indices, which determine changes made to the ceiling, and the calculation

method for mortgage loans are set by the King (by Royal Decree) after consulting the Banking, Finance and Insurance Commission (“CBFA”). For all consumer credit agreements, with the exception of revolving credit accounts, the reference rate is based upon treasury certificates for 12 months (for credit amounts up to €1,250), linear bonds on 2 years (for credit amounts between €1,250 and €5,000) and linear bonds on 3 years (for credit amounts above €5,000). The reference index for revolving credit accounts is linked to the monthly average of the 3 month Euribor and is calculated by Belgostat. The applicable maximum APR corresponds to the respective rounded reference rates. The maximum APR is published in the Official Journal. It is analysed every 6 months, to see if reference rates (Euribor term rates) have changed beyond 75 basis points in which case reference indexes and then APR ceilings will be adjusted accordingly, with a rounding to the nearest half a percentage point for the ceiling.

A.4.15 Belgium is the only country in the EU which has implemented a special rate ceiling concerning the variability rate itself. For mortgage loans, the variable (also called floating) interest rate must not only be linked to a reference rate but can only increase by a maximum of 2% during the first 3 years of the mortgage loan, thereby protecting these borrowers from large shifts in interest rates. If the contracting parties agree on a floating interest rate, only one floating interest rate per mortgage loan is allowed. The reference indices must be chosen as a function of the period between two alterations of the interest rate. Equally if the change of interest rates for revolving credit in Belgium exceeds 25% in relation to the original borrowing rate and if the revolving credit account was agreed for a term of at least 1 year, the consumer has a right to terminate the revolving credit account within 3 months as from notification by the credit provider.

M. Germany

A.4.16 German court based jurisprudence limits lenders' flexibility by requiring them to charge no more than double the average market rate. It also imposes a second condition limiting the ceiling to a fixed pre-determined maximum margin set at 12 percentage points over the average interest rate. This means that when the

average market rates move above 12.1% APR, the ceiling level applied will no longer be twice this (i.e., 24.2%) but instead be limited by the second condition to 24.1%. Interest rates exceeding the limits cause contracts to be held as usurious and declared void by the court.

A.4.17 While the proponents of interest rate restriction policies (consumer/user representatives etc.) argue that such restrictions are important tools for consumer protection, the opponents (financial sector /industry) feel that such restrictions impede customer's access to credit markets and leads to financial exclusion.

Statutory default interest rates:

A.4.18 A majority of EU countries provide statutory default rules with regard to default interest rates. These interest rates apply when the contracting parties do not agree upon the interest to be paid upon default and when the law provides for the right of the contractor to claim (additional) default interest. Statutory default interest rates differ from default interest rate ceilings. Countries such as Latvia and Lithuania make use of statutory default interest rates but do not have explicit default interest rate ceilings. Conversely, in Bulgaria, the Czech Republic, Estonia, Germany, Malta and Slovakia the statutory default interest also provides the default interest rate ceiling. In Austria and Hungary, default interest rate ceilings and statutory default interest rates exist, but are calculated differently.

A.4.19 Statutory default interest rates based on a reference rate are the most common among Member States - Bulgaria, Czech Rep, Estonia, Finland, Germany, Hungary, Italy, Portugal, Slovakia, Slovenia, and Sweden. Fixed statutory default interest rate was used in Austria, Belgium, Latvia, Lithuania, Luxembourg, Malta, and Spain. There was no statutory default interest rate in Ireland, Romania, and UK.

Annex V

Reserve Bank of India Instructions to Banks on Consumer Protection and Customer Service

A.5.1 Master circular on customer service in banks – the contents of this circular not only cover individual products / services both on the liability and asset side but also give details of the grievances redressal system that each bank is mandated to put in place. The three tier customer service / grievances redressal structure starting from the branch level Customer Service committee that is expected to meet once every month, culminates at the Board level Customer Service committee.

A.5.2 Master Circular on Interest Rates on Advances:

A.5.2.1 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.

A.5.2.2 The methodology of computing the floating rates should be objective, transparent and mutually acceptable to counter parties. The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from external market benchmark rates.

A.5.2.3 Though interest rates have been deregulated, charging of interest beyond a certain level is seen to be usurious and can neither be sustainable nor be conforming to normal banking practice. Boards of banks have, therefore, been advised to lay out appropriate internal principles and procedures so that usurious interest, including processing and other charges, are not levied by them on loans and advances. In laying down such principles and procedures in respect of small value loans, particularly, personal loans and such other loans of similar nature, banks should take into account, inter-alia, the following broad guidelines:

a. An appropriate prior-approval process should be prescribed for sanctioning such loans, which should take into account, among others, the cash flows of the prospective borrower.

b. Interest rates charged by banks, inter-alia, should incorporate risk premium as considered reasonable and justified having regard to the internal rating of the borrower. Further, in considering the question of risk, the presence or absence of security and the value thereof should be taken into account.

c. The total cost to the borrower, including interest and all other charges levied on a loan, should be justifiable having regard to the total cost incurred by bank in extending the loan, which is sought to be defrayed and the extent of return that could be reasonably expected from the transaction.

d. An appropriate ceiling should be fixed on the interest, including processing and other charges that are levied on such loans, which should be suitably publicised.

A.5.2.4 Guidelines on Benchmark Prime Lending Rate (BPLR) applicable to loans sanctioned upto June 30, 2010 stipulate that in the interest of customer protection and to have a greater degree of transparency in regard to actual interest rates charged to borrowers, banks should continue to provide information on maximum and minimum interest rates charged together with the Benchmark PLR.

A.5.3 Master Circular on Loans and Advances - Statutory and Other Restrictions, and Master Circular on Credit Card Operations of Banks, also incorporate Guidelines on Fair Practices Code for Lenders and Guidelines for Recovery Agents Engaged by Banks. These guidelines stipulate, inter alia, as under:

(i) The loan application forms in respect of all categories of loans, irrespective of the amount of loan sought by the borrower, should be comprehensive and detailed.

(ii) Banks must transparently disclose to the borrower all information about fees / charges payable for processing the loan application, the amount of fees

refundable if the loan amount is not sanctioned / disbursed, pre-payment options and charges, if any, penalty for delayed repayments, if any, conversion charges for switching loan from fixed to floating rates or vice versa, existence of any interest reset clause and any other matter which affects the interest of the borrower.

(iii) All information relating to charges / fees for processing should be invariably disclosed in the loan application forms. Further, banks must inform 'all-in-cost' to the customer to enable him to compare the rates charges with other sources of finance. It should also be ensured that such charges / fees are non-discriminatory.

(iv) Levying charges subsequently without disclosing the same initially to the borrower is an unfair practice

(v) Such information should also be displayed on the website of banks for all categories of loan products.

(vi) Banks and financial institutions should devise a system of giving acknowledgement for receipt of all loan applications.

(vii) The time frame within which loan applications up to Rupees two lakh will be disposed of should also be indicated while acknowledging such applications.

(viii) Banks / financial institutions should verify the loan applications within a reasonable period of time. If additional details / documents are required, they should intimate the borrowers immediately.

(ix) In case of all categories of loans, irrespective of any threshold limits, including credit card applications, the lenders should convey in writing, the main reason / reasons which, in the opinion of bank after due consideration, have led to rejection of the loan applications within stipulated time.

(x) The lender should also convey to the borrower the credit limit along with the terms and conditions thereof, and keep the borrower's acceptance of these terms and conditions given with his full knowledge on record.

(xi) Terms and conditions and other caveats governing credit facilities given by banks / financial institutions arrived at after negotiation by the lending institution and the borrower should be reduced in writing and duly certified by the authorised official. A copy of the loan agreement along with a copy each of

all enclosures quoted in the loan agreement should be furnished to the borrower at the time of sanction / disbursement of loans.

(xii) Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction. Lenders should give notice of any change in the terms and conditions including interest rates, service charges etc. Lenders should also ensure that changes in interest rates and charges are effected only prospectively.

(xiii) Lenders should release all securities on receiving payment of loan or realisation of loan subject to any legitimate right or lien for any other claim lenders may have against borrowers. If such right of set off is to be exercised, borrowers shall be given notice about the same with full particulars about the remaining claims and the documents under which lenders are entitled to retain the securities till the relevant claim is settled / paid.

(xiv) Lenders must not discriminate on grounds of sex, caste and religion in the matter of lending.

(xv) In the matter of recovery of loans, the lenders should not resort to undue harassment.

(xvi) In case of receipt of request for transfer of borrowal account, either from the borrower or from a bank / financial institution, which proposes to take- over the account, the consent or otherwise i.e., objection of the lender, if any, should be conveyed within 21 days from the date of receipt of request.

(xvii) Fair Practices Code should be put in place in respect of all lending. For this purpose, the Boards of banks and financial institutions should lay down a clear policy.

(xviii)The Board of Directors should also lay down the appropriate grievance redressal mechanism within the organization to resolve disputes arising in this regard. The Board of Directors should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of controlling offices.

(xix) The Fair Practices Code, which may be adopted by banks and financial institutions, should also be put on their website and given wide publicity. A copy may also be forwarded to the Reserve Bank of India.

A.5.4 RBI guidelines on appointment of recovery agents give details of the methodology to be adopted for selection, training and counseling of the recovery agents that may be appointed by banks. These also cover incentives, methods followed by Recovery Agents, taking possession of property mortgaged / hypothecated to banks, utilisation of credit counsellors etc.

A.5.5 RBI guidelines on appointment of direct selling / marketing agents.

A.5.6 Master circular on credit card operations of banks – laying down the procedure and processes to be followed for issue of cards, recoveries to be made of card dues etc.

A.5.7 Guidelines issued by the RBI regarding education loans.

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