3. The Loan Pricing System: Issues and Options

3.1 Before firming up its views on the issue of appropriate loan pricing system, the Group consulted the various stakeholders. The Working Group held a meeting with industry and trade associations, including those of SMEs and exporters on July 13, 2009 to solicit their views/suggestions on the loan pricing system. The list of associations/bodies that attended the meeting is at Annex 8. The Working Group also solicited comments from the general public through the press release of June 19, 2009. The names of all those individuals/associations who have submitted their suggestions to the Group in writing are set out in Annex 9.

Suggestions Received from Industry/Trade Associations

3.2 Various industry/trade associations were generally of the view that the present BPLR system had no relation with the market rates and there was an absence of a system-wide risk free reference rate. A suggestion was made that in order to obtain such a transparent system wide-risk free rate, the yield on 5-year Government security be considered as the benchmark rate, on which the risk premium can be further loaded to arrive at the lending rate. The existence of such a transparent benchmark was posited to be highly beneficial for large corporate as well as small borrowers. Suggestions were also made to use market-based benchmark with up to one year maturity such as the Certificate of Deposit rates or Commercial Paper rates in case the Government bonds were not suitable for the purpose. Hence, it was suggested that there was a need to have market benchmarks or credible term money market rate for encouraging the long-term loan market. Suggestions were also made to link the BPLR to the repo rate, in order make the lending rates more responsive to the changing market conditions.

3.3 For achieving greater transparency in loan pricing, it was suggested that a basic rate could be formulated which includes cost of funds and operational cost. The final lending interest rate on credit could be obtained from this basic rate by adding the credit risk premium over the base rate. In such a scenario, the multiple BPLRs should also be explored as long as they were based on a transparent basic rate. Furthermore, in order to enhance transparency, it was suggested to separate or delink the mandated lending at regulated rates

from market driven segment so that the burden of concessional lending was not passed on to the other non-concessional loans. The delinking of regulated and non-regulated lending was also suggested as a means to overcome the problem of sub-BPLR lending. Suggestions were also received for a two tier approach to bank lending. In the first tier, the lending rates should be determined sector-wise and subsequently, within each sector, lending rate should be determined based on credit rating of borrowers.

3.4 In view of the fact that bulk of the loans were extended at rates below BPLR and that the BPLR has lost its relevance as the prime rate, it was suggested that it should be re-defined as the lowest rate at which a bank will lend to any borrower. Further, as the BPLR is currently without reference to tenor, it was suggested to redefine BPLR as an internal benchmark of a bank for a 6-month loan.

3.5 In order to make the BPLR more in tune with the actual lending rates that prevail in the market, it was suggested that the BPLR be based on the average lending rate of the top 15 customers. The top 15 customers may be chosen based on the interest rates, (*i.e.,* those who get credit at least interest rates from the banks) or on the basis of quantum of lending (*i.e.,* top 15 by way of quantum of loans). Under such a system, it was pointed that banks may not have to reveal their cost structure. Further, in order to take care of the point as to which is more relevant between "marginal pricing" and "average pricing", it was suggested that the above BPLR may be calculated for the loans during the quarter (or any other chosen intervals) as well as the average on the total outstanding stock of loans.

Suggestions Received from Individuals/Associations in Writing

3.6 The following major suggestions were received from individuals/ associations in writing;

i) In order to improve the existing BPLR system, it was pointed out that an aspect that needs to be examined is how the BPLR as a mechanism and as a special case of PLR, is superior over the universal concept of PLR (i.e., the rate as applicable to the best or AAA borrowers) in achieving the overall objective of transparency as also in transmitting the interest rate signals of the central bank.

ii) The benchmark prime lending rate of PSU banks be related to the highest term deposit rates offered by them. Further, the BPLR should not be fixed at more than 2 per cent higher than the respective bank's highest term deposit rate. This principle of fixing BPLR was proposed to be applied to both categories of banks - public and private. The BPLR should be charged for the top rated customers. Borrowers, other than the top rated, would then be charged some additional basis points depending on their credit worthiness.

iii) Further, there should be a system of multiple BPLRs, *i.e.* separate BPLRs for wholesale, SME and retail advances.

iv) Considering that most of the liabilities are on a fixed interest rate basis, it creates stickiness in lending rates. It was therefore, suggested that deposits should also be on a floating rate basis. This will also help banks to manage their interest rate risk more effectively.

v) An indicative benchmark be developed to link BPLR with the repo rate or with MIBOR. It was also suggested to keep the banks' lending rate within a prescribed minimum lending rate and maximum lending rate.

vi) The current method for deriving BPLR, consisting of cost of funds, operating cost, provisioning cost and expected profit margin may be continued, but certain modifications needs to be incorporated. Since the high value short-term loans extended to corporates are basically dependant on treasury functions, based on the availability of surplus funds with the bank, the pricing of these exposures may not be linked to the BPLR. Further, such lending should not be reckoned for calculation of the quantum of sub-BPLR lending of the bank.In order to bring about transparency in such lending, the pricing of such short term exposures be linked to short term treasury rates such as G-sec rates of similar maturity with loading of expected margin.

vii) Loan facilities with administered interest rates and cases involving consortium lending, on account of the necessity to match interest rate across banks, should not be reckoned for the sub-BPLR exposure. The sub-BPLR lending should not exceed 10 per cent of total advances.

International Experiences

3.7 A survey of the Prime Lending Rate in select countries shows that in most of the countries *i.e.* Japan, Russia, Hong Kong, Singapore and Taiwan a cost plus approach is followed for determining the PLR. In case of Brazil, Poland and South Africa the PLR is based on rates in the interbank market, or the overnight money markets (Annex 10). In the case of US, it is broadly determined as a 300 bps spread over the Fed Funds rate. Irrespective of the system of PLR followed, in almost all the countries surveyed, PLRs tended to remain more or less similar among various banks and were also seen to have moderate to high correlation with central bank policy rates. Furthermore, in almost all the countries surveyed there was high elasticity of PLRs to deposit costs. In the case of Brazil and Poland, where the overnight interbank rates, the CDI (Brazil's overnight inter-bank lending rate) and Warsaw Interbank Lending Rate (WIBOR) respectively, were taken as the PLR, a system of multiple PLR also prevailed. In these countries, multiple PLRs for different segments/groups of borrowers were determined as spread over the PLR. In Brazil, while banks may borrow overnight at 100 per cent CDI, local company may only get it at a 140 per cent CDI. In Poland, while WIBOR is a fixed inter-bank rate, the spread varies for different segments. Other than Japan and Hong Kong, the PLRs of the surveyed countries were tenorless. As regards sub-BPLR lending, while there is hardly any sub-BPLR lending in Brazil, Russia and Taiwan, in United States, significant sub-PLR lending exists and to a lesser extent in Hong Kong, Malaysia, Poland, Japan, Singapore and South Africa. In Hong Kong, sub-PLR lending was primarily on account of mandated lower lending rates over PLR for residential mortgages. In others countries surveyed, the sub-PLR was primarily due to competitive pressures. Except in case of Taiwan and Malaysia where lending linked to PLR accounted for 50 to 75 per cent of total lending, bank lending linked to PLR was around 10 to 25 per cent in the countries surveyed. In South Africa almost the entire lending to individuals was linked to PLR. Lending to corporate sector was linked to floating rate, *i.e* Johannesburg Interbank Agreed Rate (JIBAR) or PLR.

The Groups views on the Suggestions Received

3.8 The Group carefully examined the various suggestions received from the industries/trade associations in the meeting held on July 13, 2009 as also from other

associations/ individuals in writing. The Group's views on the suggestions received are set out below:

3.9 In the view of the Group, linking the benchmark/reference rate to the repo rate or government securities yields would not be appropriate as they do not fully reflect the cost of funds of banks, which is determined largely by the cost of deposits as they constitute the main source of funding for banks. The disconnect between the market interest rates and deposit rates in India arises mainly from the fact that banks rely largely on retail deposits, unlike in developed economies where banks can approach the wholesale market for funding. The fixed tenure of deposits makes the adjustment in lending rates difficult due to rigidity in the cost of funds. Similarly, it would not be appropriate to link the reference rate to the CP rates as CPs are primarily issued by AAA corporates and are for shorter maturities. The CP rate includes the risk premium and is not akin to a risk free reference rate. Moreover, the volume of the CP market is small, about 3.0 per cent of non-food bank credit. Similarly, the CD rate may not be representative of the cost structure of banks as it constituted only a small portion at 5.6 per cent of aggregate deposits. Also, such instruments are used only by specific segments of the economy. Therefore, interest rates in these instruments may not be ideal benchmarks for pricing of the overall credit portfolio of banks. Further, although the suggestion that short-term government securities yields was not found acceptable, the Group did recognise certain situations when it may be desirable to allow banks to lend below their cost of funds as otherwise banks may have to park funds with the Reserve Bank at still lower rates. However, such lending has to be at the margin and cannot be allowed in general as is the case now.

3.10 As regards the suggestion of the formulation of a reference rate based on the average cost of funds and operating cost of some representative banks, the Group is of the view that lending rates based on average cost of funds will make them backward looking and hence sticky. Operating cost, of course, would need to be included. However, while doing so, significant variations that exist between operating cost for retail borrowers and wholesale borrowers will have to be taken into account. The Group did not favour the idea of fixing lending rates based on the cost structure of some representative banks. Lending rates have to be necessarily based on the cost structure of each individual bank. The suggestion regarding the separation of regulated and de-regulated segments could also not be accepted as the

volume of regulated lending is particularly small. A separation of the two segments could obfuscate the position with regard to the issue of cross-subsidisation among borrowers. The Group, however, felt that there is a need for appropriate rationalisation of administered interest rates as they are imparting a downward stickiness to overall lending rates.

3.11 The Group considered the suggestion of redefining the BPLR as the minimum lending/prime rate. However, the suggestion was not found acceptable because banks, at present, extend a large chunk of their loans at sub-BPLR rates. As a result, the weighted average rate of each bank is significantly lower than its prevailing BPLR. To redefine present BPLR as the minimum lending rate would mean accepting higher interest rates than they would otherwise be. To define the BPLR as the rate for 6 month credit extended by banks was also not accepted for the reason that it would not adequately represent the tenure of the typical working capital credit cycle which lasts at least one year.

3.12 The Group did not also favour linking the BPLR, as in the present system, with the top most rated customers, as such lending rates would depend on risk profiles of top rated borrowers and cannot be generalised for all other categories of borrowers. Moreover, the considerations relating to AAA large ticket loans are based on the banks' own assessment of the returns and cost pertaining to such lending over a period of time. The Group felt that there was a need for a uniform methodology for calculating the cost of funds.

3.13 The suggestion relating to linking BPLR with term deposit rates was deliberated upon by the Group in detail. It was felt that linking the lending rate to the interest rate with an appropriate tenor of deposit product may indeed help in enhancing transparency in setting the lending rates. The Group did not favour the suggestion of placing any band around the BPLR for setting the lending rates as this may reduce credit flow by making banks risk averse.

Views and Recommendations of the Working Group

3.14 Lending interest rates need to be appropriate to the borrowers depending on their risk profile and at the same time they should also be competitive for banks whereby they earn reasonable risk adjusted return to remain profitable. Lending interest rates should also 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 ideal benchmark for such a rate should be some money market rate with which both liabilities and

assets of banks are closely linked and the money market rate, in turn, should be sensitive to the central bank's policy rates. Although the inter-bank money market rate in India is sensitive to the Reserve Bank's policy rate, banks' overall liabilities and assets are not tied to such a rate. It would therefore, not be appropriate to price loan products with reference to a money market rate.

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

3.16 On rigidity of lending rates, the Group felt that the fixed nature of cost on the liability side was the main reason for the stickiness in lending rates. Unless the cost of liabilities also moves in line with the policy rates, it may not be possible for banks to price their loans in line with the changing policy rates of the Reserve Bank. In general, the Group felt that there was no immediate alternative to the existing fixed rate liability structure of banks given the depositors' preference. This implied that the downward stickiness in lending rates persists reflecting the maturity structure in the liability structure of the bank. The Group noted that there was no regulatory restriction on banks offering floating rate deposits. There is, therefore, a need for banks to encourage deposit contracts at floating interest rates. However, since such a structure can emerge only over time, there is a need to bring appropriate changes in the existing loan pricing system to make it more transparent and responsive to the Reserve Bank's policy rates.

3.17 Given some structural rigidities in the system, it may not be possible to have a system which is perfect for both borrowers and the banks. However, at the same time, there is both a need and room to improve upon the existing system of pricing of loans.

3.18 The modification in the existing system or the design of a new system needs to keep in view the structure of assets and liabilities of the banking sector in India. Deposits constitute the predominant source of funding assets as is reflected in the ratio of deposits to total assets (about 78 per cent as on March 2009 for all scheduled commercial banks). The ownership pattern is largely concentrated in favour of fixed tenure retail household deposits which accounted for 58.1 per cent of total deposits (Tables 7 and 8).

Table 7: Distribution Current, Savings and Term Deposits - March 2008

(per cent)

Bank Group	Current	Savings	Term	Total
1	2	3	4	5
Public Sector Banks	13.1	26.0	60.9	100
Private Sector Banks	14.9	18.7	66.4	100
Foreign Banks	26.4	14.9	58.8	100
SCBs (Excluding RRBs)	**14.2**	**23.9**	**61.9**	**100**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

Table 8: Ownership Pattern of Bank Deposits (As on March 31, 2008)

(per cent)

Sector	Current Accounts	Savings Deposits	Term Deposits	Total Deposits
1	2	3	4	5
Government Sector	14.8	8.0	15.3	13.5
Private Corporate Sector (Non-Financial)	24.8	0.4	15.2	13.0
Financial Sector	16.3	0.5	12.7	10.3
Foreign Sector	3.4	5.7	5.2	5.1
Household Sector	40.7	85.4	51.5	58.1
Overall	**100**	**100**	**100**	**100**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

3.19 The bulk of the term deposits are with maturity one year and above (Table 9).

Table 9: Term Deposits Outstanding : Distribution as per Maturity - March 2008

(per cent)

Bank Group	Less than 6 months	6 months & above but less than 1 year	1 year and above but less than 2 years	above 2 years	Total Term Deposits
1	2	3	4	5	6
Public Sector Banks	13.3	13.6	40.6	32.5	100
Private Sector Banks	21.1	16.1	40.2	22.5	100
Foreign Banks	32.8	15.8	35.5	15.8	100
SCBs (Excluding RRBs)	**16.1**	**14.3**	**40.2**	**29.4**	**100**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

3.20 On the lending side, the bulk of the accounts (about 98 per cent of the accounts) are up to Rs. 10 lakh. However, the amount outstanding in such accounts was relatively small (about 27 per cent). As a result, the average size of loans per account was also small (about Rs. 70,000) (Table 10). Given this structure of loan portfolio of banks in India, the transaction cost for retail loans is high.

Table 10: Credit Accounts by Size of Credit Limits – March 2008

Bank Group	No. of Accounts (per cent to total accounts in each bank group)		Total Credit (per cent to total credit in each bank group)		Average Amount per Account (Rs. lakh)	
	Up to Rs.10 lakh	Above Rs. 10 lakh	Up to Rs.10 lakh	Above Rs. 10 lakh	Up to Rs.10 lakh	Above Rs. 10 lakh
1	2	3	4	5	6	7
Public Sector Banks	98.2	1.8	25.6	74.4	0.8	128.8
Private Sector Banks	97.4	2.6	32.3	67.7	0.6	46.7
Foreign Banks	98.5	1.5	21.7	78.3	0.4	94.5
SCBs (excluding RRBs)	**98.0**	**2.0**	**26.7**	**73.3**	**0.7**	**95.1**

3.21 The cost of funds was a major factor explaining the overall profitability of the credit portfolios as the cost of funds and return on advances were closely linked with a correlation coefficient of close to 0.90. In terms of aggregate banking business, it was also observed that there was high degree of correspondence between the cost of funds and Net Interest Margin (NIM) as reflected in the high correlation coefficient (0.94) between the two variables (Table 11).

Table 11: Cost of Funds, Return on Funds and Net Interest Margin

(per cent)

Item	2004-05	2005-06	2006-07	2007-08	2008-09
1	2	3	4	5	6
Cost of Deposits					
Scheduled Commercial Banks	4.20	4.15	4.44	5.41	5.66
Public Sector Banks	4.36	4.32	4.45	5.41	5.60
Private Sector Banks	3.84	3.87	4.77	5.88	6.32
Foreign Banks	3.00	2.78	3.15	3.81	4.34
Cost of Funds (CoF)					
Scheduled Commercial Banks	4.00	4.05	4.35	5.26	5.53
Public Sector Banks	4.17	4.19	4.36	5.29	5.52
Private Sector Banks	3.55	3.79	4.58	5.57	6.03
Foreign Banks	3.12	3.22	3.54	3.96	4.23
Return on Advances (RoA)					
Scheduled Commercial Banks	7.07	7.2	7.89	8.93	9.58
Public Sector Banks	6.93	7.1	7.68	8.57	9.06
Private Sector Banks	7.52	7.44	8.38	9.91	10.84
Foreign Banks	7.35	7.56	8.66	9.75	12.44
Return on Investment					
Scheduled Commercial Banks	7.57	7.66	6.87	6.62	6.35
Public Sector Banks	7.93	8.17	7.09	6.64	6.23
Private Sector Banks	6.07	5.90	5.98	6.40	6.61
Foreign Banks	6.87	7.54	7.46	7.09	6.71
RoA Adjusted for Cost of Funds					
Scheduled Commercial Banks	3.07	3.15	3.54	3.67	4.05
Public Sector Banks	2.76	2.91	3.32	3.28	3.54
Private Sector Banks	3.97	3.65	3.80	4.34	4.81
Foreign Banks	4.23	4.34	5.12	5.79	8.21
NIM (% of Assets)					
Scheduled Commercial Banks	2.83	2.81	2.58	2.32	2.39
Public Sector Banks	2.91	2.85	2.55	2.12	2.12
Private Sector Banks	2.34	2.40	2.24	2.39	2.73
Foreign Banks	3.34	3.58	3.76	3.79	3.92

* Difference between Return on Advances and Cost of Funds.

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

lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, which will include product- specific operating costs, credit risk premium and tenor premium. In the view of the Group, the system could make the lending rates transparent, forward looking and sensitive to the Reserve Bank's policy rates.

3.23 What could be the constituents of the Base Rate that is expected to provide the foundation for the lending rates? In this context, the Group had to address a number of issues. Should the cost be based on the cost of deposits/or funds or any other parameter? How do regulatory costs such as carrying cost of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) be factored in? How does one allocate operating cost, which is quite different for retail and wholesale products?

3.24 There were several options before the Group. The cost of funds has to be the main element in any form of lending rate. The Group felt that a major lacuna of the current BPLR is that it is based on average historical cost of funds, which makes it backward looking and hence sticky. The Working Group considered two options, *viz.*, (i) the cost of funds (deposits, borrowings and expected return on capital) and (ii) the deposit interest rate. For the Base Rate to be dynamic and responsive to the policy measures, it ought to be forward looking. Hence, in cost of funds, it is more appropriate to take into account prospective cost rather than historic cost. Accordingly, the Working Group preferred the card interest rate on retail deposit (deposits below Rs. 15 lakh) with one year maturity for the purpose. The choice of one year deposit interest rate for the base rate was influenced by two factors. One, working capital loans are for one year. Second, the bulk of the term loans are with maturity of one year and above. The deposit interest rate was preferred over the cost of funds for three reasons. One, the one year retail deposit interest rate will be very transparent as it would be available in public domain and borrowers will know the basis on which the lending interest rates are fixed by banks. Two, one year deposit interest rate would be forward looking as in this case lending interest rate will be based on the present cost of deposits rather than historical cost. Three, such a rate will be more responsive to changes in the Reserve Bank's policy rates. However, banks also hold a sizeable share of current accounts and savings deposits (CASA). While current account does not carry any interest rate, savings deposits carry interest rate of 3.5 per cent (effective interest rate 2.8 per cent due to method of its

computation)[3]. Thus, cost of one year term deposit interest rate would need to be adjusted for the low cost of CASA deposits. In order to make the lending rates more transparent, the Group deemed it appropriate to include the negative carry in respect of CRR and SLR in the Base Rate itself. Currently, there is regulatory prescription of SLR of 24 per cent and CRR of 5 per cent of banks' net demand and time liabilities (NDTL). The inclusion of negative carry on account of CRR, which does not earn any interest for banks, in the cost of funds, was quite unambiguous. In the case of SLR maintenance, the Group did observe that interest rates on SLR securities are market determined and as may be seen from Table 11, return on investments (which comprise largely SLR investments) has been consistently higher than the cost of deposits. However, the yield of 364-day Treasury Bill was found to be lower than one year deposit interest rates of banks. Therefore, the need was felt to build in negative carry in respect of SLR prescription also. Accordingly, the Group recommends that the negative carry on SLR may be computed by adjusting the earnings based on the yield of 364-day Treasury Bill to match the one year deposit interest rate. This would make the Base Rate responsive to the movements in the yields in the government securities market, which, in turn, are sensitive to policy rates.

3.25 A major issue faced by the Group was as to how to incorporate the transaction cost which varies significantly for retail and wholesale segments. In order to make the lending rate transparent, the Group recommends that an unallocatable overhead cost component should be incorporated into the Base Rate, while variable product-specific operating cost (for the retail and wholesale segments) can be built into the actual lending rate. The unallocatable overhead cost for banks would comprise a minimum set of overhead cost elements such as aggregate employee compensation relating to administrative functions in corporate office, directors' and auditors' fees, legal and premises expenses, depreciation, cost of printing and stationery, expenses incurred on communication and advertising and IT spending *etc*. Finally, the average return on net worth may also be factored into the Base Rate. Average return on net worth would be the hurdle rate of return on equity determined by the board or management of the bank and could be proxied by projected PAT to net worth ratio or the

[3] However, beginning April 1, 2010 effective interest rate on saving bank deposits would be 3.5 per cent as banks would be required to calculate interest rate on a daily product basis. This change in methodology was announced in the Annual Policy Statement 2009-10 of the Reserve Bank released in April 2009.

average PAT to net worth ratio for the past three years. To achieve consistency in the computation of expected return on equity across banks, the PAT to net worth ratio should be multiplied by the ratio of net worth to deployable deposits. While the net worth of domestic banks would include equity, reserves (excluding revaluation reserves) and retained earnings, the same for foreign banks would incorporate infused capital or notional capital allocated to Indian operations, reserves (excluding revaluation reserves) and retained earnings. Net worth may be calculated as on the last day of the recently completed quarter. The net worth calculation would be carried out regularly once in a quarter synchronous with the review of the Base Rate. Furthermore, banks would also be permitted to adjust the cost of Tier II subordinated debt in the return on equity component.

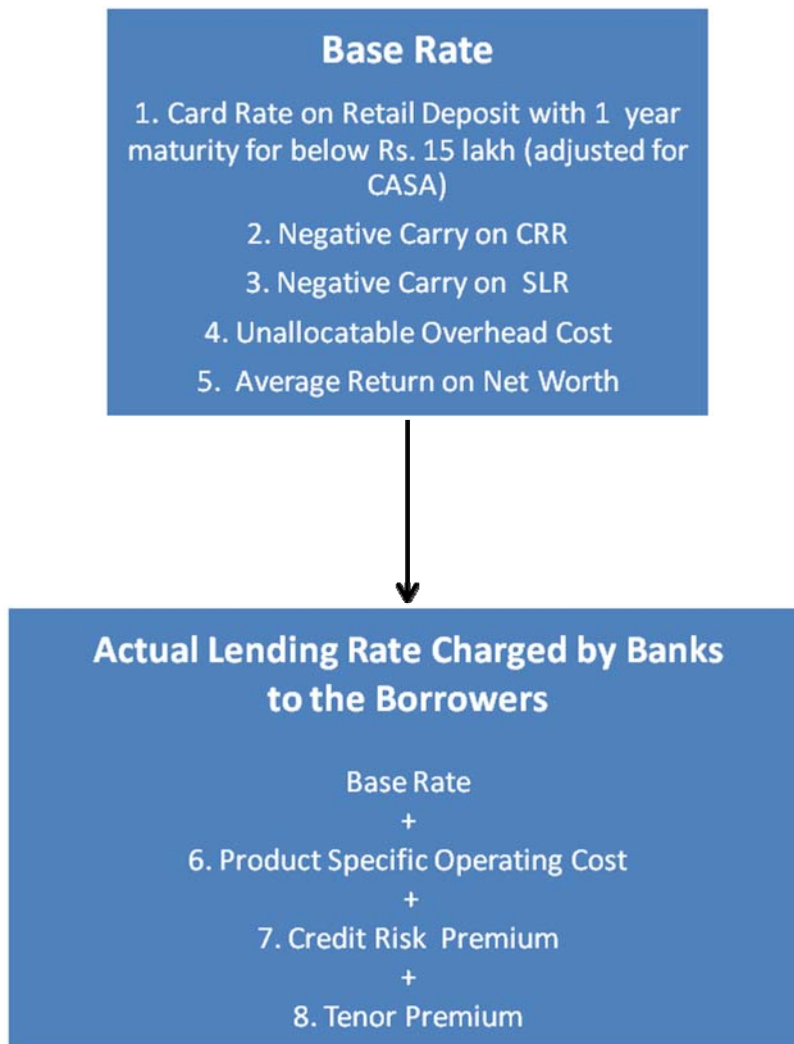
3.26 Once the Base Rate is determined, the actual lending rate to be charged by borrowers should be arrived at by including variable or product specific operating expenses and credit risk and tenor premia.

3.27 Thus, to summarise:

- In the first step, the base rate will be computed, which would include (i) card rate on retail deposit (below Rs. 15 lakh) with one year maturity (adjusted for the share of CASA), the negative carry on account of CRR and SLR (adjusted for returns based on 364-Treasury Bills in respect of SLR), unallocatable overhead operating cost and average return on net worth.
- The actual lending rates would include the Base Rate plus variable or product specific operating expenses, credit risk premium and tenor premium.

3.28 Chart 7 sums up the methodology suggested for computing the Base Rate and the final lending rate. The methodology used for computation of the Base Rate is set out in Box1.

Chart 7: Determination of Lending Rates



Box 1 : Methodology for the Computation of the Base Rate

Base Rate $= a - b + c + d + e$

a - One Year Deposit Rate $= D_{1r}$

b - CASA adjustment $= \left[\left[D_{1r} * \left(\frac{D_c}{D}\right)\right] + \left[(D_{1r} - S_r) * \left(\frac{D_s}{D}\right)\right]\right] * 100$

c - Negative Carry on CRR and SLR $= \left[\left[\frac{\{D_{1r} - (SLR * T_r)\}}{\{1 - (CRR + SLR)\}}\right] * 100\right] - D_{1r}$

d - Unallocatable Overhead Cost $= \left(\frac{U_c}{D_{ply}}\right) * 100$

e - Average Return on Net Worth $= \left[\left(\frac{NP}{NW}\right) * \left(\frac{NW}{D_{ply}}\right)\right] * 100$

Where:
D_{1r} : One year Deposit Rate
D_c : Current Account Deposits
D_T : Term Deposits
D_S : Savings Account Deposits
D : Total Deposits = Time Deposits + Current Deposits + Saving Deposits
$= D_T + D_C + D_S$
D_{ply} : Deployable Deposits
= Total deposits less share of deposits locked as CRR and SLR balances, *i.e.*
$= D * [1 - (CRR + SLR)]$
CRR : Cash Reserve Ratio
SLR : Statutory Liquidity Ratio
S_r : Savings Bank Rate
T_r : 364 T-Bill Rate
U_c : Unallocatable Overhead Cost
NP : Net Profit
NW : Net Worth = Capital + Free Reserves

CASA Adjustment

CASA adjustment $= \left[\left[D_{1r} * \left(\frac{D_c}{D}\right)\right] + \left[(D_{1r} - S_r) * \left(\frac{D_s}{D}\right)\right]\right] * 100$

The one year deposit rate is adjusted for the positive carry on account of Current and Savings Account (CASA) deposits. The CASA adjustment is based on (i) the difference between the 1-

year deposit interest rate and the savings bank deposit rate, multiplied by the share of savings bank deposits; and (ii) the share of current accounts multiplied by the 1-year deposit interest rate, expressed as a percentage.

Negative Carry on CRR and SLR

$$\text{Negative Carry on CRR and SLR} = \left[\left[\frac{\{D_{1r} - (SLR * T_r)\}}{\{1 - (CRR + SLR)\}}\right] * 100\right] - D_{1r}$$

Negative carry on CRR and SLR balances arises because the return on CRR balances is nil, while the return on SLR balances (proxied using the 364-day Treasury Bill rate) is lower than the one year deposit rate. Negative carry on CRR and SLR is arrived at in three steps. In the first step, return on SLR investment was calculated using 364-day Treasury Bills. In the second step, effective cost was calculated by taking the ratio (expressed as a percentage) of one year deposit rate (adjusted for return on SLR investment) and deployable deposits (total deposits less the deposits locked as CRR and SLR balances). In the third step, negative carry cost on SLR and CRR was arrived at by taking the difference between the effective cost and the 1-year retail deposit interest rate.

Unallocatable Overhead Cost

$$\text{Unallocatable Overhead Cost} = \left(\frac{U_c}{D_{ply}}\right) * 100$$

Unallocatable Overhead Cost is calculated by taking the ratio (expressed as a percentage) of unallocated overhead cost and deployable deposit.

Average Return on Net Worth

$$\text{Average Return on Net Worth} = \left[\left(\frac{NP}{NW}\right) * \left(\frac{NW}{D_{ply}}\right)\right] * 100$$

Average Return on Net Worth is computed as the product of net profit to net worth ratio and net worth to deployable ratio expressed as a percentage.

3.29 Based on the above methodology the Base Rate has been tentatively estimated at 8.55 per cent (Table 12 and Annex 11).

Table 12 : Estimates of Base Rate under the Proposed Regime

Components	(per cent)
1	2
Base Rate (a-b+c+d+e)	**8.55**
a. One year card deposit rate	6.50
b. CASA adjustment	1.31
c. Negative carry on CRR and SLR	0.96
d. Unallocatable Overheads Cost adjustment	0.99
e. **Average Return on Net Worth**	1.41

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

Base Rate and sub-Base Rate Lending

3.31 A major concern with the present BPLR system has been the large volume of sub-BPLR lending which made the whole system opaque. With the proposed system of Base Rate, there will not be a need for banks to lend below the Base Rate as the Base Rate represents the bare minimum rate below which it will not be viable for the banks to lend. The Group, however recognises certain situations when lending below the Base Rate may be necessitated by market conditions. This may occur when there is a large surplus liquidity in the system and banks instead of deploying funds in the liquidity adjustment facility (LAF) window of the Reserve Bank may prefer to lend at rates lower than their respective Base Rates. The Group is of the view that the need for such lending may arise as an exception only for very short-term periods and not as a rule on a regular and long-term basis. Accordingly, the Base Rate system recommended by the Group will be applicable for loans with maturity of one year and above (including all working capital loans). Banks may give loans below one year at fixed or floating rates without reference to the Base Rate. That is, short-term loans with less than one year could technically be priced below the Base Rate. However, in order to ensure that sub-Base Rate lending does not proliferate, the Group recommends that such sub-Base Rate lending in both the priority and non-priority sectors in

any financial year should not exceed 15 per cent of the incremental lending during the financial year. Of this, non-priority sector sub-Base Rate lending should not exceed 5 per cent. That is, the overall sub-Base Rate lending during a financial year should not exceed 15 per cent of their incremental lending, and banks will be free to extend entire sub-Base Rate lending of up to 15 per cent to the priority sector.

3.32 The Group recommends that the Base Rate could also serve as the reference rate for floating rate loan products, in which case actual lending rate charged to the borrower will vary in line with the changes in the Base Rate. The Base Rate can also be used for pricing fixed rate loan products, in which case the lending interest rate (Base Rate plus variable operating expenses plus credit risk premium plus tenor premium) will not change over the tenure of the loan contract. That is, banks would not have the option to re-price these loans during the term of the loan agreed to in the original loan contracts. The borrower, however, could have the option to refinance the loan at a penalty rate mutually agreed between the bank and the borrower.

3.33 The recommendation of Base Rate will necessitate amendments in the extant provisions contained in the Master Circular on 'Interest Rate on Advances' (Section 2.4 of the Master Circular on Interest Rate on Advances). As per the extant regulations in the Master Circular certain categories of loans/advances are exempted from the purview of pricing based on BPLR. At present, the following categories are without reference to PLR and regardless of the size: (i) loan for purchase of consumer durables (including credit card dues); (ii) non-priority sector personal loans; (iii) finance granted to intermediary agencies for on-lending to ultimate beneficiaries and agencies providing input support; and (iv) finance granted to housing finance intermediary agencies for on-lending to ultimate beneficiaries; (v) advances / overdrafts against domestic / NRE / FCNR (B) deposits with the bank, provided that the deposit/s stands / stand either in the name(s) of the borrower himself / borrowers themselves, or in the names of the borrower jointly with another person; (vi) discounting of bills; (vii) loans / advances / cash credit / overdrafts against commodities subject to selective credit control; (viii) loans to a cooperative bank or to any other banking institution; (ix) loans to its own employees' and (x) loans covered by participation in refinancing schemes of term lending institutions. Under the proposed system, all the above categories of loans referred to in the Master Circular be linked to the Base Rate, except

interest rates on (a) loans relating to selective credit control; (b) credit card receivables; and (c) loans to banks' own employees. Credit card loans are not in the nature of regular lines of credit and interest rates charged on credit card dues must reckon the risk inherent in unsecured nature of such advances.

3.34 The Group recommends that DRI scheme, which constitutes a very small part of banks' lending, should continue in its existing form for the benefit of the deprived sections of the society.

3.35 Furthermore, the Group recommends that the proposed system would be applicable for all new loans and for those old loans that come up for renewal. However, if the existing borrowers want to switch to the new system before the expiry of the existing contracts, in such cases the new/revised rate structure should be mutually agreed upon by the bank and the borrower.

Dissemination of Information

3.36 It is possible that some banks charge unduly high product specific operating expenses, credit risk and term premia from some borrowers. In order to avoid such unhealthy practices, the banks should continue to provide the information on lending rate to the Reserve Bank and disseminate information on the Base Rate In addition, banks should also provide information on the actual minimum and maximum interest rates charged to borrowers. This would give both existing and prospective borrowers a broad idea of variable operating cost, credit risk and term premia charged by different banks. The Group is of the view that greater dissemination of information on lending rates would enhance the transparency of the loan pricing system.

Transparency in Lending Rates

3.37 On this issue of reference rates and transparency in lending rates, it may be noted that the Banking Codes and Standards Board of India (BCSBI) has evolved two Codes *viz.,* the Code of Bank's Commitment to Customers (Code) and the Code of Bank's Commitment to Micro and Small Enterprises (MSE Code). These Codes are voluntary and aim at achieving increased transparency in the operations of banks and set minimum standards of banking practices which member banks of BCSBI are committed to follow in their dealings with their

customers. The Code for Customers addresses individual customers and excludes corporate and firms, while the Code for MSEs is exclusive to Micro and Small Enterprises.

Code of Bank's Commitment to Customer (Code)

3.38 The Code contains a number of provisions having a direct bearing on transparency in banks' dealing with retail depositors and borrowers. At the time of sourcing the loan, the Code provides for the following information to be made available to facilitate customers to take informed decisions –

- information about the interest rate applicable – whether floating rate or fixed rate;
- the reference rate to which the floating rate of interest is linked; the reference rate will remain uniform for customers contracting the loan at different points of time;
- the premium / discount applied to the reference rate for determining the rate of interest on the loan;
- fees/charges payable for processing, the amount of such fees refundable if loan amount is not sanctioned / disbursed;
- pre-payment options and charges, if any;
- penal rate of interest for delayed repayments, if any;
- conversion charges for switching a loan from fixed to floating rates or vice-versa;
- existence of any reset clause;
- existence of minimum rate of interest clause, if any;
- method of calculation of interest and the date and mode of its application; and
- any other matter which affects the interest of the borrower.

3.39 On sanction of a credit facility

- a sanction letter in writing detailing particulars of amount sanctioned, terms and conditions attached to the loan, etc. would be issued to the borrower.
- an amortization schedule in respect of the loan would be provided to the borrower.
- the Most Important Terms and Conditions (MITC) governing the credit facilities availed would also be conveyed to the borrower.
- authenticated copies of all the loan documents executed by the borrower along with a copy each of all enclosures (quoted in the loan document) would be provided to the borrower free of cost.
- the borrower will be advised whether he has an option to let equated monthly instalments stay constant and increase tenure or vice-versa when the interest rate changes.

3.40 If a loan application is rejected, the reasons for such rejection would be conveyed in writing to the applicant irrespective of the amount of loan applied for. Even guarantors are treated as customers under the Code. Banks are committed to inform a person to be considered as a guarantor to a loan (i) of his financial liability under the proposed guarantee; (ii) circumstances under which he may be called upon to discharge the same; and (iii) the recourse which the bank may have if he fails to honour the guarantee. Banks will also inform the guarantor of any material adverse change/s in the financial position of the borrower whose loan has been guaranteed by him.

Code of Bank's Commitment to Micro and Small Enterprises (MSE Code)

3.41 A simple, standardized and easy to understand application form for loans has been devised by IBA in consultation with BCSBI and circulated among banks for adoption. This form, which will be provided free of cost to MSEs, will be used across member banks for sanction of loans to MSEs irrespective of the amount of loan applied for.

3.42 A checklist of requirements will be provided along with the application form at the time of making available the application form banks will provide information about

- the interest rates applicable;
- fees/charges, if any, payable for processing the application;
- pre-payment options, if any, etc.
- checklist of documents / information to be submitted along with the application form.

3.43 Loan applications will be acknowledged and all particulars required in connection with the processing of the loan application would be received at the time of application. If any additional information is needed, banks would contact the applicant MSE within 7 days. When a credit limit is sanctioned, terms and conditions governing the credit facilities agreed to would be put down in writing and a copy of the same given to the borrower; authenticated copies of all loan documents executed, along with copies of the enclosures referred to therein will be provided to the borrower.

3.44 The Group recommends that all the banks should follow both the commitment codes scrupulously. The Group also recommends that the Reserve Bank may require banks to publish summary information relating to the number of complaints and compliance with the codes in their annual reports.