

## **Base Rate System -**

### *The New Interest Rate Structure for Indian Banks*

Till the late 1980s the interest rate structure in India was largely administered and quite complex in nature. Efforts were initiated from 1990 to rationalize interest rate structure so as to ensure price discovery and transparency in loan pricing system. The process of rationalization led to deregulation of lending rates in October 1994. The freeing up of lending rates of scheduled commercial banks for credit limits of over Rs. 2 lac along with introduction of Prime Lending Rate (PLR) system in 1994 was a step in the direction aimed at ensuring competitive loan pricing. Subsequently Benchmark Prime Lending Rate (BPLR) system of pricing loans was introduced by Reserve Bank of India (RBI) in 2003 with an expectation that BPLR would be a benchmark rate for banks' pricing of their loan products so as to ensure that it truly reflected the actual cost. Banks were free to fix BPLR with the approval of their respective Boards but their interest rates were to have a reference to the BPLR fixed. BPLR was the interest rate that the commercial banks were expected to charge their most credit worthy borrowers. However, various limitations of the BPLR system also came to light over the years as stated below:

- The BPLR tended to be out of sync with market conditions and did not adequately respond to changes in monetary policy. The banks, mostly private sector ones were not passing on the reduction in policy interest rates to customers, while they were quick to raise interest rates whenever rates increased. Besides, as banks did not adjust lending rates in response to monetary policy, an important transmission channel through which RBI actions effect the real economy of output, consumption and jobs was getting clogged.
- To overcome excess liquidity at times and lower the percentage of non-performing assets in overall loan portfolio banks were lending at sub BPLR rate to triple-A rated companies who had access to cheap global bonds. This gave rise to a situation where weak borrowers were subsidizing the strong borrowers of the banks and also raised concerns of transparency.

Consequently, following an announcement in the Annual Policy for 2009-10, RBI constituted a Working Group on Benchmark Prime Lending Rate (BPLR) to review the BPLR system and suggest changes to make credit pricing more transparent. The Working Group submitted its report on October 20, 2009. After considering the recommendations of the Group and the suggestions from various stakeholders, the RBI decided in February, 2010 as under:

- The Base Rate system will replace the BPLR system from April 1, 2010 (subsequently effective date changed to July 1, 2010)
- Each bank may decide its own base rate.
- Some of the criteria that could go into the determination of the Base Rate are ;
  - Cost of deposits
  - Adjustment for the negative carry in respect of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR);
  - Unallocatable overhead cost for banks such as aggregate employee compensation and other administration costs, advertising, IT spending, and cost incurred towards deposit insurance; and
  - Profit margin

(An illustration for computing the Base Rate is given in the Annexure)

- Actual lending rates charged to borrowers will be the Base Rate plus borrower-specific charges, which will include product-specific operating costs, credit risk premium and tenor premium
- All categories of loans will henceforth be priced only with reference to the Base Rate.
- Banks are not permitted to resort to any lending below Base Rate.
- Interest rate on loans under the Differential Rate of Interest (DRI) scheme will continue to be fixed without reference to the Base Rate.
- RBI will separately announce the stipulation for export credit.
- Banks are required to exhibit the information on their Base Rate at all branches and also on their websites.
- The Base Rate 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.

### Impact of migration from BPLR to Base Rate System

- Banks replaced their BPLR by Base Rate with effect from July 01, 2010. Declared base rate vis-à-vis earlier BPLR of some the leading banks is shown in the table below

Bank	BPLR (%)	Base Rate (%)
Allahabad Bank	12	8
Axis Bank	12.25	7.50
Bank of Baroda	12	8
Central Bank of India	12	8
Dhanalakshmi Bank	16	7
Federal Bank	14.25	7.75
HDFC Bank	15.75	7.25
IDBI Bank	12.75	8
Indian Bank	12	8
Punjab National Bank	11	8
State Bank of India	11.75	7.5
Union Bank of India	11.75	8

- SBI's BPLR was 11.75%. SBI has taken the six-month deposit rate as its main input to calculate its base rate.
- Bank of Baroda, in contrast, has taken the average cost of deposits in the last quarter to arrive at its base rate.

- Going by the RBI’s guidelines, banks can fine tune their system of arriving at the base rate until December, 2010 and from 2011, they can change their base rates once in three months
- Old customers of all banks can continue with their existing rates for at least a year, but new customers will be given loans based on a bank’s base rate.
- Although the BPLR of most public sector banks ranged between 11% and 12.5%, triple-A rated corporate borrowers were raising short term loans at a rate as low as 6 %. Around 70% of borrowers used to get loans at below banks’ BPLR but now banks will not be able to offer loans at lower than base rate. Banks will have to explain how they arrive at the base rate and justify the spread over the base rate for different borrowers. Above everything, they need to be transparent and accountable.
- Triple-A rated borrower companies, who used to get best rates, may continue to bargain for loans at the base rate, or closer to it.
- Top-rated firms may continue to get cheap money, cheaper than even base rate, through other routes such as commercial paper, bonds, debentures and external commercial borrowings. Instead of giving loans banks can invest in their debt instruments. Salient features of such instruments are given below.

Commercial Paper	<ul style="list-style-type: none"> <li>- An unsecured money market instrument in the form of promissory note</li> <li>- Can be issued by corporates with net worth above Rs. 4 crores and classified as Standard Asset by lending bank(s)</li> <li>- Credit rating required from RBI approved Credit Rating Agencies like CRISIL, ICRA, CARE, FITCH etc. (Minimum acceptable rating: P-2 of CRISIL)</li> </ul>
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	<ul style="list-style-type: none"> <li>- Maturity period: 15 days to one year</li> <li>- Amount: As approved by Board of Directors of the issuer in denomination of Rs. 5 lac and multiples thereof</li> <li>- Issued at a discount to face value</li> </ul>
External Commercial Borrowings	<ul style="list-style-type: none"> <li>- Commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds) availed from non resident lenders</li> <li>- Permitted under Automatic Route (GoI or RBI approval not required) for investment in real sector (industrial sector &amp; infrastructure sector) and specific service sectors (hotel, hospital and software)</li> <li>- Can be raised from recognized source like (i) International banks, (ii) International capital markets (ii) Multilateral financial institutions etc.</li> <li>- Max. Amount: USD 100 million for service sector (hotel, hospital and software) and USD 500 million for others</li> <li>- Maturity: 3 years up to USD 20 million and 5 years for USD 20 to 500 million</li> </ul>

	<ul style="list-style-type: none"> <li>- Permitted end use: import of capital goods, new projects and modernization/ expansion of existing production unit,</li> <li>- End use not permitted: for on-lending or investment in capital market or acquiring a new company, in real estate sector, for working capital, general corporate purpose and repayment of existing rupee loan</li> <li>- Choice of security to be provided to the lenders is left to the borrower</li> </ul>
<p>Debentures / Bonds</p>	<ul style="list-style-type: none"> <li>- An instrument of debt executed by the company to repay the sum at a specified rate carrying an interest</li> <li>- It is mandatory to appoint one or more debenture trustees before issuing prospectus or letter of offer</li> <li>- Three principal features are Maturity, Coupon Rate and Principal.</li> <li>- In the Indian securities market generally bonds mean debt instruments issued by Central, State Govt. and PSUs and debentures mean instruments issued by the private corporate sector</li> <li>- An offer document has to be filed</li> </ul>

	<p>with SEBI for all public issue of debentures</p> <ul style="list-style-type: none"><li>- All public issue of debentures should be compulsorily credit rated</li><li>- Ratings have to be sought from agencies registered with SEBI</li><li>- Mutual funds are not permitted to subscribe to unrated corporate paper</li><li>- Debt Securities Regulation, 2008 of SEBI provides for issuance and listing of non-convertible debt securities (excluding bonds issued by Governments) issued by a company, PSU or statutory corporations</li><li>- SEBI regulations apply to public issue of debt securities and listing of debt securities and listing of debt securities through public issue or on private placement basis on a recognized stock exchange</li></ul>
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- Instead of showing subscription to financial instruments of the companies as loans, banks will need to classify such exposures as investments. Unlike loans, investments run the risk of interest rate volatility. Such investments will be marked to market or valued in accordance with its prevailing market price and not the price at which it is bought. The banks will limit their exposure to such instruments when the liquidity in the banking system dries up. Demand for commercial papers will rise slightly and not much. Eventually, the companies may not find it that profitable to come to this market as interest rate will also go up in these papers due to over-supply
- The cost of money may come down for SMEs as banks will have to ensure that interest rates charged to customers are non-discriminatory in nature and inform RBI on quarterly basis the actual minimum and maximum lending rates charged to major categories of borrowers.
- Although customers are expected to benefit from the new regime, they may not move in hordes seeking low rates as many factors such as customer service, branch proximity and the comfort level play significant role in choosing a bank.
- The change from BPLR to Base Rate will leave the cost of borrowing of most borrowers pretty much unchanged. The actual lending rate depends on risk premium, based on the borrower's credit worthiness and riskiness of the venture being financed. Thus though the base rates declared by banks are lower than BPLR, that does not necessarily mean that cost of fund will decline for borrowers. Whether borrowers will benefit under the new regime or not one thing is for sure. Banks are explaining the rationale behind the base rate and making the process more transparent
- The BPLR cap for loans up to Rs. 2 lacs has been scrapped. Barring loans for agriculture, exports and few other specified areas small loans will not be subsidized.
- There may not be a dramatic change in the rate of home loans, auto loans and other consumer loans. For such loans, banks will keep a spread on their base

rate, depending on a particular customer's risk profile. Besides, competition may force banks to undercut each other. SBI's current home loan rate is half a percentage point higher than its base rate.

- The base rate will ensure that the floating rate loans get repriced in tandem with changes in policy interest rates such as the repo and reverse repo. The base rate is far better than the BPLR it will replace, but there is no way to ensure that the banks will not learn to beat the system a few years down the line.

### Annex 1: Illustrative Methodology for the Computation of the Base Rate

$$\text{Base Rate} = a + b + c + d$$

a - Cost of Deposits =  $D_{cost}$

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

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

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

Where:

$D_{cost}$  : Cost of Deposits

$D$  : Total Deposits = Time Deposits + Current Deposits + Saving Deposits

$D_{ply}$  : 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

$T_r$  : 364 T-Bill Rate

$U_c$  : Unallocatable Overhead Cost

NP : Net Profit

NW : Net Worth = Capital + Free Reserves

TL : Total Liabilities

#### Negative Carry on CRR and SLR

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

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 cost of deposits. 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 cost of deposits (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 cost of deposits.

**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**

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

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