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Journey of Lending rates in Indi-PLR to Base rate

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Abstract:

Indian Banking System has come a long way. It has moved from administered interest rate regime to deregulated interest rate. The aim of deregulation of interest rate is to make the banking system more transparent and efficient. Market driven interest rate helps in smooth transmission of monetary policy of the central bank. Monetary policy transmission in India is slowly and gradually getting more mature. RBI has helped the banks in this transition. It started with introduction of prime lending rate, then base rate, finally dynamic pricing of base rate.

This paper is an attempt to explore the journey of lending rates in India fromPLR regime to Base rate regime. How these development ensure smooth monetary policy transmission. How Banking companies are preparing themselves to adapt this new system of pricing lending product.

Keywords: Base rate, Cost of deposit, PLR, Net Interest Margin

JEL Classification: G21, G28

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Introduction:

Indian Banking system has passed various phases of change marking its development. Interest rate on lending product is one of the major sources of revenue. As per Narshimhan committee Report on banking reform, banks should be given authority to price the lending product. It aimed at enhancing the profitability and efficiency of banking system. It also aims at developing an efficient channel of monetary policy transmission. Lending rate in India has passed through various stages starting from BPLR to Base rate, now new form of base rate.

The objectives of Study:

1. To understand the evolution of lending rates in India post banking sector reform
2. To understand the interest rate as channel of monetary policy transmission in India
3. To understand the implication of RBI's new guideline for Base rate calculation on Banking sector.

Research Methodology:

This is a conceptual paper, highlighting the dynamics of lending rates. How has it evolved over a period of time? This paper is an attempt to understand the guiding factor for calculation of lending rates in India and emergence of Interest as an efficient channel of monetary policy transmission. It used various data from Indian economy database of RBI and Annual report of various banks.

De-regulation of Interest Rate in India:

As per recommendation of Narshimhan on banking sector reform, lending rate should be freed from any regulation. Banks should be given freedom to decide their lending rates based on availability of fund and various operational expenses. It was decided that these de-regulation of interest rate will be introduced in phased manner. First de-regulation started by allowing banks to decide their lending on loans up to 2 lakhs. All loans are linked with PLR. PLR is the minimum rate of interest charged by banks to their best customer.

PLR is the rate quoted by banks to its best rated customer but Borrower often took undue advantage of the system and took loans for short term periods at minimal rate of interest. This led to a situation where the banks were forced to quote competitive, lower rates of interest to retain customers. This posed serious threat to the profitability of the banks; subsequently RBI introduced the "Benchmark Prime Lending Rate" (BPLR) in place of PLR. It made bank quote BPLR, based on its affordability of credit. BPLR was arrived at after taking into account four important components like average cost of deposits, operating expenses, probable loan losses and profit margin. Interest rate is considered as cost of credit. It is an important measure that tells us at what rate credit is flowing into the system. BPLR emerged as benchmark for credit flow. It has brought transparency in lending but with change in time many new sources of funding has developed in the financial system. New economy has opened new avenue for fund raising such as ECB, FCCB, ADR and GDR. These all new sources of finance have reduced the dependency of corporate on Banking and bargaining power of borrowers has increased manifold. This increased competition has made bank to lend at lower rate than quoted rate of interest BPLR. RBI's committee on BPLR found that BPLR is no more a benchmark, most of the credit is flowing at much lower than published BPLR.

It gets reflected in the poor monetary transmission. Poor monetary transmission forced RBI to introduce new system lending i.e. base rate system of lending.

What is Base rate?

Interest rate is one of the important channels of monetary policy transmission. When BPLR is fails to transmit the monetary policy signals then need for alternative channel for measure of credit flow is felt.

Base rate is the minimum rate set by the Reserve Bank of India below which banks are not allowed to lend to its customer. It aimed at promoting the transparency in the credit market and ensures that banks pass on the lower cost of fund to their customer. It includes the entire cost element which can be clearly identified and are common across the borrowers.

Short-coming of Existing method of Base rate calculation:

Base rate was introduced to bring the transparency in lending and ensure a smooth monetary policy transmission. But it is not reflected in the base rate movement. RBI has cut 125 bps in policy rate but the most banks have responded by lowering just 30 bps. Borrowers are not getting the advantage of rate cut with immediate effect. In other word base rate doesn't reflect the monetary policy decision. Bankers found difficulty incorporating immediate change in base rate as per RBI's monetary policy measures. Most of the bank follows average cost of fund to calculate the cost of deposit and hence difficult to reflect the policy measures.RBI wanted base rates to be more responsive and dynamic, hence they suggested change in the method of calculation of Base rate. Cost of deposit is one of the major components of Base rate and should be calculated on marginal cost basis so as to incorporate the change in base with immediate effect.

Proposed Change in method of Base rate calculation:

RBI wants the interest rate should be responsive and reflect the monetary policy decision. In existing scenario, it is not possible to incorporate the changes in monetary policy. It h

According to RBI draft guidelines, the base rate has to be arrived at by taking into consideration the following:

- Cost of deposit
- Adjustment for negative carry in respect of CRR and SLR
- Unallocable overhead cost for the banks
- Profit margin

The actual rate of lending would be base rate plus borrower specific charges, which will include product specific operating cost, credit risk premium and tenor premium.

Under the proposed guideline, to be implemented from FY17, banks are required to move in a time bound manner to a new base rate calculation based on marginal cost of funds. With the base rate linked to marginal cost of funds, monetary policy would be faster and more effective.

However this move will lead to frequent change in the base rate, thereby increasing its volatility.

Component of Base rate calculation as per new guideline:

Cost of Funds:

Banks have to calculate base rate as per marginal cost of funds after considering all sources of funds other than equity in proportion of outstanding balance on the date of review. Cost of deposit will be calculated using latest interest rate/ card rate payable on CASA deposit and term deposit of various maturities. Cost of borrowings should be calculated using average rate at which funds were raised in the last month preceding the date of review.

Negative Carry on Statutory Reserve:

Negative carry needs to be calculated on mandatory levels of statutory reserves (CRR-4% and SLR 21.5%) based on the marginal cost of funds. Negative carry on CRR arises because banks don't earn interest on this balance with RBI. On SLR, negative carry will arise only if return on SLR investment is less than cost of fund.

Un-allocable overhead cost:

Un-allocable overhead costs should comprise expenses that are incurred for the bank as a whole, and cannot be allocated to any business activity or any unit. These components would be fixed for three years, subject to review thereafter.

Average return of net worth:

The average return on net worth is the hurdle rate of return on equity determined by the bank's board or Management .The RBI expects bank to maintain this component. Any change needs to be made if there is a major shift in the business strategy.

<u>Interest rates on loans:</u>

Earlier, Banks were allowed to adjust the overhead cost and average return on net worth to arrive at their base rate. However, to stablise the component, the RBI has asked to delineate the components of spread with the approval of the board.

Impact of proposed change in base rate calculation:

Bank with low CASA and higher exposure to long term corporate loan will impact more :

Introduction of change in base rate is likely to make monetary policy transmission smooth and efficient. It will benefit the borrowers. Impact of the guideline will be higher on banks with more focus on corporate loans (Table3). Banks with retail focussed loan is likely to be least affected.

Reduced flexibility in loan pricing and higher demand for refinancing will put pressure on asset liability management. It will reduce the margin of banks. Banks with higher share of fixed rate loan portfolio and higher tenure loan will stand to benefit whereas higher share of short term loan will likely to face yield pressure.

Bank with low CASA and higher share of base rate linked loan may be impacted more.

Growth in retail loans to accelerate:

Retail loan growth may get accelerated from rate cuts given the high sensitivity to rates. Privates banks especially the retail focused banks likely to be the key beneficiaries. Share of private banks share in retail loan would continue to rise (Table 1).

NBFCs will benefit:

NBFCs would benefit from the decline in cost of funds from banks. Share of bank funding in the borrowing mix of most of the NBFCs range from 30-70%. Consequently cost of fund for NBFCs would start declining. SME borrower would stand to benefit as decline in base rate will reduce their interest burden.

Commercial paper issuance may increase:

Due to limited flexibility in Base rate, bank may find it more profitable to invest in Commercial paper issue by companies. Commercial paper will be popular in falling interest rate scenario as it is cheaper than bank. Company may use this instrument more to raise fund.

Table1: Share of private banks in retail loans rising.

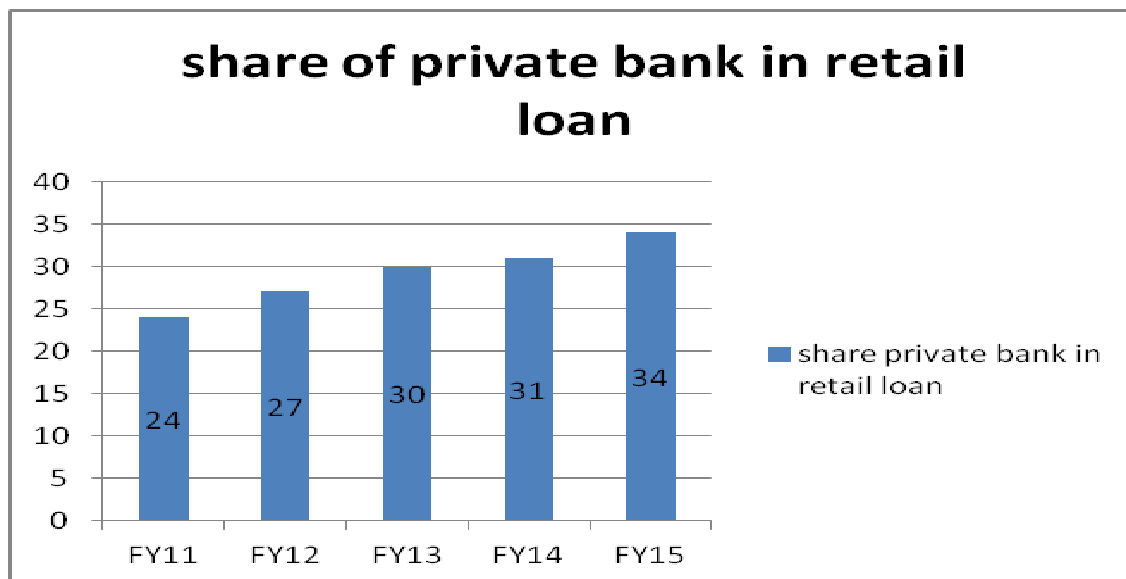
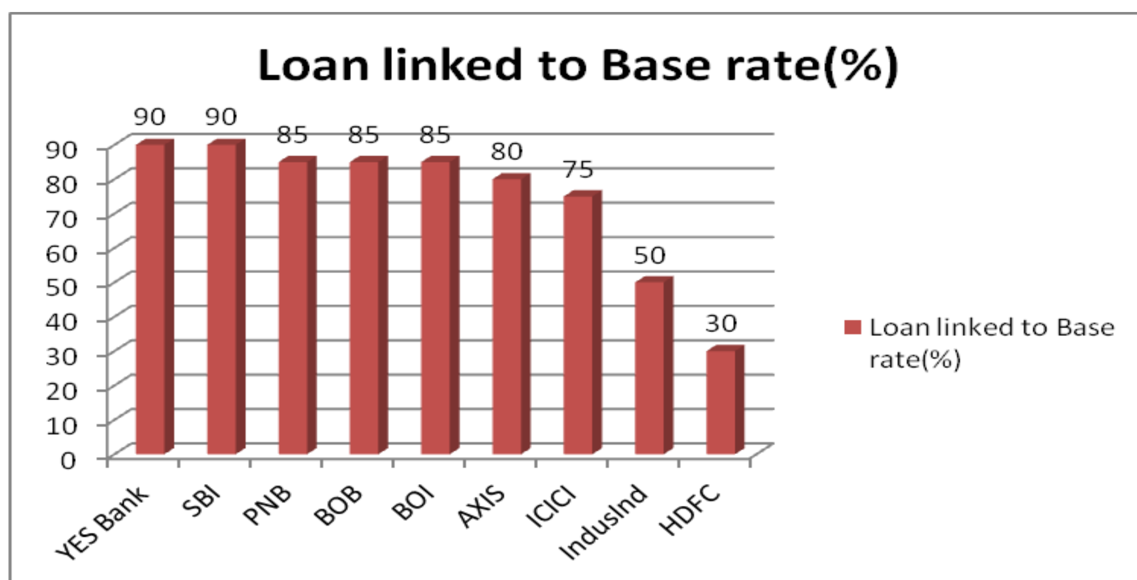
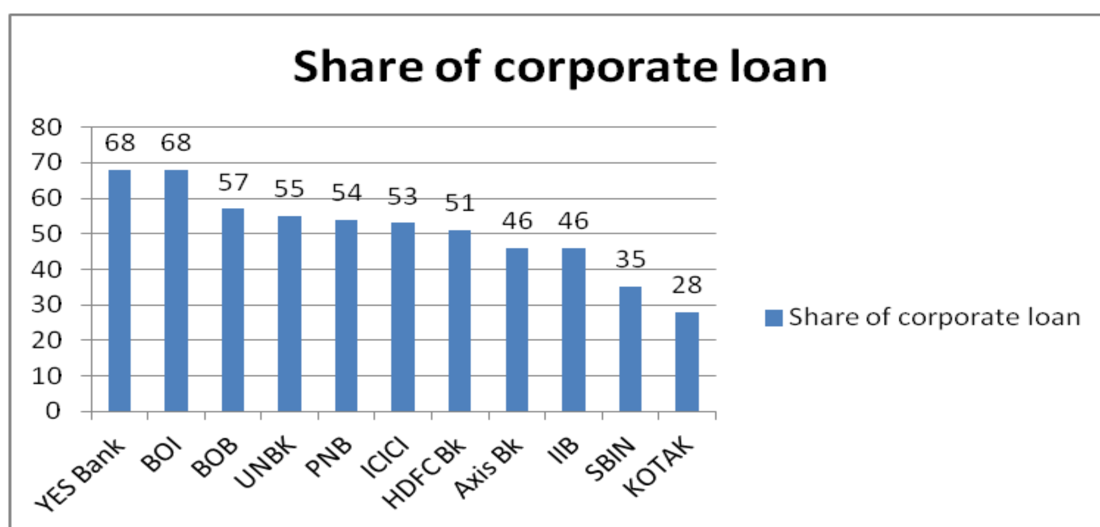


Table 2: Loan linked to base rate



Source: Company annual report

Table 3: Share of corporate loan



Source: company annual report

Table 4: MCLR estimate for major banks –excluding tenure premium

Banks	**Weighted Average cost of deposit**	**Weighted Average cost of borrowing**	**Weighted Average cost of funds(Deposit* Borrowing)**	**Negative carry from CRR**	**Net operating cost to be recovered**	**ROE margin-based on regulatory capital**	**MCLR without tenor premium**
ICICI	4%	1.60%	5.60%	0.23%	1%	1.40%	8.25%
HDFC	4.90%	0.40%	5.30%	0.22%	1.80%	1.80%	9.03%
Axis	4.40%	0.70%	5.10%	0.21%	1.40%	1.60%	8.26%
IIB	4.30%	1.70%	6.00%	0.25%	2.00%	1.80%	9.92%
KMB	4.20%	1.10%	5.40%	0.22%	2.70%	1.40%	9.69%
YES	5.20%	1.40%	6.60%	0.27%	1.00%	1.80%	9.66%
SBIN	5.00%	0.30%	5.20%	0.22%	1.40%	1.40%	8.26%
PNB	5.00%	0.40%	5.40%	0.23%	1.20%	1.40%	8.26%
BOB	5.20%	0.20%	5.40%	0.23%	1.00%	1.40%	8.08%
BOI	5.10%	0.40%	5.50%	0.23%	1.00%	1.40%	8.15%

Source: Company data

Table 5: **Scenario analysis for SBI- Highlighting segmental MCLR and resultant lending Yield**

	MCLR excl. tenor premium	Tenor premium	Internal Benchmark for MCLR	Spread	Lending rate	Current loan mix	Contribution to lending yield
overnight	8.26%	0.25%	8.5%	1.00%	9.51%	7.20%	0.69%
1- month	8.26%	0.50%	8.8%	1.25%	10.01%	2.70%	0.27%
3-month	8.26%	0.75%	9.0%	1.50%	10.51%	5.30%	0.55%
6- month	8.26%	1.00%	9.3%	2.00%	11.26%	5.70%	0.64%
1-year	8.26%	1.50%	9.8%	2.50%	12.26%	79.20%	9.71%
						Average Yield on MCLR basis	**11.85%**
						current domestic yield (estimated)	**12.08%**

Source: Company Data

Conclusion:

This guideline aim at passing on the benefit of change in policy rate to the borrower and establish a more responsive and transparent lending rate. It will improve monetary policy transmission. Marginal cost of lending rate is being seen as one of the tools to get bank more generous and benefit retail borrower. Though this initiative will put some pressure on banks margin but in long run it will increase efficiency of banking system. Better transmission of monetary policy, bring efficiency in the financial system and promote economic development.

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