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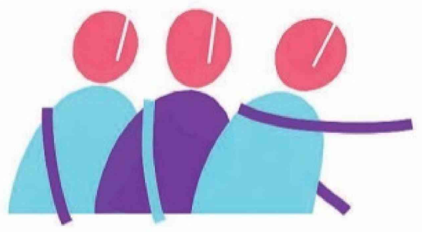

LOAN-PRICING SYSTEMS

For better transmission, RBI in search of yet another benchmark

After prime lending rate, benchmark prime lending rate, base rate and marginal cost of funds-based lending rate, the central bank is planning to come up with another system to price loans

Illustration: C R Sasikumar

GEORGE MATHEW
MUMBAI, AUGUST 7

IN 1994, during C Rangarajan's tenure as the Governor of the Reserve Bank of India (RBI), the central bank announced a landmark decision to fully deregulate interest rates on advances above Rs 2 lakh. Since then, the RBI has introduced four benchmark lending rates for proper pricing of loans and transmission of rates. However, these rate structures have been found to be ineffective for various reasons. The RBI has now formed a committee to formulate market-determined benchmarks to ensure a better transmission of interest rates.

On August 2, RBI Governor Urjit Patel said that the central bank is not satisfied with the marginal cost of funds-based lending rate (MCLR) system, which was introduced with much fanfare a year ago. The experience with the MCLR system, introduced in April 2016 for improving the monetary policy transmission, has not been entirely satisfactory, even though it has been an advance over the base rate system, RBI Deputy Governor Viral Acharya said at the monetary policy conference last week.

The RBI's complaint is that banks have been selective in their rate cuts in aggressive segments such as home and auto loans, but there are many other segments, especially those where borrowers are still tied to the base rate, where they can ease more. In short, the RBI's rate cuts have not been passed on to borrowers in many segments of the economy.

The base rate of some banks after the introduction of MCLR has moved significantly less than MCLR. The RBI says that the rigidity of the base rate is a matter of concern for an efficient transmission of monetary policy to the real economy. Given that a large part of the floating rate loan portfolio of banks is still anchored to the base rate, the RBI will be exploring various options in the near term to make the base rate more responsive to changes in cost of funds of banks, the RBI said while unveiling the monetary policy last week. While the repo rate has fallen 200 basis points to 6 per cent since January 2014, base rate and benchmark prime lending rate (BPLR) have not shown similar declines, and borrowers ended up paying high equated monthly instalments (EMIs). MCLR failed to bring any cheers to old customers who were stuck with BPLR or base rate-linked rates.

"For different banks, the cost of funds is different. The asset-liability situation of banks is also different. The pricing can vary from bank to bank. There can't a uniform rate," said M Narendra, former chairman and managing director, Indian Overseas Bank.

The new benchmark, which is on the anvil will be the fifth such experiment of the RBI. The interest rate structure in the banking sector in India was largely administered in nature and was characterised by numerous rate prescriptions for various segments till 1980s. After the financial sector reforms launched by the Narasimha Rao government in the early 1990s, interest rates were progressively deregulated.

The process of rationalisation which started in 1990 culminated in almost complete deregulation of lending rates by October 1994, except for small loans of credit limit up to Rs 2 lakh. A system of prime lending rate (PLR), the rate charged from the prime borrowers of the bank, was introduced in October 1994. "Since then, for almost a decade till March 2003, the PLR system went through several modifications from a single PLR to multiple PLRs and tenor-linked PLRs and banks were given increasingly greater freedom in setting lending rates," Deepak Mohanty, A B Chakraborty and S Gangadaran wrote in an RBI working paper on interest rate deregulation.

The system of the BPLR was introduced in 2003, which was expected to serve as a benchmark rate for banks' pricing of their loan products so as to ensure that it truly reflected the actual cost, the report said. "However, the BPLR system fell short of its original objective of bringing transparency to lending rates. Competition forced the pricing of a significant proportion of loans far out of alignment with BPLRs and in a non-transparent manner," it said, and added that the lack of transparency in the BPLR system also caused impediment to the effective transmission of monetary policy signals.

On the basis of the recommendations of a working group, the RBI — when D Subbarao was the Governor — introduced the base rate system in July 2010, under which all categories of loans were to be priced only with reference to the base rate with a few exceptions. The base rate included all those elements of the lending rate that are common across all categories of borrowers. Banks are allowed to 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. While all categories of loans are required to be priced only with reference to the base rate, transmission of the RBI rate cuts moved at snail's pace.

MCLR was the next experiment which was kicked off when Raghuram Rajan was the RBI Governor. The RBI directed that all rupee loans approved and credit limits renewed with effect from April 1, 2016, should be priced with reference to the MCLR which will be the internal benchmark for such purposes. The MCLR comprises marginal cost of funds, negative carry on account of cash reserve ratio (CRR), operating costs and tenor premium. Banks reduced their MCLR by nearly one percentage point, benefiting new borrowers. "True banks reduced MCLR at fast pace but it can rise faster than this when the economy faces a rate rising cycle," said a senior official of a nationalised bank.

Banks and markets also briefly experimented with the Mumbai inter-bank offer rate (Mibor) on the lines of London's Libor, a major global interest rate indicator. Modalities for the benchmark rate for the call money market was suggested by the Committee for the Development of the Debt Market. Accordingly, in June 1998, the National Stock Exchange had developed and launched the Mumbai interbank bid (Mibid) rate and Mibor for the overnight money market.

However, banks found it difficult to use external benchmarks for pricing their loan products, as the available external market benchmarks (Mibor, G-Sec) are mainly driven by liquidity conditions in the market, and do not reflect the cost of funds of the banks. Various representations from the banks and the Indian Banks' Association were received in this regard to allow them to continue to use their respective bank's BPLR as the reference rate for pricing the floating rate loan, the central bank said in the report.

Bankers and analysts don't think that the cut in the repo rate will kick-start lending from the banking sector to the real sector in any significant way. This is because the demand-side dynamics are yet not positive in a way that the private sector starts to invest. Capacity utilisation in the economy broadly continues to languish at a 70-72 per cent. The area that the RBI seeks to tackle now is the issue of transmission of monetary policy, indicating that transmission via the MCLR has not been "entirely satisfactory". "While this (the new RBI committee) might be a thought in the right direction, implementation challenges could come from the fact that different banks in India could have different cost structures for raising deposits," said Indranil Pan, chief economist, IDFC Bank.

With investments in new projects dipping, credit offtake has also fallen. On a year-on-year basis, non-food bank credit increased 4.8 per cent in June 2017, compared with an increase of 7.9 per cent in June 2016. Credit to industry contracted by 1.1 per cent in June in contrast with an increase of 0.6 per cent in June 2016. The RBI is likely to come up with another benchmark lending rate for borrowers, speeding up the transmission of rate cuts to the customers. The million dollar question is: will it improve credit offtake and revive the sentiment and growth?

EVOLUTION OF LENDING RATE STRUCTURE IN INDIA

SEPT 1990 The structure of lending rates was rationalised into 6 size-wise slabs; banks allowed to set interest rates on loans of over ₹2 lakh with minimum lending rates prescribed by the RBI

OCT 1994 Lending rates for loans with credit limits of over ₹2 lakh deregulated; banks were required to declare their prime lending rates (PLRs)

FEB 1997 Banks allowed to prescribe separate PLRs and spreads over PLRs, both for loan and cash credit components

OCT 1997 For term loans of 3 years and above, separate prime term lending rates (PTLRs) were required to be announced by banks

APR 1998 PLR converted as a ceiling rate on loans up to ₹2 lakh

APR 2000 Banks allowed to charge fixed/floating rate on their lending for credit limit of over ₹2 lakh

APR 2001 The PLR ceased to be the floor rate for loans above ₹2 lakh

- Banks allowed to lend at sub-PLR rate for loans above ₹2 lakh

APR 2003 Benchmark PLR (BPLR) system introduced and tenor-linked PLRs discontinued.

APR 2010 Base rate system of loan pricing introduced with effect from July 1, 2010; Rupee lending rate structure completely deregulated

APR 2016 MCLR system introduced to speed up rate cut transmission

Source: Reserve Bank of India