Bank Financial Management – Additional Reading Material

Module B

Base Rate System

Till the late 1980s, the interest rate structure in India was largely administered in nature by RBI and was characterized by numerous rate prescriptions for different activities. On account of the complexities under the administered rate structure, efforts were made since 1990 by RBI to rationalize the interest rate structure so as to ensure price discovery and transparency in the loan pricing system. The freeing up of lending rates of scheduled commercial banks for credit limits of over Rs.2 lacs along with the introduction of Prime Lending Rate (PLR) system in October1994 was a major step in this direction aimed at ensuring competitive loan pricing. Initially, PLR acted as a floor rate for credit above Rs. 2 lacs.

To bring in transparency, RBI directed banks to declare maximum spread over PLR for all advances other than consumer credit. Banks were allowed prescribing separate PLRs and spreads over PLRs, both for loan and cash credit component. With regard to term loans of 3 years and above, the banks were given the freedom to announce separate Prime Term Lending Rates (PTLRs) in 1997.

In 2001, RBI relaxed the requirement of PLR being the floor rate for loans above Rs.2 lakhs and allowed Banks to offer loans at below PLR to exporters and other creditworthy borrowers with objective policy approved by the Banks' Boards in a transparent manner. Banks were allowed to charge fixed/floating rate on their lending for credit limit of over Rs.2 lakh. However, there was large divergence among banks in their PLRs and spread over PLRs. It failed to reflect the credit market conditions in the country. Therefore, Benchmark PLR system (BPLR) came into being and tenor-linked PLRs got discontinued

The system of BPLR introduced in 2003 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. In course of time, competition forced the Banks to price a significant portion of their loans out of alignment with BPLRs and thereby undermining the role of BPLR as a reference rate. The worrying factor was that most of the banks started lending at Sub-BPLR rates ignoring the risk sensitivity of the borrowers and also quoted 'competition' as the main reason for going below the BPLR. Hence, RBI opined that the BPLR system had fallen short of its original objective of bringing transparency to lending rates.

In April 2004, the then RBI Governor, Sri Y.V. Reddy had asked industry body IBA to come up with a transparent calculation of the BPLR. In October 2005, RBI again stated that the BPLR system might be reviewed as there is public perception that there is under-pricing of credit for corporates, while there could be over-pricing of lending to agriculture and SME (cross subsidization).

Over time, sub-BPLR lending had become a rule rather than an exception as about two-thirds of bank lending took place at rates below the BPLR. Further Banks have been reluctant to adjust their BPLRs in response to policy changes. Mainly, it lacked the downward stickiness. To explain further, there was a general complaint from the borrowers that lenders are quick to raise their BPLR when the regulator raises the signaling rates (repo, reverse repo, CRR & SLR), but lag behind considerably when the regulator drop these rates. The BPLR system has, therefore, become an inadequate tool to evaluate monetary transmissions.

To overcome the above hiccups, RBI set up a Working Group headed by its Executive Director Shri Deepak Mohanty in the month of June 2009 to review the current system of loan pricing by the Banks popularly known as BPLR and also to improve the transmission of monetary signals to interest rates in the economy. The Group came out with its report on 20th October 2009. In April 2010, after a series of circulars, discussions and consultative process, the RBI announced its decision to implement the base rate from 1 July 2010. Banks were not allowed to lend below this rate. Under this new rule, banks were free to use any method to calculate their base rates (the RBI did provide an 'illustrative' formula), provided the RBI found it consistent. Banks were also directed to announce their base rates on their websites, in keeping with the objective of making lending rates more transparent.

Banking major, State Bank of India first announced its Base Rate on 29th June, 2010 by fixing the same at 7.50% per annum. Soon, all other banks announced their base rates. Most public sector banks kept their rates at 8%. As per RBI norms, the following inputs have to be factored while arriving at the Base Rate:

- **Cost of deposits/borrowings.**
- **Negative Carry on CRR & SLR** – This arises as RBI is not paying any interest on the portion of CRR kept with it. Also, the investments that Banks make in Government Bonds having SLR status carries less rate of interest when compared to the deposit rate at which Banks accept deposits from the public.
- **Unallocable overhead cost** such as maintaining administrative office, Board expenses, and common advertisements about the Bank etc.
- **Average Return on Networth** (Profit element) as decided by the Bank's Board.

The cost of deposits has the highest weight in calculating the Base Rate. For arriving at the Cost of deposits/funds in Base Rate working, Banks can choose any benchmark for a specific tenor that may be disclosed transparently. For example, SBI took cost of its 6 month deposit into account while initially calculating its Base Rate. To the Base Rate, borrower-specific charges, product specific operating costs and premium on account of credit risks and tenure would be added for arriving at the borrower specific lending rate. The Base Rate would set the floor for interest rates on all types of loans. There would be exceptions as permitted by RBI (given below):

- Loans covered by schemes specially formulated by Government of India wherein banks have to charge interest rate as per the scheme.
- Working Capital Term Loan, Funded Interest Term Loan etc granted as part of the rectification / restructuring package.
- Loans granted under various refinance schemes formulated by Government of India or any Government Undertakings wherein banks charge interest at the rates prescribed under the schemes.
- Advances to banks' depositors against their own deposits.
- Advances to banks' own employees including retired employees.
- Advances granted to the Chief Executive Officer / Whole Time Directors.
- Loans linked to a market determined external benchmarks such as LIBOR, MIBOR etc.

RBI had stipulated that the banks should declare their Base Rate and made it effective from July, 1, 2010. However, all the existing loans, including home loans and other retail loans, would continue to be at the current rate. Only the new loans taken on or after July 1, 2010 would be linked to Base Rate. All the existing loans when they come for renewal, borrowers are given a choice either to go with Base Rate or with BPLR.

In the first year of operation of Base Rate, RBI had permitted banks a window of six months till December 2010 during which they can revisit the methodology. This flexibility was subsequently extended by RBI upto June 2011. Banks were allowed to use whatever benchmark they felt was best suited to arrive at the rate, provided, the Bank used the same consistently. However, RBI had asserted that:

- The methodology needed to be transparent.
- Banks are required to review the Base Rate at least once in a quarter with the approval of the Board or the Asset Liability Management Committees (ALCOs) as per the bank's practice.

Once the methodology for arriving at the Base Rate has been finalized by the Banks, they cannot change the same for first five years. In case a Bank desires to review its Base Rate methodology after five years from the date of its finalization, the Bank has to approach RBI for permission in this regard. However, RBI has recently (January 19, 2016) changed this norm. With a view to providing banks greater operational flexibility, RBI has permitted bank to review the Base Rate methodology after three years from the date of its finalization, instead the earlier periodicity of five years. Accordingly, Banks can change their Base Rate methodology after completion of prescribed period with the approval of their Board / ALCO.

Again in the methodology, Banks were following different methods. RBI wanted to streamline this procedure also. Hence, RBI took feedback from the Banks and other stakeholders. Thereafter, it has come out with its fresh guidelines in this regard (December 17, 2015). RBI has instructed all the Banks that for all the rupee loans sanctioned and credit limits renewed w.e.f. April 1, 2016 would be priced with reference to the Marginal Cost of Funds based Lending Rate (MCLR). Hence, from April, 2016, MCLR would act as Internal Benchmark for the lending rates. The component of MCLR is almost same when compared to the previous instructions and the same is given below:

- Marginal Cost of Funds.
- Negative carry on account of CRR.
- Operating Costs.
- Tenor premium.

Accordingly, RBI has permitted banks to publish the internal benchmark for the following maturities:

1. Overnight MCLR.
2. One-month MCLR.
3. 3 month MCLR.
4. 6 month MCLR.
5. One year MCLR.
6. In addition to the above, Banks are given the option of publishing MCLR of any other longer maturity.

Further, RBI has advised the Banks that they should have Board approved policy delineating the components of spread charged to a customer. Existing customers are given the option to move to the MCLR linked loan at mutually acceptable terms.

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Loan to Value Ratio

The loan-to-value ratio (LTV Ratio) is a lending risk assessment ratio that Banks and Financial institutions arrive at before sanctioning Housing or Home Loans. Typically, assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan would generally be charged with high interest when compared to another loan proposal with lesser LTV ratio.

The formula for calculating LTV ratio is:

Loan to Value Ratio = (Loan amount sanctioned/Apprised value of the property) x 100.

For example, Mr. X needs to borrow Rs. 60 lakhs to purchase a flat worth Rs. 80 lakhs. The LTV ratio would work out to 75% (60/80 x 100). In fact, the Sub-Prime crisis that took place in 2007-08 and the Japanese Housing Bubble that occurred from 1986 to 1991 have emanated out of Lenders not giving the due importance that was required for maintaining this ratio.

Realizing the value of LTV ratio, RBI has also come out with its norms on this ratio. As per RBI guidelines, lending to individuals meant for acquiring residential property which are fully secured by mortgages on the residential property that is or would be occupied by the borrower, or that is rented, would be risk weighted as per norms stipulated by RBI. Based on RBI guidelines, every bank should have a Board mandated Valuation Policy. RBI has also given its formula for arriving at this ratio.

LTV ratio should be computed as a percentage with total outstanding in the account (viz. "principal + accrued interest + other charges pertaining to the loan" without any netting) in the numerator and the realisable value of the residential property mortgaged to the bank in the denominator.

RBI has in the month of October, 2015 rationalized this ratio for individual housing loans. The revised LTV ratio is given below:

Category of Loan	LTV ratio (%)	Risk Weight (%)
Upto Rs. 30 lakhs	Equal to and less than 80%	35
	More than 80% and equal to and less than 90%	50
Above Rs. 30 lakhs and upto Rs. 75 lakhs	Equal to and less than 75%	35
	More than 75% and equal to and less than 80%	50
Above Rs. 75 lakhs	Equal to and less than 75%	75