Vol. 6 No. 1 December 2017 ISSN: 2319-961X UGC Approval No: 44192 Impact Factor: 3.104

BANK LENDING CHANNEL: THE ROLE AND EFFECTIVENESS OF BENCHMARK INTEREST RATES

Article Particulars

Received: 22.11.2017 Accepted: 25.11.2017 Published: 23.12.2017

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Abstract

Since the deregulation of Bank interest rates in India, to make the credit pricing more transparent, Banks were asked to declare a reference benchmark rate for lending around which they should normally lend. This article briefs the history of benchmark lending rates of Banks, various methodologies used and its effectiveness in transmitting the monetary policy rate.

Keywords: *benchmark lending rate, monetary policy transmission mechanism, base rate, marginal cost*

Introduction

In an emerging market economy like India, Banks play a major role in mobilisation of domestic savings and channelising these funds to promote economic growth. Bank Lending Channel is an important source of loanable funds in India as a majority of the business firms (especially the Micro, Small and Medium Enterprises) and agriculture depends on Bank credit for their timely requirement of funds. In India Banks have been the main source of finance for the above borrowers.

Interest rates being the signalling device which affect savings, investment and credit demand, it has to be kept reasonable from the point of view of depositors, borrowers and lending institutions. Since Independence the Reserve Bank of India (India's Central Bank) has been following an administered interest rate mechanism with a view to channelise funds to priority sector#. Time has proved that these administered interest rates along with credit controls and credit directives has helped the financial deepening of the priority sector, especially the agriculture. However it has blunted the market oriented mechanism of price discovery of interest rates based on demand and supply. The Chakravarty Committee Report (RBI, 1985) has well-documented the shortcomings of administered interest rate. The Narasimham Committee Report-I of 1991 also recommended for a market oriented interest rate determination.

It was from April 1985, RBI has brought in step by step measures of deregulation in interest rates. The liberalisation and the onset of reforms in the Indian Financial Sector since 1991 has brought a major change in RBI's monetary policy and has influenced the setting of policy interest rates. The conventional methods of Bank rate, SLR and CRR has given way to Liquidity Adjustment Facility (LAF) introduced since 2000.

It was advocated that the deregulation of interest rates are necessary to reduce the complexities of the administered rates and provide more transparency (Transparency in bank lending is understood as bank lending practices with appropriate information disclosures that ensure that the borrowers clearly understand the terms and conditions) and flexibility in Bank interest rates responding to monetary policy rates. One of the major steps in the process of deregulation that started in 1985 was the introduction of Prime Lending Rates(PLR) during 1994. Banks were required to declare their PLRs and subsequently in 1996 they were required to declare a maximum spread over PLR. PLR was considered as the floor rate for loans above Rs.2.0 Lakh. In the annual policy statement of 2001, PLR was made a reference benchmark rate and Banks were allowed to lend below PLR for creditworthy borrowers. But in fact the spread above the PLR were substantially high for normal borrowings and at the same time big corporates were able to borrow at Sub-PLR rates which presented a wide disparity in lending between big corporates and common borrowers.

There was also wide variation among the spread over PLR for different banks and it blunted the reflection of true credit market rates as well as non-transparency in setting interest rates and transmission of policy rates. (RBI Annual Policy, 2002). The various methodologies of benchmarking lending rates as stipulated by RBI and followed by commercial banks are briefed below.

Benchmark Prime Lending Rate (BPLR)

The PLRs remained sticky even though the average cost of funds has reduced for Indian Banks during 2002-03. This is mainly because banks seldom priced their loans close to PLR. For corporate clients they were charging well below PLR and for common borrowers they were charging well above PLR. This has paved the way for introduction of BPLR (in RBI’s annual policy statement of 2003). Following this the Indian Bank's Association (IBA) has issued guidelines to its member banks for computation of BPLR based on

1. Actual cost of Funds
2. Operating Expenses
3. A minimum margin to cover regulatory requirements of provisioning/capital charge

and profit margin (with approval of their boards) Keeping in view the operational requirements.

In short, BPLR was intended to be a benchmark interest rate system around which most of the bank lending should take place in a transparent manner. However the banks were free to price their loan portfolio above or below the BPLR and to offer floating rate with relate to market interest rate benchmarks. But in practice, the BPLR system has not produced the result it was intended for, better transparency in lending rates and the effectiveness of policy rate transmission. Intense competition, along with favourable liquidity position has forced many banks to price loans well below BPLR especially to large corporates and at the same time loans to small business and agriculture remained costly as they were priced well above BPLR. One of the main reasons pointed out for this difference was that, while large corporates had multiple avenues for credit including bank-lending, the small business and agriculture still depended on Banks and for them other avenues (like money lenders, Micro finance, RRBs etc) were still costlier than bank lending channel. Moreover banks considered big corporate houses to be less risky among other borrowers. As there was no restriction to lend below BPLR, banks were lending much below BPLR for corporates.

The Reserve Bank, vide paragraphs 59 and 66 of the Monetary and Credit Policy for 2002-03 announced on April 29, 2002, indicated its intention of collecting maximum and minimum interest rates on advances charged by banks and place the same in the public domain to enhance transparency. Accordingly, Reserve Bank is receiving actual lending rates from scheduled commercial banks (excluding RRBs) under Special Quarterly Return VI-AC. While submitting information on the maximum and minimum interest rates on rupee export credit as well as other credit, banks are advised to ignore extreme values in the lending rates (up to 5 per cent of advances on either side). Further, banks are also advised to furnish the range of interest rates in which large value of business (say, 60 per cent or more) is contracted so that RBI can monitor the general trend in lending rate charged by banks in India.(RBI - LENDING RATES OF SCHEDULED COMMERCIAL BANKS, Explanatory Notes)

The working group on Benchmark Prime Lending Rate constituted by RBI in 2009 (Chairman: Shri.Deepak Mohanty) has commented that "The BPLR has tended to be out of sync with market conditions and does not adequately respond to changes in monetary policy. In addition, the tendency of banks to lend at sub BPLR rates on a large scale raises concerns of transparency. The Working Group also noted that on account of competitive pressures, banks were lending at rates which did not make much commercial sense. Accordingly, 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 and needs to be modified. " However BPLR seldom played its role as a benchmark rate as most of the loans were priced well below BPLR and there was no transparency with regard to the minimum interest rate charged to a borrower or a group of borrower in identical sectors. This lack of transparency has blunted the transmission of policy rates of RBI. Also the number of categories of Loan that can be priced without reference to BPLR (around ten) allowed the banks to keep the lending rates away from policy rates.It was evident that a benchmark rate which reflects the actual cost will be transparent and responsive to policy rates. The percentage of sub-BPLR lending to total lending by scheduled commercial banks for the period 2004 to 2009 remained between 56% in 2004 (lowest) to 77% in 2007(highest).

Bank Base Rate (BBR)

It was evident that the system of BPLR is to be reviewed as it failed to meet the expectations of transparency in lending rates and pass through of policy rates. In the face of competition and excess liquidity BPLR has not played the intending role. In the annual policy statement for the year 2009-10 BPLR system was reviewed and it was stated that '*Over time, however, the system of BPLR has evolved in such a manner that it has lost its relevance as a meaningful reference rate as bulk of loans is advanced below BPLR*'. The working group constituted to review the BPLR has recommended the introduction of Base Rate system in place of Benchmark Prime Lending Rate.

The Reserve Bank of India has issued guidelines on the Base Rate system on April 9, 2010. *It is expected that the Base Rate system will facilitate better pricing of loans, enhance transparency in lending rates and improve the assessment of transmission of monetary policy.*(RBI Annual Policy Statement for the year 2010-11)

Banks were directed by RBI to follow Base Rate system for pricing the loans with effect from July 01, 2010. Banks were required to price their loans with reference to Base Rate, which being the minimum lending rate Banks were not allowed to price loans below Base Rate and hence lending below base rate was not permitted#(Interest rates on (a) loans relating to selective credit control, (b) credit card receivables (c) loans to banks' own employees; and (d) loans under DRI scheme were allowed to price below base rate).This has removed the one of the major disadvantages in earlier benchmark systems where in pricing below the benchmark were allowed.

An Illustrative Methodology for the Computation of the Base Rate is given below:

a – Cost of Deposits/funds = D_{cost}
(benchmark)

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

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

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

Dcost = Cost of deposits/funds

D = Total Deposits (Time deposits + Current deposits + Savings deposits)

Dply = Deployable deposits (Total Deposits – Amount blocked in CRR & SLR)

CRR = Cash Reserve Ratio

SLR = Statutory Liquidity Ratio

Tr = 364 T – Bill rate

Uc = Unallocatable Overhead Cost

NP = Net Profit

NW = Net Worth (Capital + Free Reserves)

Base Rate = a+b+c+d

As per RBI master direction, Banks were free to calculate the cost of funds based on average cost of funds or marginal cost of funds or any other methodology which is transparent, reasonable and consistent but at the same time should be available for supervisory scrutiny. A methodology once finalised should be consistent at least for three years and the base rate thus arrived should be reviewed at least once in a quarter.

However it is to be noted that the Base rate is only a benchmark rate for loan pricing and loans seldom get priced at base rate. A spread or margin will be added to base rate to arrive at the actual lending rate.

Tenor premium (an additional slab of interest over the base rate for over a year), risk premium (depending on the risk slot in which a bank places a customer) and product premium (cost of administering a particular product) will be added to the base rate. All these premiums are legitimate and have been allowed by the RBI. Hence, the final rate paid by a housing loan borrower is unlikely to be lower than the current interest rate. This seems even more probable in the environment of rising interest rates.

Marginal Cost of Lending Rates (MCLR)

Most of the Banks were using average cost of funding as amongst methodologies for calculation of Base Rate even though marginal cost of funds and blended cost of funds methodologies are available and as of now there is no common methodology amongst Banks. RBI has commended that marginal cost of funds methodology is more sensitive to policy change rates. Hence RBI, in their First Bi-monthly Monetary Policy Statement, 2015-16 has encouraged Banks to move to marginal cost of funds based calculation method in a time bound manner which will improve the efficiency of monetary policy transmission mechanism.

RBI has issued draft guidelines for calculation of benchmark rate based on marginal cost of funds methodology. The calculation of base rate as per the revised methodology will include (a) Cost of funds (b) Negative Carry on CRR/SLR, (c) Un-allocable overhead costs and (d) Average return on Networth.

(a) Cost of funds

Sl	Source of funds (excluding equity)	Rates offered on the date of review/rates at which funds raised	Balance outstanding in the books of the bank on the date of review as a percentage of total funds (excluding equity)	Marginal cost (1) x(2)
		(1)	(2)	
1	Deposits			
a	Current Deposits	0.00	7%	0.00
b	Savings Deposits	4.00	21%	0.84
c	Term deposits *			
	Upto one month	4.5	2%	0.09
	One month to six months	7.00	10%	0.70
	Six months to one year	7.5	26%	1.95
	More than one year	8.0	22%	1.76
2	Borrowings			
	RBI	7.25	2%	0.15
	Other banks and institutions	7.20	2%	0.14
	Bonds and debentures	9.0	8%	0.72
	Marginal cost of borrowings			**6.35**

* Maturity buckets should be the same as the buckets included in the schedule of interest rates on deposits.

Marginal cost of funds = 92% x Marginal cost of borrowings + 8% x Return on net worth

Return on Net worth is amount of common equity Tier 1 capital required to be maintained for Risk Weighted Assets as per extant capital adequacy norms shall be included for computing marginal cost of funds. Since currently, the common equity Tier 1 capital is (5.5% +2.5%) 8% of RWA, the weightage given for this component in the marginal cost of funds will be 8%. (RBI)

based on draft guidelines issued by RBI)

For example if interest rates offered on savings bank is 4% and the percentage of savings bank balance outstanding is 21% of total funds, the marginal cost is 0.84 (4/100 * 21/100). Likewise all the points mentioned above shall be calculated and total marginal cost of funds is to be arrived.

(b) Negative carry of CRR: As the return on balances kept as CRR is nil, there arises a negative carry on the funds kept as CRR. It is calculated as

Required CRR * (marginal cost) / (1-CRR)

(c) Operating costs: All operating cost incurred in providing the loan except which can be recovered by way of service charge and fees shall be included in this

(d) Tenor premium: the cost arising due to longer term commitment for loans shall be included in this. A spread considering the business strategy and credit risk premium components shall be charged along the MCLR to borrowers. These components should be uniform across all the banks. The interest rate will be determined by adding the spread to MCLR.

The timeline for implementation of marginal cost based lending rates was set as April 2016. The earlier benchmark rates has shown downward stickiness towards a monetary policy change, ie an increase in monetary policy rate has lead to higher interest rates but a reduction in policy rate has not lead to lower interest rates. Rather Banks were reluctant to reduce the benchmark rate in accordance with monetary policy rate due to obvious reasons (Fixed interest bearing long term deposits being one reason). It is to been seen how MCLR system tackles the above issue which is crucial in monetary policy transmission.

Conclusion

The objective of Bank's lending rate policy should effectively (i)provide the flexibility to the lender to adjust interest rates more quickly to the dynamic economic scenario (ii) better transmission of monetary policy interest rates and (iii) transparent and non-discriminatory in fixing the interest rate to consumers.

It can be seen that a benchmark rate which is arrived based on the elements of costs which can be identified, understood better and which are common amongst borrowers will transmit the policy rate in a transparent way.

RBI's monetary policy has come a long way since the liberalisation of Indian economy and moving towards existing practices prevailing in the economically developed countries. The latest methodology, Marginal Cost of Lending rates (MCLR) has for sure reduced the lending rates of Banks by about 25 to 50 basis points from the existing base rate mechanism. The advantage of MCLR can be seen from the difference in benchmark rate compared to Benchmark Prime Lending Rates(BPLR); where the difference is about 300 to 400 basis points.

The success of MCLR depends how closely Bank's can price the lending rates with reference to MCLR thereby reducing the spread which depends on multiple factors like profitability, existing deposit rates, CASA ratioetc and a competent Bank can always price their lending with minimum spread from MCLR. There is no doubt that over time since the deregulation of interest rates, the methodology of calculating benchmark rate has become more transparent. It is to be noted that the MCLR declared by banks since April 2016 does not vary much from bank to bank especially for banks having similar competitive edge. As you can note from RBI's publication of lending rates, MCLR remains the lowest among all the benchmark rates, MCLR of SBI being 8.65% for quarter ending December 2016 while their last declared BR and BPLR in October 2015 is 9.30% and 14.05% respectively. A study of MCLR system in the coming years will reveal how quickly and transparently it transmits the policy rates.

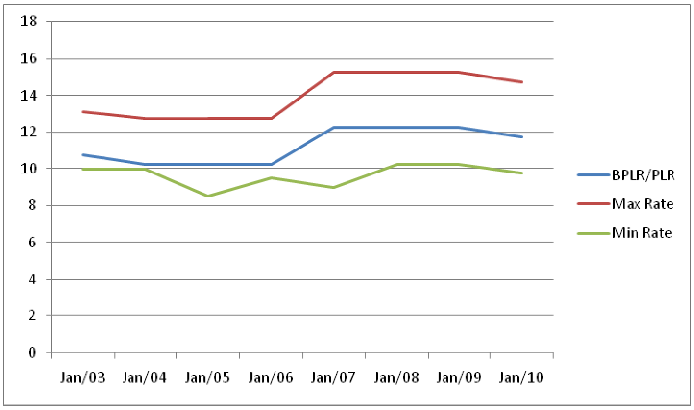

Figure (1) Interest rate range at which 60% of the business is contracted with reference to BPLR/PLR for State Bank of India

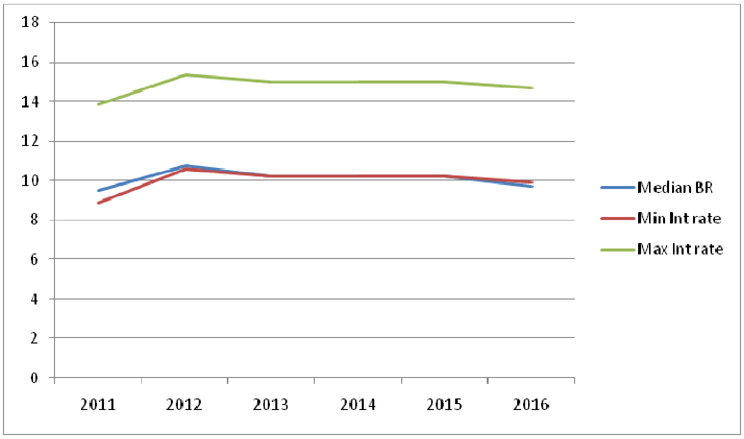

Figure (2) Interest rate range at which 60% of the business is contracted with reference to Base Rate (BR) for All Public Sector Banks

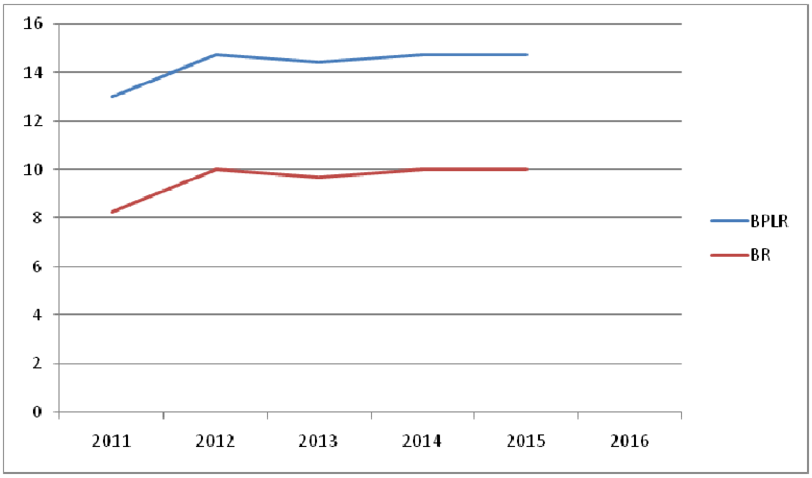

Figure (3) Comparison of Benchmark Prime Lending Rate and Base Rate for State Bank of India

Figure (1) represents the 60% of lending happened in State Bank of India with reference to BPLR. You can very well see the downward and upward pricing of loans with reference to BPLR. Seldom Loans get priced close to BPLR. For common borrowers higher interest rate has been charged and corporate were charged well below BPLR.

However in Figure (2) when Base rate was implemented, the minimum interest rate charged was very close to the base rate even though higher interest rates well above base rate was charged as maximum interest rate which displays the effectiveness of base rate over BPLR system, that banks were not able to price much below the base rate which reflects the system to be much closer to cost of funds. This is very much clear in Figure (3) where there is a huge difference in spread between BPLR and base rate which shows that base rate is much effective benchmark system than BPLR.

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