External benchmarking of loans

October 11, 2019
Source: *The Hindu*

Manifest pedagogy: Monetary Policy Transmission Mechanism has been a pain point in the Indian financial markets. This has reflected in persistent high cost of credit and high cost of borrowing (bond yields much higher than the rest of the world, at a time when globally yields are negative). UPSC covers banking and finance topics especially important policy changes in prelims and may go into formulae, policy and outcomes off the same.

In news: RBI recently mandated all banks to link new floating rate loans to an external benchmark effective October 1, 2019.

Placing it in syllabus: Banking sector in India (explicitly mentioned)

Static dimensions: Base Rate, MCLR and Prime lending rate (PLR)

Current dimensions: Need for External Benchmarking and its Pros and cons

Content:

Base rate:

- Base Rate is the **lending rate calculated based on the total cost of funds of the banks and is the minimum interest** rate at which a bank can lend **except** for loans to its own employees, its retired employees and against bank's own deposits.
- All floating and fixed rate loans sanctioned by banks before 1st April, 2016 were priced using base rate as

benchmark.

- Starting from 1st April 2016, all banks in India were required to benchmark and price their loans to MCLR.
- Starting from April 2018, RBI had mandated that banks' base rates be linked to MCLR rates.

Marginal Cost of Fund based Lending Rate (MCLR):

- It is the **internal benchmark rate** used by banks to fix the interest rate on floating rate loans.
- It is **calculated based on** cost of raising new funds for the bank which include the cost of maintaining CRR/SLR, operating costs of banks and tenor premium.
- As **MCLR is closely linked to repo rate,** it improves the transmission of RBI's repo rate cut to the end borrower.
- Banks publish MCLR for at least five durations which are overnight, 1 month, 3 months, 6 months and 1 year MCLR.
- Interest rate on each floating rate loan would be reset based on the duration of the MCLR to which it is linked.

Prime Lending Rate (PLR):

- It is the **internal benchmark rate** used for setting up the interest rate on floating rate loans sanctioned by **Non Banking Financial Companies (NBFC) and Housing Finance Companies (HFC).**
- PLR rate is calculated based on average cost of funds.
- NBFC and HFC generally price their loans at a discount on their existing PLR.

Need for external benchmarking:

- The RBI, as an **initiative for faster monetary policy transmission** recently announced its intention to make it mandatory for banks to link all new floating rate personal or retail loans and floating rate loans to MSMEs to an external benchmark.
- The external benchmark would be **RBI's policy repo rate, three or six-month Treasury Bill yield** published by the

Financial Benchmarks India Private Ltd (FBIL) and any other benchmark market interest rate published by the FBIL from **1 October 2019.**

- Several banks have already launched **repo-linked lending rate (RLLR) products.**
- RBI has mandated banks to reset interest rates under external benchmark **at least once every three months** from the earlier practice of resetting interest rates once a year under MCLR.

External benchmarks:

Repo Rate: It refers to the rate at which commercial banks borrow money from the RBI in case of shortage of funds. Repo stands for 'Repurchasing Option'.

It is a contract in which banks provide eligible securities such as Treasury Bills to the RBI while availing overnight loans. An agreement to repurchase them at a predetermined price will also be in place.

Treasury bills (T-bills) – These are **money market instruments** which are **short term debt instruments** issued by the Government of India and are presently issued in **three tenors,** namely, 91 day, 182 day and 364 day.

Treasury bills are **zero coupon securities and pay no interest.** Instead, they are issued at a discount and redeemed at the face value at maturity. The return to the investors is the difference between the maturity value or the face value and the issue price.

The 91 day T-Bills are issued on weekly auction basis while 182 day T-Bill auction is held on Wednesday preceding Non-reporting Friday.

Effects of External Benchmarking

Pros:

- It will greatly help in **better transmission of the RBI's monetary policy rates.**
- The asset resolution and bank recapitalisation are expected to **strengthen bank balance sheets.**
- **Loans under the new external benchmark structure would get cheaper and fast, if the RBI continues to cut rates.**
- This **improves banks' willingness** to change their lending rates in tandem with the change in the policy rates.
- Enabling effective monetary transmission **increases the credibility of RBI** and helps in **strengthening the financial structure.**

Cons:

- Results in **higher payout** for borrowers when the RBI starts to hike rate.
- Even if banks link lending rates to the same external benchmark, the initial base or benchmark would vary across banks. E.g For SBI repo rate lending rate (RLLR) is 7.65 percent currently and for IDBI Bank, it is 8.3 percent.

While in future lending rates may move higher or lower by the same quantum in both banks, as the initial base is different, the effective lending rate would vary. Hence, **borrowers will still have to compare the underlying benchmark** across banks to zero in on the cheapest option.

- Under MCLR, lending rates are reset only at intervals corresponding to the tenure of the MCLR. E.g. in the case of home loans benchmarked against the one-year MCLR, lending rates are reset every year.

Under the external benchmark structure the RBI has mandated that **loans are reset at least once every three months** which means lending rate will be revised much faster. Aside from quicker transmission, this also implies other **changes in borrowers' monthly payouts (EMI)**.