Linking External Benchmark Interest Rates

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Manifest Pedagogy

Transmission of monetary policy, health of banks and supporting growth are key concerns of RBI. These issues are not only important from theoretical perspective but last with regard to important events and structure of monetary policy in India.

In news

SBI & external benchmarking

Placing it in the syllabus

Banking Sector Reforms in India

Static dimensions

- PLR
- BPLR
- Base Rate
- MCLR

Current dimensions

- What is external Benchmarking?
- Latest RBI circular of External Benchmarking debate

Content

Prime Lending Rate(PLR)

A prime rate or prime lending rate is an interest rate (average rate of interest charged on loans) used by banks, usually, the rate at which banks lend to favored customers — i.e. those customers with good credit. PLR was replaced by BPLR

Benchmark Prime Lending Rate (by RBI in 2003)

Like PLR it is also the rate at which commercial banks charge their customers who are creditworthy. It can be fixed by the approval of the boards of these banks

Base Rate (by RBI in 2010)

It is the minimum rate set by the Reserve Bank of India below which banks are not allowed to lend to its customers. The base rate is chosen to enhance credit market transparency and ensure that banks pass on their customers the lower cost of fund. It was replaced by MCLR in 2016.

The marginal cost of funds based lending rate (MCLR) (by RBI in 2010)

It refers to the minimum interest rate of a bank below which it cannot lend, except in some cases allowed by the RBI. it is the banks' internal benchmark or reference rate. In fact, MCLR describes the method by which a bank determines the minimum interest rate for loans on the basis of marginal costs or the additional or incremental costs of arranging another rupee for the prospective borrower.

Aims of MCLR

- To improve the **transmission** of policy rates into the lending rates of banks.
- To bring transparency in the methodology followed by banks for determining interest rates on advances.
- To ensure availability of bank credit at interest rates which are fair to borrowers as well as banks.
- To enable banks to become more competitive and enhance

their long-run value and contribution to economic growth.

What is external Benchmarking?

An external benchmark is outside the control of the bank (for example, it could be market determined rate such as Certificate of Deposit rate or Treasury Bill rate or Interbank Offer Rate, or it could simply be the central bank's policy rate). The virtue of an external benchmark is that it is transparent, common across banks, and borrowers can compare various loan offers by simply comparing spreads over the benchmark (all else, such as maturity of the loan, being equal).

Latest RBI circular of External Benchmarking debate

According to the RBI, all new personal or retail floating rate loans (housing, auto) and floating rate loans to Micro and Small Enterprises (MSE) extended by banks **will be linked to one of the four benchmarks** – Reserve Bank of India's **policy repo rate, or 91 days Treasury Bill, or 182 days Treasury Bill, or any other benchmark market interest rate** generated by the Financial Benchmarks India Private Ltd.

The spread over the benchmark rate – to be decided wholly at the discretion of banks at the start of the loan – will remain unchanged throughout the lifespan of the loan, unless the borrower's credit assessment undergoes a substantial change and as agreed in the loan agreement, the central bank said in its Development and Regulatory Policy Statement.

While the RBI guidance was to pass on the benefit of falling interest rates to borrowers by linking lending rate to an external benchmark, SBI also linked its savings interest rates (over Rs 1 lakh) to the external benchmark.

External Benchmark for Floating Rate Loans: RBI takes a U-Turn

RBI due to pressure from banks (opposition) has delayed its plan to link floating interest rates for retail loans to external benchmark. This is in line with shortage of liquidity and crisis in financial sector. Moreover, in light of RBI exploring new tools, changing benchmarks in times of global uncertainty is a risky proposition.