# RBI makes external benchmarking mandatory for certain categories of loans

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Source: Monthly Policy Review of PRS

The Reserve Bank of India (RBI) has made it mandatory for banks to link all new (a) floating rate personal or retail loans (including housing and auto loans), and (b) floating rate loans to MSMEs, to an external benchmark from October 1, 2019.

Background

The RBI had constituted an Internal Study Group to review the working of the marginal cost of funds based lending rate in 2017.4 In its report, the Group had observed that internal benchmarks such as the base rate and marginal cost of funds-based lending rate have not delivered effective transmission of monetary policy. The Group recommended switching to an external benchmark in a time-bound manner.

What are the rate loans?

Floating rate loans are loans with variable interest rates.

Key highlights

Currently, the banks' lending rates are based on either the base rate or the marginal cost of funds based lending rate.
The banks can choose from the following external benchmarks:
RBI repo rate (the rate at which RBI lends to commercial banks)
3- month or 6-month treasury bill yield, or any other

benchmark market interest rate published by the Financial Benchmarks India Private Limited. Banks are not allowed to lend below the benchmark rate.

Banks are required to adopt a uniform external benchmark within a loan category. However, they are free to decide the spread over the external benchmark. The spread is a range of interest rate above the benchmark rate, as per the risk premium.

Further, banks are free to offer such external benchmark linked loans to other types of borrowers as well.

The banks have to reset the interest rate under the external benchmark at least once in three months.

Borrowers with existing floating rate loans, who are eligible to prepay without pre-payment charges, will be eligible to switch to external benchmark without any charge or fees (except reasonable administrative/legal costs). The rate charged to these borrowers after switching will be the same as the rate charged for a new loan with the same specifics (category, tenor, amount) at the time of origination of the loan.