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PLATINUM JUBILEE

REPORT OF THE WORKING GROUP ON BENCHMARK PRIME LENDING RATE

OCTOBER 2009

RESERVE BANK OF INDIA

MUMBAI

Letter of Transmittal

October , 2009
Ashwina , 1931

The Governor
(S) Reserve Bank of India
Mumbai

Dear Sir,

We submit herewith the Report of the Working Group on Benchmark Prime Lending Rate.

Yours faithfully,

(Deepak Mohanty)
Chairman

(Abhijit Sen) Member	(H. S. Upendra Kamath) Member	(Jahangir Aziz) Member
(Janak Raj) Member	(K Ramakrishnan) Member	(N. S. Kannan) Member
(P. Vijaya Bhaskar) Member	(R C Arora) Member	(R. K. Gupta) Member
(S. S. Ranjan) Member	(T T Ram Mohan) Member	(Himanshu Joshi) Member Secretary

CONTENTS

LIST OF ACRONYMS

BPLR	-	Benchmark Prime Lending Rate
CASA	-	Current Account and Savings Account Deposits
CDs	-	Certificates of Deposit
CDI	-	Brazil’s Overnight Inter-Bank Lending Rate
CPs	-	Commercial Papers
CRR	-	Cash Reserve Ratio
CoF	-	Cost of Funds
DRI	-	Differential Rate of Interest
FCNR(B)	-	Foreign Currency Non-Resident (Banks)
G-Sec	-	Government Securities
IBA	-	Indian Banks’ Association
JIBAR	-	Johannesburg Inter-bank Agreed Rate
LAF	-	Liquidity Adjustment Facility
MFI	-	Micro-Finance Institutions
MSS	-	Market Stabilisation Scheme
NDTL	-	Net Demand and Time Liabilities
NIM	-	Net Interest Margin
NR(E)RA	-	Non-Resident (External) Rupee Account
OLS	-	Ordinary Least Squares
PLR	-	Prime Lending Rate
PTLR	-	Prime Term Lending Rate
PSBs	-	Public Sector Banks
PSUs	-	Public Sector Undertakings
RoA	-	Return on Advances
RRBs	-	Regional Rural Banks
SBI	-	State Bank of India
SCBs	-	Scheduled Commercial Banks
SHGs	-	Self-Help Groups
SME	-	Small and Medium Enterprises
TPLR	-	Tenor- Linked Prime Lending Rate
TSLS	-	Two Stage Least Squares
WIBOR	-	Warsaw Inter-bank Lending Rate
WSS	-	Weekly Statistical Supplement

Executive Summary

The Reserve Bank announced the constitution of the Working Group on Benchmark Prime Lending Rate (BPLR) in the Annual Policy Statement of 2009-10 (Chairman: Shri Deepak Mohanty) to review the BPLR system and suggest changes to make credit pricing more transparent. The Working Group was assigned the following terms of reference (i) to review the concept of BPLR and the manner of its computation; (ii) to examine the extent of sub-BPLR lending and the reasons thereof; (iii) to examine the wide divergence in BPLRs of major banks; (iv) to suggest an appropriate loan pricing system for banks based on international best practices; (v) to review the administered lending rates for small loans up to Rs 2 lakh and for exporters; (vi) to suggest suitable benchmarks for floating rate loans in the retail segment; and (vii) consider any other issue relating to lending rates of banks. The main recommendations of the Group are set out below:

- 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.

- After carefully examining the various possible options, views of various stakeholders from industry associations and those received from the public, and international best practices, the Group is of the view that there is merit in introducing a system of Base Rate to replace the existing BPLR system.

- The proposed Base Rate will include all those cost elements which can be clearly identified and are common across borrowers. The constituents of the Base Rate would include (i) the card interest rate on retail deposit (deposits below Rs. 15 lakh) with one year maturity (adjusted for CASA deposits); (ii) adjustment for the negative carry in respect of CRR and SLR; (iii) unallocatable overhead cost for banks which would comprise a minimum set of overhead cost elements; and (iv) average return on net worth.

- The actual lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, which will include product-specific operating costs, credit risk premium and tenor premium.

- The Working Group has worked out an illustrative methodology for computing the base rate for the banks. According to this methodology with representative data for the year 2008-09, the illustrative Base Rate works out to 8.55 per cent.

- With the proposed system of Base Rate, there will not be a need for banks to lend below the Base Rate as the Base Rate represents the bare minimum rate below which it will not be viable for the banks to lend. The Group, however, also recognises certain situations when lending below the Base Rate may be necessitated by market conditions. This may occur when there is a large surplus liquidity in the system and banks instead of deploying funds in the LAF window of the Reserve Bank may prefer to lend at rates lower than their respective Base Rates. The Group is of the view that the need for such lending may arise as an exception only for very short-term periods. Accordingly, the Base Rate system recommended by the Group will be applicable for loans with maturity of one year and above (including all working capital loans).

- Banks may give loans below one year at fixed or floating rates without reference to the Base Rate. However, in order to ensure that sub-Base Rate lending does not proliferate, the Group recommends that such sub-Base Rate lending in both the priority and non-priority sectors in any financial year should not exceed 15 per cent of the incremental lending during the financial year. Of this, non-priority sector sub-Base Rate lending should not exceed 5 per cent. That is, the overall sub-Base Rate lending during a financial year should not exceed 15 per cent of their incremental lending, and banks will be free to extend entire sub-Base Rate lending of up to 15 per cent to the priority sector.

- At present, at least ten categories of loans can be priced without reference to BPLR. The Group recommends that such categories of loans may be linked to the Base Rate except 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.

- The Base Rate could also serve as the reference benchmark rate for floating rate loan products, apart from the other external market benchmark rates.
- In order to increase the flow of credit to small borrowers, administered lending rate for loans up to Rs. 2 lakh may be deregulated as the experience reveals that lending rate regulation has dampened the flow of credit to small borrowers and has imparted downward inflexibility to the BPLRs. Banks should be free to lend to small borrowers at fixed or floating rates, which would include the Base Rate and sector-specific operating cost, credit risk premium and tenor premium as in the case of other borrowers.
- The interest rate on rupee export credit should not exceed the Base Rate of individual banks. As export credit is of short-term in nature and exporters are generally wholesale borrowers, there is need to incentivise export credit for exporters to be globally competitive. By this change in stipulation of pricing of export credit, exporters can still access rupee export credit at lower rates as the Base Rate envisaged is expected to be significantly lower than the BPLRs. The Base Rate based on the methodology suggested by the Group is comparable with the present lending rate of 9.5 per cent charged by the banks to most exporters. The proposed system will also be more flexible and competitive.
- At present the interest rates on education loans are linked to ceilings with reference to the BPLR. In view of the critical role played by education loans in developing human resource skills, the interest rate on these loans may continue be administered. However, in view of the fact that the Base Rate is expected to be significantly lower than BPLR, the Group recommends that there is a need to change the mark up. Accordingly, the Group recommends that the interest rates on all education loans may not exceed the average Base Rate of five largest banks plus 200 basis points. Even with this stipulation, the actual lending rates for education loans would be lower than the current rates prevailing. The information on the average Base Rate should be disseminated by IBA on a quarterly basis to enable banks to price their education loan portfolio.

- In order to bring about greater transparency in loan pricing, the banks should continue to provide the information on lending rates to the Reserve Bank and disseminate information on the Base Rate. In addition, banks should also provide information on the actual minimum and maximum interest rates charged to borrowers.
- All banks should follow the Banking Codes and Standards Board of India (BCSBI) Codes for fair treatment of customers of banks, viz., the Code of Bank's Commitment to Customers (Code) and the Code of Bank's Commitment to Micro and Small Enterprises (MSE Code) scrupulously. The Group also recommends that the Reserve Bank may require banks to publish summary information relating to the number of complaints and compliance with the codes in their annual reports.

WORKING GROUP ON BPLR

1. Introduction

1.1 The ultimate objective of bank lending is to promote economic growth by channelling resources to the most productive uses at reasonable rates. Therefore, the level and structure of interest rates are critical determinants of the economic efficiency with which resources are allocated in an economy. Interest rate distortions in any form may lead to a misallocation of resources. Accordingly, lending rates of banks need to be appropriate and reasonable from the point of view of both lending institutions and borrowers. Lending rates which are either too high or low and out of sync with the realistic pricing of credit could have implications for credit quality and cause concerns about financial stability. Lending interest rates should also be responsive to the monetary policy actions, if they are to achieve the desired objective.

1.2 Till the late 1980s the interest rate structure in India was largely administered in nature and was characterised by numerous rate prescriptions for different activities, and borrowers were charged vastly different rates for the same loan amount thereby distorting the structure of lending rates. On account of the complexities of the interest rate structure under the administered rate structure, efforts since 1990 has been of rationalisation of the interest rate structure so as to ensure price discovery and transparency in loan pricing system. The process of rationalisation culminated in almost complete deregulation of lending rates in October 1994. The freeing up of lending rates of scheduled commercial banks for credit limits of over Rs. 2 lakh along with the introduction of PLR system in 1994 was a major step in this direction aimed at ensuring competitive loan pricing. The system of Benchmark Prime Lending Rate (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. However, the BPLR system has fallen short of its Original objective of bringing transparency to lending rates. Competition has forced the pricing of a significant proportion of loans far out of alignment with BPLRs and in a non-transparent manner, undermining the role of the BPLR as a reference rate. There was also widespread public perception that the BPLR system has led to cross-subsidisation in terms of underpricing of credit for corporates and overpricing of loans to agriculture and small and medium enterprises. The Annual Policy

Statement 2009-10 noted that since the bulk of bank loans were lent at sub-BPLR rates, the system of BPLR evolved in such a manner that it had lost its relevance as a meaningful reference rate. The lack of transparency in the BPLR system also caused impediment to the effective transmission of monetary policy signals. In view of the concerns pertaining to the shortcomings in the BPLR system raised by the public and those recognised by the Reserve Bank, the Annual Policy Statement of 2009-10 announced the constitution of Working Group on BPLR to review the BPLR system and suggest changes to make credit pricing more transparent. Accordingly, a Working Group was constituted with the following members:

Shri Deepak Mohanty Executive Director Reserve Bank of India	Chairman
Shri Abhijit Sen MD & CFO Citi Bank	Member
Shri H. S. Upendra Kamath Executive Director Canara Bank	Member
Dr. Jahangir Aziz Chief Economist (India) J.P. Morgan	Member
Dr. Janak Raj Adviser-in-Charge Monetary Policy Department Reserve Bank of India	Member
Dr. K. Ramakrishnan Chief Executive Indian Banks' Association	Member
Shri N. S. Kannan ED & CFO ICICI Bank	Member
Shri P. Vijaya Bhaskar Chief General Manager-in-Charge Department of Banking Operations and Development Reserve Bank of India	Member

Shri R C Arora Sr. V P & Compliance Head Banking Codes and Standards Board of India	Member
Shri R. K. Gupta General Manager Punjab National Bank	Member
Shri S. S. Ranjan Dy.MD & CFO State Bank of India	Member
Dr. T T Rammohan Professor Indian Institute of Management Ahmedabad	Member
Dr. Himanshu Joshi Director Monetary Policy Department Reserve Bank of India	Member Secretary

Terms of Reference of the Working Group

1.3 The Working Group had the following terms of reference:

(i) to review the concept of BPLR and the manner of its computation;

(ii) to examine the extent of sub-BPLR lending and the reasons thereof;

(iii) to examine the wide divergence in BPLRs of major banks;

(iv) to suggest an appropriate loan pricing system for banks based on international best practices;

(v) to review the administered lending rates for small loans up to Rs 2 lakh and for exporters;

(vi) to suggest suitable benchmarks for floating rate loans in the retail segment; and consider any other issue relating to lending rates of banks.

Acknowledgements

1.4 The members of the Group place on record its appreciation to the chambers of commerce and industry such as Confederation of Indian Industry, Federation of Indian Chamber of Commerce and Industry, Associated Chamber of Commerce and Industry of India, Indian Merchant Chamber, Federation of Indian Export Organisation, Bombay

Chamber of Commerce and Industry, Small & Medium Business Development Chamber of India, Federation of Indian Micro and Small & Medium Enterprises, Federation of Association of Small Industries of India and Thane Small Scale Industries Association for their views and suggestions.

1.5 The Group also expresses it thanks to all those who have submitted their comments and suggestions, by post and by email, in response to the press release of June 11, 2009 soliciting comments on the terms of reference of the Group.

1.6 The Group places on record its deep appreciation for the excellent support provided by the Secretariat comprising Shri Deepak Mathur, Assistant Adviser of Department of Statistics and Information Management and S/Shri Asish Thomas George and Edwin Prabu, Research Officers of the Monetary Policy Department.

1.7 The Report is organised in six chapters. Chapter 2 traces the evolution of BPLR. Chapter 3 provides the methodology for appropriate pricing of loans. Chapter 4 examines the benchmarks for pricing floating rate loans. Chapter 5 evaluates the working of administered lending rates. Chapter 6 sets out the major recommendations of the Group.

2. Evolution of BPLR in India

2.1 Consistent with the objective of providing credit to the productive sectors of the economy, the lending rates as well as the allocation of bank credit, was, by and large, regulated by the Reserve Bank till the late 1980s. Further, there were numerous sector-specific, programme-specific and purpose-specific credit stipulations provided from time to time. Initial attempt to rationalise the administered lending rate structure was made in September 1990 by removing multiplicity and complexity of interest rates. Interest rates on advances, other than advances under Differential Rate of Interest Scheme[1] and export credit, were linked to the size of advances. Under this revised structure of lending rates, the advances of scheduled commercial banks were divided into six slabs and progressively higher interest rates were prescribed for larger advances (subject to a floor rate). While for the lowest slab consisting of advances amounting up to Rs. 7,500, a minimum interest rate of 10 per cent per annum was prescribed, advances of above Rs. 2 lakh, which fell under the highest slab were prescribed a minimum rate of interest of 16 per cent per annum. The above rationalised structure of lending rates was applied to both working capital and term loans. However, concessional rates were offered on term loans to agriculture, small-scale industry and specific transport operators.

Deregulation of Lending Rates and the Emergence of Prime Lending Rates (PLR)

2.2 After the initiation of financial sector reforms in the early 1990s, various steps were initiated to deregulate the lending rates of commercial banks. The credit limit size classes of scheduled commercial banks, on which administered rates were prescribed, were reduced into three slabs in April 1993. The slabs or credit limit size class under the revised guidelines consisted of three categories: (i) advances up to and inclusive of Rs. 25,000; (ii) advances over Rs. 25,000 and up to Rs. 2 lakh; and (iii) advances over Rs. 2 lakh. In a major step towards deregulation of lending rates, it was decided in October 1994 that banks would determine their own lending rates for credit limits over Rs.2 lakh in accordance with their risk-reward perception and commercial judgment. Banks were at the same time required to

[1] Under the differential rate of interest (DRI) scheme, weaker sections of society are provided small loans at an interest rate of 4 per cent per annum.

declare their prime lending rate (PLR), the rate charged for the prime borrowers of the bank, with the approval of their boards taking into account their cost of funds, transaction cost, etc. Initially, the PLR acted as a floor rate for credit above Rs. 2 lakh. Subsequently, on account of the large instances of banks charging lending rates far higher than PLR on a significant portion of bank credit to borrowers with credit limit to over Rs. 2 lakh, in October 1996 it was made mandatory for banks, while announcing the PLR, to also announce the maximum spread over the PLR for all advances other than consumer credit.

2.3 In order to bring about greater discipline in the utilisation of bank credit and gain better control over credit flow, a 'loan system' of delivery of bank credit was introduced in April 1995, whereby the banks were given the freedom to charge interest rate on the 'cash credit' and 'loan' components with reference to the prime lending rate approved by their Boards. Further, in February 1997, in order to encourage borrowers to switch to loan delivery system, banks were allowed to prescribe separate PLRs and spreads (over PLRs) for both loan and cash credit components.

2.4 In October 1997, with regard to term loans of 3 years and above, the banks were given the freedom to announce separate Prime Term Lending Rates (PTLR), while PLR remained applicable to the loans taken for working capital and short-term purposes. With a view to removing the disincentive to the flow of credit to small borrowers below Rs.2 lakh, instead of prescribing a specific rate uniformly for all banks, PLR was converted as a ceiling rate on loans up to Rs. 2 lakh in April 1998. The rationale for this policy was that the PLR, being the rate chargeable to the best borrower of the bank, should be the maximum rate chargeable to the small borrowers.

Tenor- linked Prime Lending Rates (TPLRs)

2.5 The system of PLRs and spread above PLR that were being implemented had by and large served the purpose of ensuring transparency and objectivity. In addition to the two PLRs that banks were permitted to operate – one for short term and the other for long term loans - there were request from banks and borrowers for tenor linked PLR, *i.e.,* PLR for different maturities. Hence, the concept of tenor-linked prime lending rates (TPLRs) was introduced in April 1999 to provide banks with freedom to operate different PLRs for different maturities, provided the transparency and uniformity of treatment that were envisaged under the PLR system continued to be maintained. Moreover in October 1999, with the aim of imparting greater operational flexibility to banks in the applicability of PLR, based on suggestions received from banks and other market participants, banks were given the freedom to charge interest rates without reference to the PLR in respect of certain categories of loans/credit such as loans covered by refinancing schemes of term lending institutions, lending to intermediary agencies, discounting of bills and advances/overdraft against domestic/ NRE/FCNR(B) deposits. As announced in the Annual Policy Statement for 2000-01, banks were permitted to charge fixed/floating rates on all loans with credit limit of more than Rs. 2 lakh with PLR as the reference rate. Banks were, however, advised to ensure that while sanctioning such loans, the PLR stipulations as applicable were complied with and the nature of alignment with PLR in the case of both fixed and floating rate loans/advances made explicit at the time of sanction of the loan.

Relaxation of PLR and sub-PLR lending

2.6 The Monetary and Credit Policy for the year 2001-02 noted that "…in recent meetings with bankers, a request was made that the PLR should be converted into a reference or benchmark rate for banks rather than treating it as the minimum rate chargeable to the borrowers. In this context, a review of the international practices also shows that while the PLR was traditionally the lowest rate charged to the prime borrowers with highest credit rating, in recent years, the practice of providing loans even below the PLR by banks has become common…" (para 82 of Monetary and Credit Policy for the year 2001-2002, April 19, 2001).

2.7 Accordingly, keeping in view the international practice and to provide further operational flexibility to commercial banks in deciding their lending rates, the Reserve Bank relaxed the requirement of PLR being the floor rate for loans above Rs.2 lakh in its Annual Policy Statement for the year 2001-02. Banks were allowed to offer loans at below-PLR rates to exporters or other creditworthy borrowers including public enterprises on the lines of a transparent and objective policy approved by their respective boards. Thus beginning April 19, 2001 commercial banks were allowed to lend at sub-PLR rates for loans above Rs.2 lakh. However, even while doing so, banks were required to continue with the earlier practice of declaring the maximum spread of interest rates charged on loans which were priced above the PLR. Given the prevailing structure of the credit market in India and the need to continue with concessionality for small borrowers, the practice of treating PLR as the ceiling for loans up to Rs.2 lakh was continued forthwith.

2.8 Large capital inflows and a number of monetary easing measures undertaken by the Reserve Bank, as part of its overall monetary policy stance to promote growth, resulted in abundant liquidity during 2001-04. As a result, interest rates in general softened considerably in this period**.** However, reduction in interest rates in general was not uniformly reflected in the lending rates across all banks. It was also observed that the actual lending rates by banks were much higher than their PLRs on a significant portion of bank credit to borrowers with credit limits of over Rs.2 lakh. Therefore, in the Monetary and Credit Policy for the year 2002-03, banks were urged to review the present maximum spreads over PLR and reduce them wherever they were unreasonably high so that credit was available to the borrowers at reasonable interest rates. Banks were also advised to announce the maximum spread over PLR to the public along with the announcement of their PLRs.

2.9 With a view to enhancing transparency with regard to actual interest rates for depositors as well as borrowers, in the interest of customer protection as also meaningful competition, the reporting requirements to the Reserve Bank by commercial banks on loan pricing were augmented. The Reserve Bank, beginning June 2002, started monitoring the actual trend in lending rates in India through information received from banks at regular intervals. Additional information was sought from banks on the maximum and minimum rates charged by them. Banks were advised to submit information on the maximum and minimum interest rates after taking out extreme values in the interest rates (say, up to 5 per cent of advances on either side). Further, banks were also advised to furnish the range of interest rates in which large value of business (say, 60 per cent or more of advances) was contracted in order to monitor the general trend in lending rate charged by banks in India. The quarterly information on lending rates so collected under the special quarterly return VI-AC was placed on the Reserve Bank’s website. It is now available for the period beginning June 2002. Banks were also urged to switch over to 'all in cost' concept for borrowers by explicitly declaring the processing charges, service charges, etc. charged to borrowers and to place the information on such bank charges in the public domain.

Benchmark Prime Lending Rate

2.10 The Mid-Term Review of Monetary and Credit Policy for the year 2002-2003 observed that based on the information collected under the new reporting standards introduced, both PLR and spread were seen to vary widely across banks/bank-groups. The Mid-Term Review noted that in a competitive market, PLRs among various banks/bank-groups should converge to reflect credit market conditions and that the spreads around the PLR should be reasonable. It called on the banks to review both their PLRs and spreads and to align spreads within reasonable limits around PLRs, subject to approval of their boards. However, the divergence in PLR and the widening of spreads between bank borrowers continued to persist. Moreover, the prime lending rates continued to be rigid and inflexible in relation to the overall direction of interest rates in the economy.

2.11 With an aim of introducing transparency and ensuring appropriate pricing of loans – wherein the PLRs truly reflect the actual costs – in the Annual Policy Statement of April 2003, the Reserve Bank advised banks to announce a Benchmark PLR (BPLR) with the approval of their boards. The BPLR was seen as a reference rate and was to be computed taking into consideration (i) cost of funds; (ii) operational expenses; and (ii) a minimum margin to cover regulatory requirements of provisioning and capital charge, and profit margin. At the same time, given the lack of transparency, banks were also advised to discontinue the system of tenor-linked PLR since all other lending rates could be determined with reference to the single Benchmark PLR arrived at by taking into account term premia and/or risk premia. Banks were also permitted the flexibility in pricing floating rate loans and advances using market benchmarks and time varying spread in an objective and transparent manner. Further, interest rates on a number of loans and advances such as advances for acquiring residential properties and purchase of consumer durables could be determined without reference to the benchmark PLR. Almost all banks implemented the system by April 2004 after the IBA specified the detailed guidelines.

2.12 The Reserve Bank refrained from issuing detailed/micro level regulatory guidelines on the manner in which the components of BPLR were to be computed. Banks however sought the Reserve Bank's advice on standardised methodology for the computation of BPLR for all banks. Banks however highlighted the need to have differential pricing strategies owing to different risks of defaults in different segments which needed different load factors for capital charges. Generally, as banks offered various products which differed in terms of 'capital committed' and 'resources allocated', banks felt that there was need for flexibility in loan pricing to reflect in the interest rate characteristics of the product, including credit and market risks and the structuring required. Banks also mentioned the fact that since transaction costs were different for different sectors such as consumer and corporate business accounts, there was a need to have different pricing structures for these segments. To accommodate the above concerns, banks wanted the Reserve Bank to allow separate BPLRs for pricing loans in different sectors. Besides, as changes in interest rates over a period of time made it difficult to consider term premia as a fixed component in the pricing of loans, need was also felt by banks for resetting term premia, particularly for loans with longer term maturities. Banks also suggested that short-term lending rates could not be linked to historical accounting data, they may prefer to deploy their surplus funds to highly rated borrowers even if a slightly higher spread was available over the yield of money market instruments. While taking cognisance of banks' observations, it was deemed appropriate by the Reserve Bank to announce the introduction of the BPLR system in the interest of transparency in the pricing of credit.

2.13 In order to monitor the BPLRs of banks, the Reserve Bank introduced a system of collecting information from banks and publicly disseminating it in various publications. The Weekly Statistical Supplement (WSS) of the Reserve Bank of India Monthly Bulletin disseminates information on the BPLRs of five major public sector banks. The information on BPLRs and actual lending rates of SCBs is also regularly disseminated on a quarterly basis through the Reserve Bank's website (www.rbi.org.in).

2.14 Subsequently, reviewing the BPLR system, the Mid-Term Review of the Annual Policy Statement for the year 2005-06 observed that the system of BPLR had evolved in a manner that had not fully met expectations. Competition had forced the pricing of a significant proportion of loans far out of alignment with BPLRs and in a non-transparent manner. As a consequence, this had undermined the role of the BPLR as a reference rate. Furthermore, there was a public perception that there was under-pricing of credit for corporates while there could be overpricing of lending to agriculture and small and medium enterprises. Several requests were received by the Reserve Bank from banks suggesting a review of the BPLR system. Therefore, a need has arisen to review the current procedures and processes of pricing of credit through a well structured and segment-wise analysis of costs at various stages of intermediation in the whole credit cycle**.** The evolution of the BPLR system in India is summed up in Table 1.

Table 1: Evolution of BPLR in India : A Snapshot

October 1994	Lending rates for loans with credit limits of over Rs. 2 lakh deregulated. Banks were required to declare their Prime lending rates (PLRs).
February 1997	Banks allowed to prescribe separate PLRs and spreads over PLRs, both for loan and cash credit components.
October 1997	For term loans of 3 years and above, separate Prime Term Lending Rates (PTLRs) were required to be announced by banks.
April 1998	PLR converted as a ceiling rate on loans up to Rs.2 lakh.
April 1999	Tenor-linked Prime Lending Rates (TPLRs) introduced.
October 1999	Banks were given flexibility to charge interest rates without reference to the PLR in respect of certain categories of loans/credit.
April 2000	Banks allowed to charge fixed/floating rate on their lending for credit limit of over Rs.2 lakh.
April 2001	The PLR ceased to be the floor rate for loans above Rs. 2 lakh. Commercial banks allowed to lend at sub-PLR rate for loans above Rs.2 lakh.
April 2002	A system of collection of additional information from banks on the (a) maximum and minimum interest rates on advances charged by the banks; and (b) range of interest rates with large value of business and disseminating through the Reserve Bank's website was introduced.
April 2003	The Reserve Bank advised banks to announce a benchmark PLR (BPLR) with the approval of their boards. The system of tenor-linked PLR discontinued.

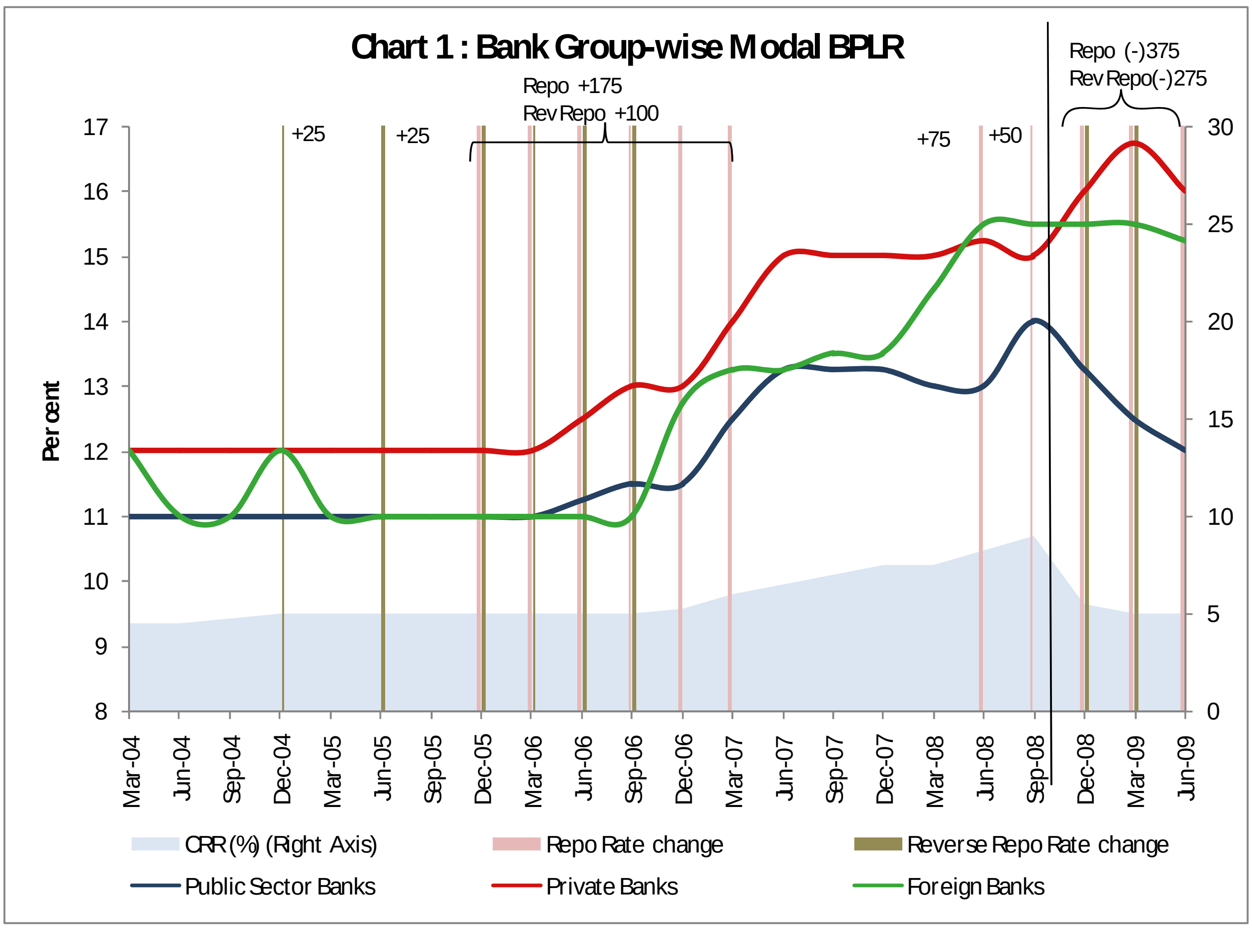
Trends in BPLRs

2.15 The lending rates of different banks in a deregulated competitive environment by nature are expected to be different as the cost of funds, cost of operations and margins for capital charge and profits for each bank are different. However, the experience of the BPLR system shows that BPLR of different bank groups have tended to vary significantly.

Bank-Group wise Trends in BPLR

2.16 The bank group-wise trends in the modal BPLR since March 2004 show three distinct phases. In the first phase between March 2004 and March 2006, the BPLRs of public sector banks and private sector banks remained almost steady and range bound, though the BPLRs of private sector banks were about 100 bps higher than those of public sector banks. BPLRs of foreign banks showed some variations, but converged to BPLR of public sector banks by

March 2006. During March 2006 to June 2007, modal BPLRs of all three bank groups showed sharp upward movement in line with the general tightening of monetary conditions. Even in this phase, modal BPLRs of private sector banks remained at around 100 bps higher than those of public sector bank. Modal BPLRs of foreign banks remained close to those of public sector banks. In the next phase from June 2007 to September 2008, the divergence in the modal BPLRs of public sector banks and private sector banks widened somewhat; modal BPLRs of foreign banks converged to the modal BPLR of private sector banks. However, since September 2008, modal BPLRs of private and public sector banks have diverged significantly. The modal BPLRs of public sector banks have shown a significant decline since September 2008, while those of private banks' after showing an upward movement till March 2009, have exhibited a downward movement (Chart 1).



Responsiveness of BPLR to changes in the Reserve Bank's Policy Rates

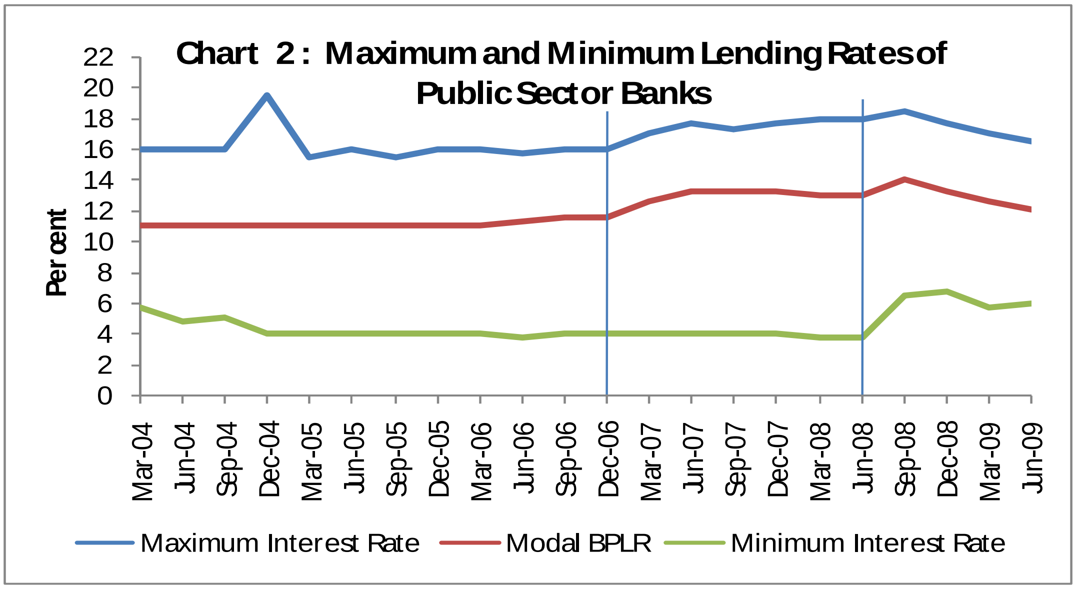
2.17 An empirical exercise carried out to ascertain the responsiveness of modal BPLR to the changes in the Reserve Bank's policy rates (repo rate) for the period from Q1:2004 to Q1:2009 suggests a mixed picture across the bank groups and interest rate cycles (Table 2 and Annex 2). An increase in the repo rate was observed to bring about a contemporaneous change in modal BPRLs of private sector banks and major foreign banks and a lagged response in the case of public sector banks. A decrease in the repo rate had a significant contemporaneous impact only in the case of public sector banks. This asymmetric response shows that while public sector banks were slow to respond to an increase in policy rate, they were quick on the reverse. This could be attributed to the ownership structure of public sector banks which makes them more amenable to moral suasion by the authorities. Apart from the policy rate, the weighted average call money rate was also used to assess the impact on modal BPLRs. An increase in the weighted average call money rate, an indication of tightness of liquidity, was observed to have a significant contemporaneous effect across all bank groups. A decline was seen to have a significant impact, albeit with a lag in the case of public sector banks and contemporaneous as well as lagged impact in the case of private banks while in the case of five major foreign banks, no significant impact was seen.

Table 2 : Responsiveness of modal BPLRs to the Policy Rates and Liquidity Conditions

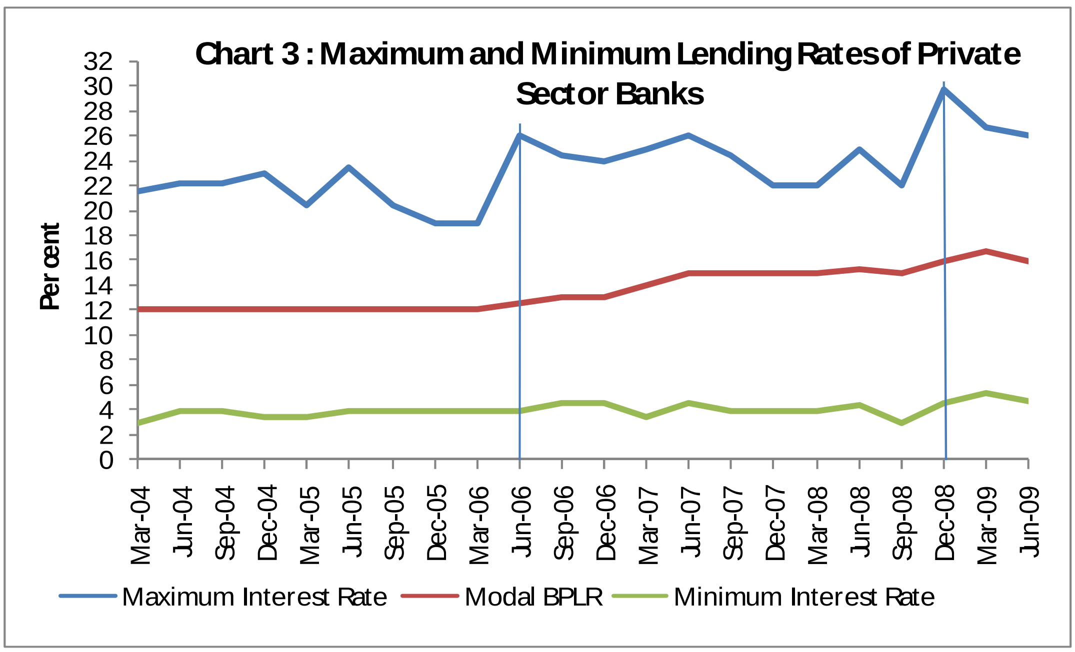
Bank Group	**All Public Sector Banks**	**All Private Sector Banks**	**5 Major Foreign Banks**
Increase in Repo Rate	Lagged (one quarter)	Contemporaneous and Lagged (two quarters)	Contemporaneous
Decrease in Repo Rate	Contemporaneous	No significant impact	No significant impact
Increase in Reverse Repo Rate	No significant impact	No significant impact	No significant impact
Decrease in Reverse Repo Rate	No significant impact	No significant impact	No significant impact
Increase in Weighted Average Call Money Rate	Contemporaneous	Contemporaneous	Contemporaneous
Decrease in Weighted Average Call Money Rate	Lagged (two quarters)	Contemporaneous and Lagged (one quarter)	No significant impact

2.18 An analysis of the interest rate spreads around modal BPLR for the period March 2004 to 2009 revealed considerable variations among different bank groups. Minimum interest rates, in particular, showed relatively subdued movements suggesting that they were rather insensitive to the overall movements in BPLRs.

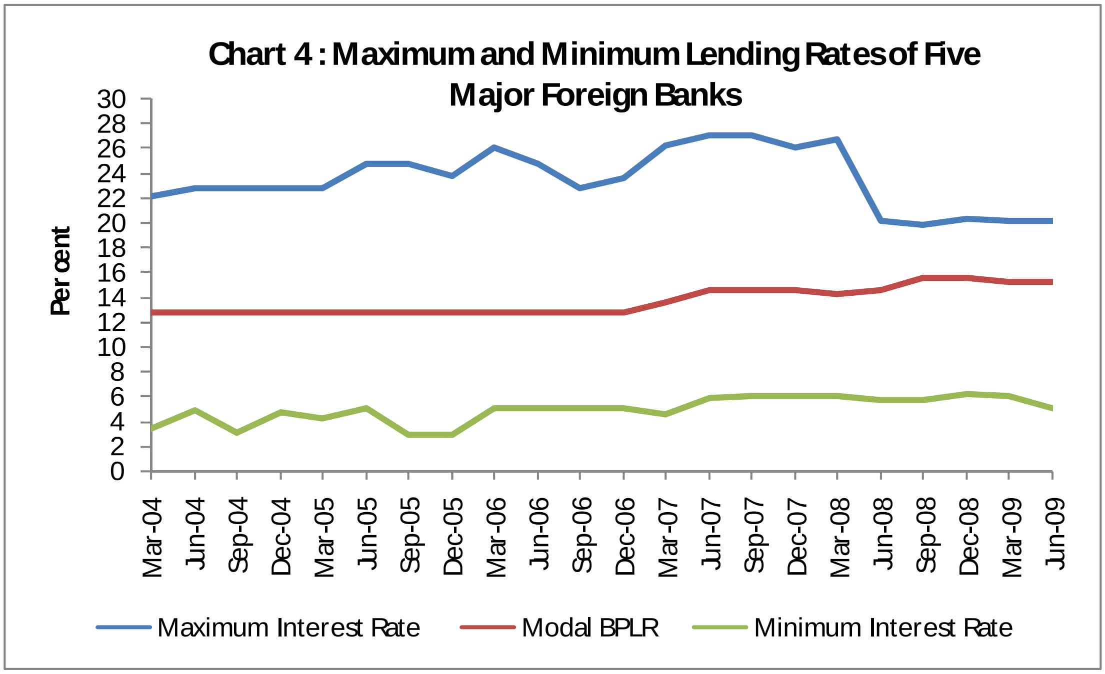
2.19 The maximum and minimum spread of lending rates around BPLR of public sector banks has remained broadly stable since March 2004, barring a brief period between March 2007 over June 2008, when the spread around BPLR, especially the minimum spread below BPLR, increased significantly (Chart 2).



2.20 In the case of private sector banks, maximum interest rate exhibited considerable variations during the March 2004 - June 2009 period. The spread particularly widened in December 2008, before narrowing down in June 2009 (Chart 3).

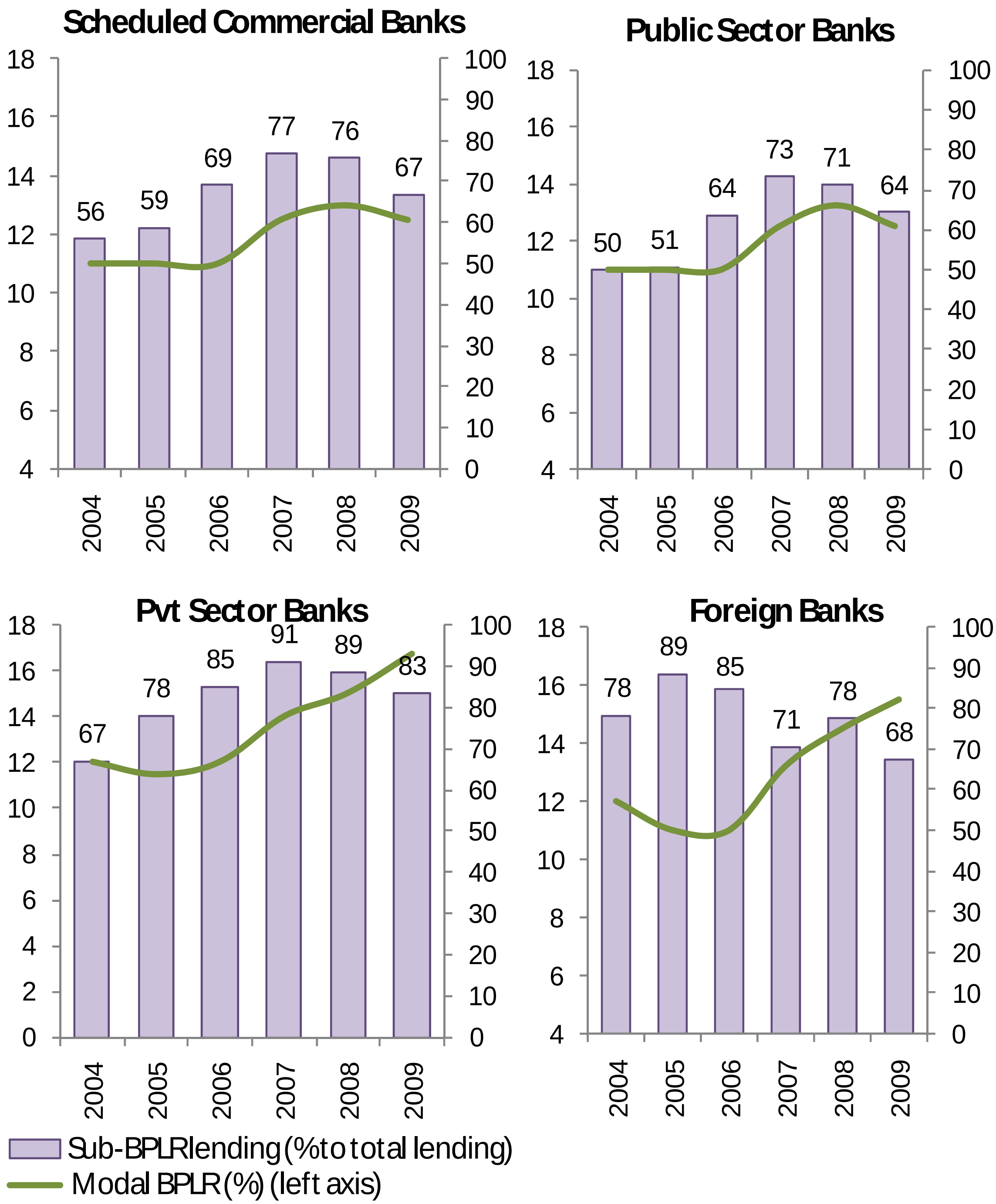


2.21 In the case of five major foreign banks, both the minimum and maximum lending rates have shown wide variations. The maximum lending rate which stood at a peak of 27.0 per cent in March 2008, declined to 19.8 per cent in September 2008, before increasing moderately to 20.0 per cent in June 2009 (Chart 4).



2.22 The movements in BPLR, however, do not capture a true picture of lending interest rates in the country as banks resort to sub-BPLR lending to a varying degree. It is observed that in the case of all scheduled commercial banks, except foreign banks, periods of increase in share of sub-BPLR lending were also associated with high BPLR rates (Chart 5).

Chart 5: Modal BPLR and Sub-BPLR lending by SCBs

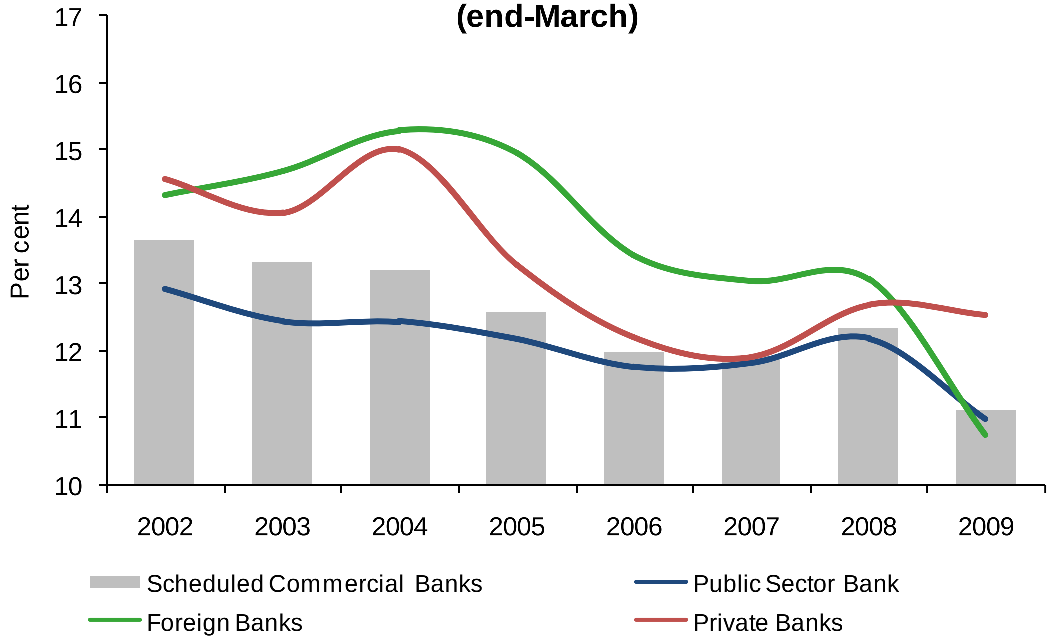


2.23 An empirical analysis of the relationship between changes in BPLRs and sub-BPLR lending rates for select major banks showed that they were positively related[2]. As established by the empirical results above, the co-movements in BPLR and sub-BPLR lending could be for the reason that banks are unable to reduce their BPLRs, which are worked out based on the average cost of funds, when the marginal costs declines. This resulted in incremental lending at sub-BPLR. True movements in lending interest rate of banks, therefore, are better captured in the weighted average lending rate of banks. Though there was considerable divergence in weighted average lending rates in 2004 among the various bank groups, the weighted average lending rates have tended to converge in the recent period. Furthermore, the weighted average lending rate kept coming down beginning 2002 before rising in 2008. However, the weighted average lending rate was lower in 2008 than in 2005. In 2009, the weighted average lending rates have registered a significant decline, except in the case of private banks (Chart 6).

[2] An OLS regression with partial adjustment was estimated for data on five major public sector banks, four major private sector banks and three major foreign banks for the period 2007 Q1 to 2009 Q1 to explain the changes in BPLRs based on the following explanatory variables (i) change in the share of sub-BPLR lending, (ii) change in the share of personal loans and (iii) liquidity (change in quarterly average of LAF & MSS balances, +increase, -decrease). The results are given below:

Dependent Variable **: Change Share of sub- BPLR lending**	
Sample → **Dep. Variables ↓**	**Major Scheduled Commercial Banks**
Change in BPLR	4.89 (3.58*)
Change .Share of Personal Loans	0.11 (0.52)
Change in Liquidity	0.05 (1.81)
Change in share of sub BPLR lending (t-1)	-0.39 (-3.60*)
R squared	0.19
Durbin-Watson Statistic	2.26
Note: Figures in parentheses represent ‘t-statistics’. * and ** denote significance at 5 and 10 per cent level respectively.	

Chart 6: Weighted Average Lending Rates (end-March)



Source : Statistical Tables Relating to Banks in India

Major Issues in the BPLR-based System

2.24 The BPLR system was expected to be a step forward from the PLR system, which more or less represented the minimum lending rates, to that of one which stood as a benchmark or a reference rate around which most of the banks' lending was expected to take place. However, over a period of time, several concerns have been raised about the way the BPLR system has evolved.

Extent of Sub-BPLR Lending

2.25 Following the permission given for sub-BPLR lending, banks were permitted to offer sub-BPLR rates to exporters and other creditworthy borrowers, including public sector enterprises on the lines of a transparent objective policy approved by their respective boards. Sub-BPLR lending was expected to be at the margin. However, over the years, because of competitive pressures banks have increasingly resorted to financing of various categories of borrowers at sub-BPLR rates such as corporates, housing and retail sector. An examination of the data on sub-BPLR lending reveals that the share of sub-BPLR lending (excluding export credit and small loans) for scheduled commercial banks which was at 28 per cent in March 2002, increased to 77 per cent in September 2008, before declining to 67 per cent in

March 2009 (Table 3 and Annex 3). In the case of public sector banks (PSBs), the share of sub-BPLR lending was 73 per cent in March 2007, declined marginally to 64 per cent by March 2009 (Annex 4). The sub-BPLR lending of private sector banks moderated from the elevated level of 91 per cent in March 2007 to 84 per cent in March 2009 (Annex 5). Similarly, the sub-BPLR lending of foreign banks, which touched a high of 81 per cent in June 2008, declined to 68 per cent in March 2009 (Annex 6).

2.26 At the disaggregated level, the major share of sub-BPLR lending was of longer term loans (above 3 years), whereas in respect of private sector banks and foreign banks, the major share of sub-BPLR loans was in the form of consumer credit. The Group deliberated on the possible reasons for such a sharp increase in sub-BPLR loans. The Group recognised that in the event of temporary excessive liquidity, there could be a case for short-term lending at rates lower than BPLR. However, the large share of such sub-BPLR loans of higher tenor would suggest that in the absence of the practice of sub-BPLR lending, BPLRs of banks would have been significantly lower than their current levels.

Table 3: Sub-BPLR lending of Scheduled Commercial Banks* – Credit Type

(Percentage share in total loans)

Credit Type	March-2002	March - 2003	September-2004	March -2005	March-2006	March-2007	March-2008	March-2009
1	2	3	4	5	6	7	8	9
i) Cash Credit	**5.4**	**6.5**	**9.5**	**7.7**	**11.7**	**13.2**	**14.0**	**12.4**
ii) Consumer Credit	**0.6**	**3.3**	**7.7**	**8.7**	**8.1**	**10.7**	**8.9**	**3.7**
iii) Demand Loan (including bill - discounting)	**5.9**	**6.9**	**7.6**	**8.2**	**7.4**	**6.4**	**8.5**	**6.9**
iv) Term Loans	**16.5**	**21.0**	**31.3**	**34.4**	**41.9**	**46.6**	**44.3**	**43.9**
a) up to 180 days	2.8	3.0	1.7	2.6	3.4	2.9	5.7	3.1
b) 180 days-1 year	1.0	1.0	1.8	2.1	1.9	1.9	2.3	2.2
c) 1-3 years	1.6	1.9	3.4	4.6	5.6	5.2	6.1	5.3
d) 3-5 years	1.4	4.8	10.9	11.2	14.0	17.7	11.7	15.7
e) above 5 years	6.4	6.6	8.9	10.2	12.6	14.7	13.7	13.7
f) Others	3.5	3.8	4.7	3.7	4.5	4.3	5.0	4.0
Total (i to iv) as percentage of all loans	**28.4**	**37.7**	**56.1**	**58.9**	**69.2**	**76.9**	**75.8**	**66.9**

* Excluding small loans (loans up to 2 lakh) and export credit.

Table 4: Sub-BPLR lending of Scheduled Commercial Banks*

(Percentage share in respective credit type)

Credit Type	March-2002	March - 2003	September-2004	March - 2005	March-2006	March-2007	March-2008	March-2009
1	2	3	4	5	6	7	8	9
i) Cash Credit	**17.6**	**23.6**	**37.8**	**36.1**	**51.1**	**59.7**	**63.1**	**50.8**
ii) Consumer Credit	**33.4**	**50.0**	**75.9**	**77.0**	**74.4**	**80.2**	**73.9**	**58.6**
iii) Demand Loan (including bill - discounting)	**43.5**	**50.0**	**65.5**	**68.2**	**73.0**	**78.9**	**85.4**	**74.1**
iv) Term Loans								
a) up to 180 days	70.2	76.6	76.7	90.2	93.1	88.8	91.1	75.5
b) 180 days-1 year	48.5	59.0	82.9	85.1	88.1	90.2	85.0	70.6
c) 1-3 years	28.8	40.5	49.0	64.6	77.8	83.1	79.9	71.5
d) 3-5 years	13.5	29.7	56.5	57.0	70.8	79.4	77.3	69.1
e) above 5 years	26.2	36.7	61.4	61.3	74.7	86.2	76.1	78.7
f) Others	41.4	47.7	57.9	55.0	69.6	77.6	80.1	75.7
Total sub-BPLR credit (i to iv) as percentage of all loans	**28.4**	**37.7**	**56.1**	**58.9**	**69.1**	**76.9**	**75.8**	**66.9**

* Excluding small loans (loans up to 2 lakh) and export credit.

Lack of Transparency

2.27 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. Higher levels of transparency can be achieved by disclosing important information on loan pricing and possible fees to the borrower before he or she signs an agreement. Transparency also implies that banks must not indulge in irresponsible lending by having hidden additional costs and unexpected rate increases the possibility of which is not made known upfront to the borrower. It should be ensured that all charges and possibility of increases are made clear to the borrower at the beginning of the agreement. The existence of a benchmark rate, to which the various loans are tied to, is a crucial component in attaining transparency in loan pricing.

2.28 Given the large proportion of sub-BPLR lending by the banking system, concerns have been raised on the transparency aspect of computation of BPLRs by banks. In terms of definition, the components of the BPLR include the cost of funds of both purchased deposits and funds borrowed from markets, operational expenses including fixed and variable costs incurred by a bank, minimum margin to cover regulatory requirement of provisioning/capital charges and profit margin the appropriateness of which should be determined by the bank itself.

2.29 The Reserve Bank has received several representations on the arbitrariness of resetting the lending rates on loans and the benchmark rates used for pricing floating rate products. Many banks charge lending rates with reference to benchmarks which are internal and non-transparent. In addition, provisions on conditional resetting interest rates are placed as '*force majeure*' in loan covenants thereby making the terms of contract non-transparent for the borrower. This practice has added further opaqueness in the setting of lending rates since the re-pricing is generally arbitrary and not with reference to a transparent publicly known benchmarks.

2.30 *Downward Stickiness of BPLRs*

2.31 Another issue that is often raised is the asymmetric downward stickiness of the BPLRs. This not only raises an issue of equity but also results in poor transmission of monetary policy in credit markets. For instance, during the monetary policy tightening phase (March 2004 to September 2008), it has been observed that while banks were often quick in raising lending rates during an upturn in the interest rate cycle, they were slow to bring down the interest rate in the downturn of the interest rate cycle (Table 5).

Table 5 : Movements in Monetary Policy Instruments and BPLRs

(Changes in basis points)

Phase	CRR	Repo Rate	Reverse Repo Rate	Benchmark Prime Lending Rate		
				Public Sector Banks	Private Banks	Foreign Banks
1	2	3	4	5	6	7
Monetary Tightening Phase (Mar. 04 - Sep. 08)	450	300	150	325 – 350	225 – 375	100 – (-)150
Monetary Easing Phase (Sep. 08 - May. 09)	(-) 400	(-) 425	(-)275	(-)150 – (-)275	(-)100 – (-) 125	(-)50 – (-)100

2.32 One of the major reasons for downward stickiness is the large share of deposits contracted at high rates in the past. The marginal cost of funds is more relevant for banks for pricing current loans/advances rather than the average cost which is computed on the basis of the cost of all outstanding purchased and borrowed liabilities reflected in the balance sheet.

The pricing of credit based on marginal cost is, however, impeded by asymmetric contractual relationship with depositors and borrowers. Thus while reduction of interest rates could lead to repayment or swapping of loans taken by borrowers, the fixed nature of deposit contracts imply that banks would continue to pay higher interest rates despite the general decline in interest rates. This produces an impediment to the effective transmission of monetary policy impulses as well.

2.33 Besides, as noted in the Annual Policy Statement 2009-10, the downward stickiness in BPLRs is also attributed to several other factors such as (i) the administered interest rate structure on small savings, which constrains the reduction in deposit rates; (ii) concessional lending rates linked to BPLRs for some sectors, which make overall lending rates less flexible; and (iii) persistence of the large market borrowing programme of the government, which hardens interest rate expectations. As liquidity remains ample, the competitive pressure on lending rates has increased.

Cross-subsidisation in Lending

2.34 The BPLR system based on the average costs incurred by banks on fund-based business actually reflects the break-even cost for banks and does not represent "prime lending" rate in the usual sense of the term at which banks accommodate their highly rated/most creditworthy borrowers. However, as in other markets, the scope of differential pricing for different borrowers based on risk-reward perceptions continues on the basis of customer relationship. A large loan offered to a highly rated borrower may be offered at a lower rate below the current all-in-cost BPLR due to little risk and savings on account of processing and monitoring costs. Although justifiable to some extent, such sub-BPLR lending on a large scale has created a perception that large borrowers are being cross subsidised by retail and small borrowers.

2.35 The latest available information as at end-March 2008 (based on the BSR data) suggests that loans to individual borrowers are generally (other than for housing purposes) in the high interest rate range (14 per cent and above).

Table 6: Interest rate range and outstanding credit of SCBs- March 2008*
(As per cent of total loans and advances in each segment)

Interest Rate Range	Agriculture	Industry	Personal Loans: Loans for Purchase of Consumer Durables	Personal Loans: Loans for Housing	Personal Loans: Rest of the Personal Loans	Total Loans and Advances
1	2	3	5	6	7	8
Less than 10 %	18.1	5.0	0.0	30.6	7.4	9.5
10 % to 12%	26.0	32.0	0.6	48.9	9.4	30.5
12 % to 14%	41.4	32.5	9.3	17.7	27.4	32.4
14% to 18%	14.2	30.5	45.7	2.8	48.7	26.9
Greater than 18 %	0.2	0.1	44.4	0.0	7.1	0.7
Total	**100**	**100**	**100**	**100**	**100**	**100**

* Data pertain to accounts with credit limit above Rs. 2 lakh.

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

3. The Loan Pricing System: Issues and Options

3.1 Before firming up its views on the issue of appropriate loan pricing system, the Group consulted the various stakeholders. The Working Group held a meeting with industry and trade associations, including those of SMEs and exporters on July 13, 2009 to solicit their views/suggestions on the loan pricing system. The list of associations/bodies that attended the meeting is at Annex 8. The Working Group also solicited comments from the general public through the press release of June 19, 2009. The names of all those individuals/associations who have submitted their suggestions to the Group in writing are set out in Annex 9.

Suggestions Received from Industry/Trade Associations

3.2 Various industry/trade associations were generally of the view that the present BPLR system had no relation with the market rates and there was an absence of a system-wide risk free reference rate. A suggestion was made that in order to obtain such a transparent system wide-risk free rate, the yield on 5-year Government security be considered as the benchmark rate, on which the risk premium can be further loaded to arrive at the lending rate. The existence of such a transparent benchmark was posited to be highly beneficial for large corporate as well as small borrowers. Suggestions were also made to use market-based benchmark with up to one year maturity such as the Certificate of Deposit rates or Commercial Paper rates in case the Government bonds were not suitable for the purpose. Hence, it was suggested that there was a need to have market benchmarks or credible term money market rate for encouraging the long-term loan market. Suggestions were also made to link the BPLR to the repo rate, in order make the lending rates more responsive to the changing market conditions.

3.3 For achieving greater transparency in loan pricing, it was suggested that a basic rate could be formulated which includes cost of funds and operational cost. The final lending interest rate on credit could be obtained from this basic rate by adding the credit risk premium over the base rate. In such a scenario, the multiple BPLRs should also be explored as long as they were based on a transparent basic rate. Furthermore, in order to enhance transparency, it was suggested to separate or delink the mandated lending at regulated rates from market driven segment so that the burden of concessional lending was not passed on to the other non-concessional loans. The delinking of regulated and non-regulated lending was also suggested as a means to overcome the problem of sub-BPLR lending. Suggestions were also received for a two tier approach to bank lending. In the first tier, the lending rates should be determined sector-wise and subsequently, within each sector, lending rate should be determined based on credit rating of borrowers.

3.4 In view of the fact that bulk of the loans were extended at rates below BPLR and that the BPLR has lost its relevance as the prime rate, it was suggested that it should be re-defined as the lowest rate at which a bank will lend to any borrower. Further, as the BPLR is currently without reference to tenor, it was suggested to redefine BPLR as an internal benchmark of a bank for a 6-month loan.

3.5 In order to make the BPLR more in tune with the actual lending rates that prevail in the market, it was suggested that the BPLR be based on the average lending rate of the top 15 customers. The top 15 customers may be chosen based on the interest rates, (*i.e.,* those who get credit at least interest rates from the banks) or on the basis of quantum of lending (*i.e.,* top 15 by way of quantum of loans). Under such a system, it was pointed that banks may not have to reveal their cost structure. Further, in order to take care of the point as to which is more relevant between "marginal pricing" and "average pricing", it was suggested that the above BPLR may be calculated for the loans during the quarter (or any other chosen intervals) as well as the average on the total outstanding stock of loans.

Suggestions Received from Individuals/Associations in Writing

3.6 The following major suggestions were received from individuals/ associations in writing;

i) In order to improve the existing BPLR system, it was pointed out that an aspect that needs to be examined is how the BPLR as a mechanism and as a special case of PLR, is superior over the universal concept of PLR (i.e., the rate as applicable to the best or AAA borrowers) in achieving the overall objective of transparency as also in transmitting the interest rate signals of the central bank.

ii) The benchmark prime lending rate of PSU banks be related to the highest term deposit rates offered by them. Further, the BPLR should not be fixed at more than 2 per cent higher than the respective bank's highest term deposit rate. This principle of fixing BPLR was proposed to be applied to both categories of banks - public and private. The BPLR should be charged for the top rated customers. Borrowers, other than the top rated, would then be charged some additional basis points depending on their credit worthiness.

iii) Further, there should be a system of multiple BPLRs, *i.e.* separate BPLRs for wholesale, SME and retail advances.

iv) Considering that most of the liabilities are on a fixed interest rate basis, it creates stickiness in lending rates. It was therefore, suggested that deposits should also be on a floating rate basis. This will also help banks to manage their interest rate risk more effectively.

v) An indicative benchmark be developed to link BPLR with the repo rate or with MIBOR. It was also suggested to keep the banks' lending rate within a prescribed minimum lending rate and maximum lending rate.

vi) The current method for deriving BPLR, consisting of cost of funds, operating cost, provisioning cost and expected profit margin may be continued, but certain modifications needs to be incorporated. Since the high value short-term loans extended to corporates are basically dependant on treasury functions, based on the availability of surplus funds with the bank, the pricing of these exposures may not be linked to the BPLR. Further, such lending should not be reckoned for calculation of the quantum of sub-BPLR lending of the bank.In order to bring about transparency in such lending, the pricing of such short term exposures be linked to short term treasury rates such as G-sec rates of similar maturity with loading of expected margin.

vii) Loan facilities with administered interest rates and cases involving consortium lending, on account of the necessity to match interest rate across banks, should not be reckoned for the sub-BPLR exposure. The sub-BPLR lending should not exceed 10 per cent of total advances.

International Experiences

3.7 A survey of the Prime Lending Rate in select countries shows that in most of the countries *i.e.* Japan, Russia, Hong Kong, Singapore and Taiwan a cost plus approach is followed for determining the PLR. In case of Brazil, Poland and South Africa the PLR is based on rates in the interbank market, or the overnight money markets (Annex 10). In the case of US, it is broadly determined as a 300 bps spread over the Fed Funds rate. Irrespective of the system of PLR followed, in almost all the countries surveyed, PLRs tended to remain more or less similar among various banks and were also seen to have moderate to high correlation with central bank policy rates. Furthermore, in almost all the countries surveyed there was high elasticity of PLRs to deposit costs. In the case of Brazil and Poland, where the overnight interbank rates, the CDI (Brazil's overnight inter-bank lending rate) and Warsaw Interbank Lending Rate (WIBOR) respectively, were taken as the PLR, a system of multiple PLR also prevailed. In these countries, multiple PLRs for different segments/groups of borrowers were determined as spread over the PLR. In Brazil, while banks may borrow overnight at 100 per cent CDI, local company may only get it at a 140 per cent CDI. In Poland, while WIBOR is a fixed inter-bank rate, the spread varies for different segments. Other than Japan and Hong Kong, the PLRs of the surveyed countries were tenorless. As regards sub-BPLR lending, while there is hardly any sub-BPLR lending in Brazil, Russia and Taiwan, in United States, significant sub-PLR lending exists and to a lesser extent in Hong Kong, Malaysia, Poland, Japan, Singapore and South Africa. In Hong Kong, sub-PLR lending was primarily on account of mandated lower lending rates over PLR for residential mortgages. In others countries surveyed, the sub-PLR was primarily due to competitive pressures. Except in case of Taiwan and Malaysia where lending linked to PLR accounted for 50 to 75 per cent of total lending, bank lending linked to PLR was around 10 to 25 per cent in the countries surveyed. In South Africa almost the entire lending to individuals was linked to PLR. Lending to corporate sector was linked to floating rate, *i.e* Johannesburg Interbank Agreed Rate (JIBAR) or PLR.

The Groups views on the Suggestions Received

3.8 The Group carefully examined the various suggestions received from the industries/trade associations in the meeting held on July 13, 2009 as also from other associations/ individuals in writing. The Group's views on the suggestions received are set out below:

3.9 In the view of the Group, linking the benchmark/reference rate to the repo rate or government securities yields would not be appropriate as they do not fully reflect the cost of funds of banks, which is determined largely by the cost of deposits as they constitute the main source of funding for banks. The disconnect between the market interest rates and deposit rates in India arises mainly from the fact that banks rely largely on retail deposits, unlike in developed economies where banks can approach the wholesale market for funding. The fixed tenure of deposits makes the adjustment in lending rates difficult due to rigidity in the cost of funds. Similarly, it would not be appropriate to link the reference rate to the CP rates as CPs are primarily issued by AAA corporates and are for shorter maturities. The CP rate includes the risk premium and is not akin to a risk free reference rate. Moreover, the volume of the CP market is small, about 3.0 per cent of non-food bank credit. Similarly, the CD rate may not be representative of the cost structure of banks as it constituted only a small portion at 5.6 per cent of aggregate deposits. Also, such instruments are used only by specific segments of the economy. Therefore, interest rates in these instruments may not be ideal benchmarks for pricing of the overall credit portfolio of banks. Further, although the suggestion that short-term government securities yields was not found acceptable, the Group did recognise certain situations when it may be desirable to allow banks to lend below their cost of funds as otherwise banks may have to park funds with the Reserve Bank at still lower rates. However, such lending has to be at the margin and cannot be allowed in general as is the case now.

3.10 As regards the suggestion of the formulation of a reference rate based on the average cost of funds and operating cost of some representative banks, the Group is of the view that lending rates based on average cost of funds will make them backward looking and hence sticky. Operating cost, of course, would need to be included. However, while doing so, significant variations that exist between operating cost for retail borrowers and wholesale borrowers will have to be taken into account. The Group did not favour the idea of fixing lending rates based on the cost structure of some representative banks. Lending rates have to be necessarily based on the cost structure of each individual bank. The suggestion regarding the separation of regulated and de-regulated segments could also not be accepted as the volume of regulated lending is particularly small. A separation of the two segments could obfuscate the position with regard to the issue of cross-subsidisation among borrowers. The Group, however, felt that there is a need for appropriate rationalisation of administered interest rates as they are imparting a downward stickiness to overall lending rates.

3.11 The Group considered the suggestion of redefining the BPLR as the minimum lending/prime rate. However, the suggestion was not found acceptable because banks, at present, extend a large chunk of their loans at sub-BPLR rates. As a result, the weighted average rate of each bank is significantly lower than its prevailing BPLR. To redefine present BPLR as the minimum lending rate would mean accepting higher interest rates than they would otherwise be. To define the BPLR as the rate for 6 month credit extended by banks was also not accepted for the reason that it would not adequately represent the tenure of the typical working capital credit cycle which lasts at least one year.

3.12 The Group did not also favour linking the BPLR, as in the present system, with the top most rated customers, as such lending rates would depend on risk profiles of top rated borrowers and cannot be generalised for all other categories of borrowers. Moreover, the considerations relating to AAA large ticket loans are based on the banks' own assessment of the returns and cost pertaining to such lending over a period of time. The Group felt that there was a need for a uniform methodology for calculating the cost of funds.

3.13 The suggestion relating to linking BPLR with term deposit rates was deliberated upon by the Group in detail. It was felt that linking the lending rate to the interest rate with an appropriate tenor of deposit product may indeed help in enhancing transparency in setting the lending rates. The Group did not favour the suggestion of placing any band around the BPLR for setting the lending rates as this may reduce credit flow by making banks risk averse.

Views and Recommendations of the Working Group

3.14 Lending interest rates need to be appropriate to the borrowers depending on their risk profile and at the same time they should also be competitive for banks whereby they earn reasonable risk adjusted return to remain profitable. Lending interest rates should also be responsive to changes in the policy rate of the central bank. It is only then that the central bank can achieve the desired objectives through monetary policy actions. The ideal benchmark for such a rate should be some money market rate with which both liabilities and assets of banks are closely linked and the money market rate, in turn, should be sensitive to the central bank's policy rates. Although the inter-bank money market rate in India is sensitive to the Reserve Bank's policy rate, banks' overall liabilities and assets are not tied to such a rate. It would therefore, not be appropriate to price loan products with reference to a money market rate.

3.15 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. More importantly, perhaps, in the present system, the BPLR has tended to be out of sync with market conditions and does not adequately respond to changes in monetary policy. The Working Group was of the opinion that until the system was modified and/or replaced with some other system, the tendency to extend loans at sub-BPLR rates on a large scale in the market would continue raising concerns on transparency. The Working Group also noted that on account of competitive pressures, banks were lending a part of their portfolio at rates which did not make much commercial sense.

3.16 On rigidity of lending rates, the Group felt that the fixed nature of cost on the liability side was the main reason for the stickiness in lending rates. Unless the cost of liabilities also moves in line with the policy rates, it may not be possible for banks to price their loans in line with the changing policy rates of the Reserve Bank. In general, the Group felt that there was no immediate alternative to the existing fixed rate liability structure of banks given the depositors' preference. This implied that the downward stickiness in lending rates persists reflecting the maturity structure in the liability structure of the bank. The Group noted that there was no regulatory restriction on banks offering floating rate deposits. There is, therefore, a need for banks to encourage deposit contracts at floating interest rates. However, since such a structure can emerge only over time, there is a need to bring appropriate changes in the existing loan pricing system to make it more transparent and responsive to the Reserve Bank's policy rates.

3.17 Given some structural rigidities in the system, it may not be possible to have a system which is perfect for both borrowers and the banks. However, at the same time, there is both a need and room to improve upon the existing system of pricing of loans.

3.18 The modification in the existing system or the design of a new system needs to keep in view the structure of assets and liabilities of the banking sector in India. Deposits constitute the predominant source of funding assets as is reflected in the ratio of deposits to total assets (about 78 per cent as on March 2009 for all scheduled commercial banks). The ownership pattern is largely concentrated in favour of fixed tenure retail household deposits which accounted for 58.1 per cent of total deposits (Tables 7 and 8).

Table 7: Distribution Current, Savings and Term Deposits - March 2008

(per cent)

Bank Group	Current	Savings	Term	Total
1	2	3	4	5
Public Sector Banks	13.1	26.0	60.9	100
Private Sector Banks	14.9	18.7	66.4	100
Foreign Banks	26.4	14.9	58.8	100
SCBs (Excluding RRBs)	**14.2**	**23.9**	**61.9**	**100**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

Table 8: Ownership Pattern of Bank Deposits (As on March 31, 2008)

(per cent)

Sector	Current Accounts	Savings Deposits	Term Deposits	Total Deposits
1	2	3	4	5
Government Sector	14.8	8.0	15.3	13.5
Private Corporate Sector (Non-Financial)	24.8	0.4	15.2	13.0
Financial Sector	16.3	0.5	12.7	10.3
Foreign Sector	3.4	5.7	5.2	5.1
Household Sector	40.7	85.4	51.5	58.1
Overall	**100**	**100**	**100**	**100**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

3.19 The bulk of the term deposits are with maturity one year and above (Table 9).

Table 9: Term Deposits Outstanding : Distribution as per Maturity - March 2008

(per cent)

Bank Group	Less than 6 months	6 months & above but less than 1 year	1 year and above but less than 2 years	above 2 years	Total Term Deposits
1	2	3	4	5	6
Public Sector Banks	13.3	13.6	40.6	32.5	100
Private Sector Banks	21.1	16.1	40.2	22.5	100
Foreign Banks	32.8	15.8	35.5	15.8	100
SCBs (Excluding RRBs)	**16.1**	**14.3**	**40.2**	**29.4**	**100**

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2008.

3.20 On the lending side, the bulk of the accounts (about 98 per cent of the accounts) are up to Rs. 10 lakh. However, the amount outstanding in such accounts was relatively small (about 27 per cent). As a result, the average size of loans per account was also small (about Rs. 70,000) (Table 10). Given this structure of loan portfolio of banks in India, the transaction cost for retail loans is high.

Table 10: Credit Accounts by Size of Credit Limits – March 2008

Bank Group	No. of Accounts (per cent to total accounts in each bank group)		Total Credit (per cent to total credit in each bank group)		Average Amount per Account (Rs. lakh)	
	Up to Rs.10 lakh	Above Rs. 10 lakh	Up to Rs.10 lakh	Above Rs. 10 lakh	Up to Rs.10 lakh	Above Rs. 10 lakh
1	2	3	4	5	6	7
Public Sector Banks	98.2	1.8	25.6	74.4	0.8	128.8
Private Sector Banks	97.4	2.6	32.3	67.7	0.6	46.7
Foreign Banks	98.5	1.5	21.7	78.3	0.4	94.5
SCBs (excluding RRBs)	**98.0**	**2.0**	**26.7**	**73.3**	**0.7**	**95.1**

3.21 The cost of funds was a major factor explaining the overall profitability of the credit portfolios as the cost of funds and return on advances were closely linked with a correlation coefficient of close to 0.90. In terms of aggregate banking business, it was also observed that there was high degree of correspondence between the cost of funds and Net Interest Margin (NIM) as reflected in the high correlation coefficient (0.94) between the two variables (Table 11).

Table 11: Cost of Funds, Return on Funds and Net Interest Margin

(per cent)

Item	2004-05	2005-06	2006-07	2007-08	2008-09
1	2	3	4	5	6
Cost of Deposits					
Scheduled Commercial Banks	4.20	4.15	4.44	5.41	5.66
Public Sector Banks	4.36	4.32	4.45	5.41	5.60
Private Sector Banks	3.84	3.87	4.77	5.88	6.32
Foreign Banks	3.00	2.78	3.15	3.81	4.34
Cost of Funds (CoF)					
Scheduled Commercial Banks	4.00	4.05	4.35	5.26	5.53
Public Sector Banks	4.17	4.19	4.36	5.29	5.52
Private Sector Banks	3.55	3.79	4.58	5.57	6.03
Foreign Banks	3.12	3.22	3.54	3.96	4.23
Return on Advances (RoA)					
Scheduled Commercial Banks	7.07	7.2	7.89	8.93	9.58
Public Sector Banks	6.93	7.1	7.68	8.57	9.06
Private Sector Banks	7.52	7.44	8.38	9.91	10.84
Foreign Banks	7.35	7.56	8.66	9.75	12.44
Return on Investment					
Scheduled Commercial Banks	7.57	7.66	6.87	6.62	6.35
Public Sector Banks	7.93	8.17	7.09	6.64	6.23
Private Sector Banks	6.07	5.90	5.98	6.40	6.61
Foreign Banks	6.87	7.54	7.46	7.09	6.71
RoA Adjusted for Cost of Funds					
Scheduled Commercial Banks	3.07	3.15	3.54	3.67	4.05
Public Sector Banks	2.76	2.91	3.32	3.28	3.54
Private Sector Banks	3.97	3.65	3.80	4.34	4.81
Foreign Banks	4.23	4.34	5.12	5.79	8.21
NIM (% of Assets)					
Scheduled Commercial Banks	2.83	2.81	2.58	2.32	2.39
Public Sector Banks	2.91	2.85	2.55	2.12	2.12
Private Sector Banks	2.34	2.40	2.24	2.39	2.73
Foreign Banks	3.34	3.58	3.76	3.79	3.92

* Difference between Return on Advances and Cost of Funds.

3.22 After carefully examining the views expressed by trade and industry associations and others and international best practices, the Group is of the view that there is merit in introducing a system of Base Rate. The proposed Base Rate will include all those cost elements which could clearly identified and are common across borrowers. The actual lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, which will include product- specific operating costs, credit risk premium and tenor premium. In the view of the Group, the system could make the lending rates transparent, forward looking and sensitive to the Reserve Bank's policy rates.

3.23 What could be the constituents of the Base Rate that is expected to provide the foundation for the lending rates? In this context, the Group had to address a number of issues. Should the cost be based on the cost of deposits/or funds or any other parameter? How do regulatory costs such as carrying cost of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) be factored in? How does one allocate operating cost, which is quite different for retail and wholesale products?

3.24 There were several options before the Group. The cost of funds has to be the main element in any form of lending rate. The Group felt that a major lacuna of the current BPLR is that it is based on average historical cost of funds, which makes it backward looking and hence sticky. The Working Group considered two options, *viz.*, (i) the cost of funds (deposits, borrowings and expected return on capital) and (ii) the deposit interest rate. For the Base Rate to be dynamic and responsive to the policy measures, it ought to be forward looking. Hence, in cost of funds, it is more appropriate to take into account prospective cost rather than historic cost. Accordingly, the Working Group preferred the card interest rate on retail deposit (deposits below Rs. 15 lakh) with one year maturity for the purpose. The choice of one year deposit interest rate for the base rate was influenced by two factors. One, working capital loans are for one year. Second, the bulk of the term loans are with maturity of one year and above. The deposit interest rate was preferred over the cost of funds for three reasons. One, the one year retail deposit interest rate will be very transparent as it would be available in public domain and borrowers will know the basis on which the lending interest rates are fixed by banks. Two, one year deposit interest rate would be forward looking as in this case lending interest rate will be based on the present cost of deposits rather than historical cost. Three, such a rate will be more responsive to changes in the Reserve Bank's policy rates. However, banks also hold a sizeable share of current accounts and savings deposits (CASA). While current account does not carry any interest rate, savings deposits carry interest rate of 3.5 per cent (effective interest rate 2.8 per cent due to method of its computation)[3]. Thus, cost of one year term deposit interest rate would need to be adjusted for the low cost of CASA deposits. In order to make the lending rates more transparent, the Group deemed it appropriate to include the negative carry in respect of CRR and SLR in the Base Rate itself. Currently, there is regulatory prescription of SLR of 24 per cent and CRR of 5 per cent of banks' net demand and time liabilities (NDTL). The inclusion of negative carry on account of CRR, which does not earn any interest for banks, in the cost of funds, was quite unambiguous. In the case of SLR maintenance, the Group did observe that interest rates on SLR securities are market determined and as may be seen from Table 11, return on investments (which comprise largely SLR investments) has been consistently higher than the cost of deposits. However, the yield of 364-day Treasury Bill was found to be lower than one year deposit interest rates of banks. Therefore, the need was felt to build in negative carry in respect of SLR prescription also. Accordingly, the Group recommends that the negative carry on SLR may be computed by adjusting the earnings based on the yield of 364-day Treasury Bill to match the one year deposit interest rate. This would make the Base Rate responsive to the movements in the yields in the government securities market, which, in turn, are sensitive to policy rates.

3.25 A major issue faced by the Group was as to how to incorporate the transaction cost which varies significantly for retail and wholesale segments. In order to make the lending rate transparent, the Group recommends that an unallocatable overhead cost component should be incorporated into the Base Rate, while variable product-specific operating cost (for the retail and wholesale segments) can be built into the actual lending rate. The unallocatable overhead cost for banks would comprise a minimum set of overhead cost elements such as aggregate employee compensation relating to administrative functions in corporate office, directors' and auditors' fees, legal and premises expenses, depreciation, cost of printing and stationery, expenses incurred on communication and advertising and IT spending *etc*. Finally, the average return on net worth may also be factored into the Base Rate. Average return on net worth would be the hurdle rate of return on equity determined by the board or management of the bank and could be proxied by projected PAT to net worth ratio or the

[3] However, beginning April 1, 2010 effective interest rate on saving bank deposits would be 3.5 per cent as banks would be required to calculate interest rate on a daily product basis. This change in methodology was announced in the Annual Policy Statement 2009-10 of the Reserve Bank released in April 2009.

average PAT to net worth ratio for the past three years. To achieve consistency in the computation of expected return on equity across banks, the PAT to net worth ratio should be multiplied by the ratio of net worth to deployable deposits. While the net worth of domestic banks would include equity, reserves (excluding revaluation reserves) and retained earnings, the same for foreign banks would incorporate infused capital or notional capital allocated to Indian operations, reserves (excluding revaluation reserves) and retained earnings. Net worth may be calculated as on the last day of the recently completed quarter. The net worth calculation would be carried out regularly once in a quarter synchronous with the review of the Base Rate. Furthermore, banks would also be permitted to adjust the cost of Tier II subordinated debt in the return on equity component.

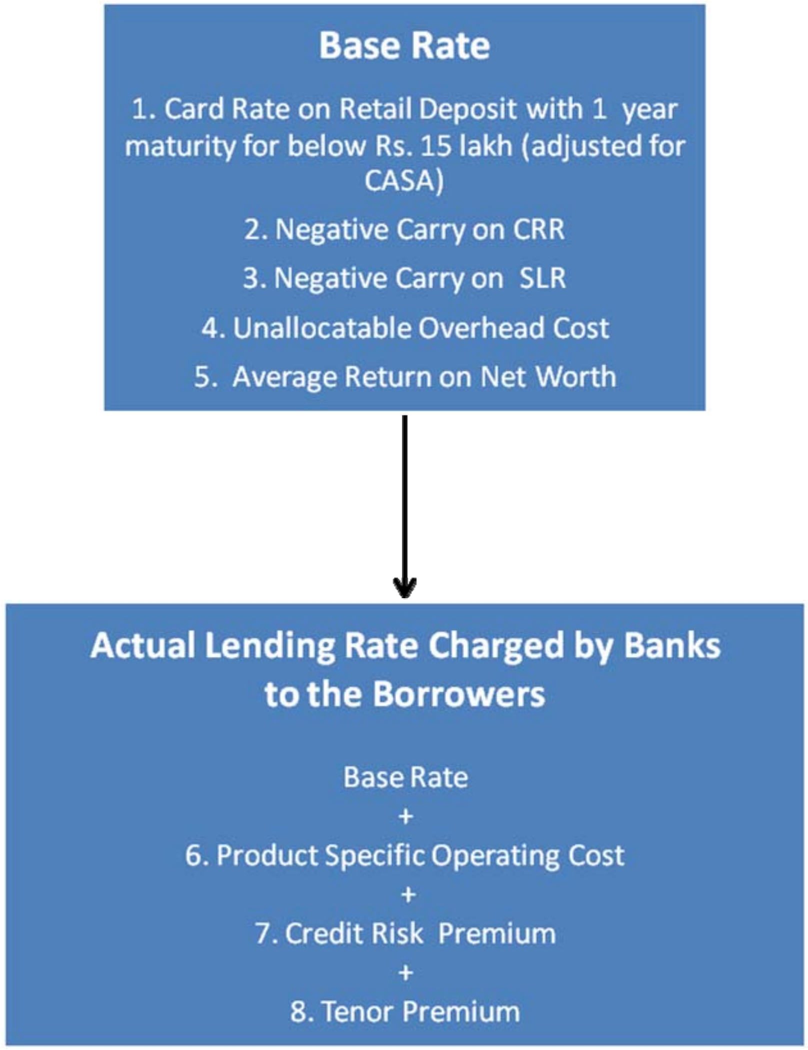
3.26 Once the Base Rate is determined, the actual lending rate to be charged by borrowers should be arrived at by including variable or product specific operating expenses and credit risk and tenor premia.

3.27 Thus, to summarise:

- In the first step, the base rate will be computed, which would include (i) card rate on retail deposit (below Rs. 15 lakh) with one year maturity (adjusted for the share of CASA), the negative carry on account of CRR and SLR (adjusted for returns based on 364-Treasury Bills in respect of SLR), unallocatable overhead operating cost and average return on net worth.
- The actual lending rates would include the Base Rate plus variable or product specific operating expenses, credit risk premium and tenor premium.

3.28 Chart 7 sums up the methodology suggested for computing the Base Rate and the final lending rate. The methodology used for computation of the Base Rate is set out in Box1.

Chart 7: Determination of Lending Rates



Box 1 : Methodology for the Computation of the Base Rate

$$\text{Base Rate} = a - b + c + d + e$$

a - One Year Deposit Rate = D_{1r}

b - CASA adjustment = $\left[\left[D_{1r} * \left(\frac{D_c}{D}\right)\right] + \left[(D_{1r} - S_r) * \left(\frac{D_s}{D}\right)\right]\right] * 100$

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

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

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

Where:

D_{1r} : One year Deposit Rate

D_c : Current Account Deposits

D_T : Term Deposits

D_S : Savings Account Deposits

D : Total Deposits = Time Deposits + Current Deposits + Saving Deposits

$= D_T + D_C + D_S$

D_{ply} : Deployable Deposits

= Total deposits less share of deposits locked as CRR and SLR balances, *i.e.*

$= D * [1 - (CRR + SLR)]$

CRR : Cash Reserve Ratio

SLR : Statutory Liquidity Ratio

S_r : Savings Bank Rate

T_r : 364 T-Bill Rate

U_c : Unallocatable Overhead Cost

NP : Net Profit

NW : Net Worth = Capital + Free Reserves

CASA Adjustment

CASA adjustment = $\left[\left[D_{1r} * \left(\frac{D_c}{D}\right)\right] + \left[(D_{1r} - S_r) * \left(\frac{D_s}{D}\right)\right]\right] * 100$

The one year deposit rate is adjusted for the positive carry on account of Current and Savings Account (CASA) deposits. The CASA adjustment is based on (i) the difference between the 1-

year deposit interest rate and the savings bank deposit rate, multiplied by the share of savings bank deposits; and (ii) the share of current accounts multiplied by the 1-year deposit interest rate, expressed as a percentage.

Negative Carry on CRR and SLR

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

Negative carry on CRR and SLR balances arises because the return on CRR balances is nil, while the return on SLR balances (proxied using the 364-day Treasury Bill rate) is lower than the one year deposit rate. Negative carry on CRR and SLR is arrived at in three steps. In the first step, return on SLR investment was calculated using 364-day Treasury Bills. In the second step, effective cost was calculated by taking the ratio (expressed as a percentage) of one year deposit rate (adjusted for return on SLR investment) and deployable deposits (total deposits less the deposits locked as CRR and SLR balances). In the third step, negative carry cost on SLR and CRR was arrived at by taking the difference between the effective cost and the 1-year retail deposit interest rate.

Unallocatable Overhead Cost

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

Unallocatable Overhead Cost is calculated by taking the ratio (expressed as a percentage) of unallocated overhead cost and deployable deposit.

Average Return on Net Worth

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

Average Return on Net Worth is computed as the product of net profit to net worth ratio and net worth to deployable ratio expressed as a percentage.

3.29 Based on the above methodology the Base Rate has been tentatively estimated at 8.55 per cent (Table 12 and Annex 11).

Table 12 : Estimates of Base Rate under the Proposed Regime

Components	(per cent)
1	2
Base Rate (a-b+c+d+e)	**8.55**
a. One year card deposit rate	6.50
b. CASA adjustment	1.31
c. Negative carry on CRR and SLR	0.96
d. Unallocatable Overheads Cost adjustment	0.99
e. **Average Return on Net Worth**	1.41

3.30 In order to make the lending rates responsive to the Reserve Bank's policy rates, the Group recommends that banks may review and announce their Base Rate at least once in a calendar quarter with the approval of their Boards. The Base Rate alongside actual minimum and maximum lending rates may be placed in the public domain.

Base Rate and sub-Base Rate Lending

3.31 A major concern with the present BPLR system has been the large volume of sub-BPLR lending which made the whole system opaque. With the proposed system of Base Rate, there will not be a need for banks to lend below the Base Rate as the Base Rate represents the bare minimum rate below which it will not be viable for the banks to lend. The Group, however recognises certain situations when lending below the Base Rate may be necessitated by market conditions. This may occur when there is a large surplus liquidity in the system and banks instead of deploying funds in the liquidity adjustment facility (LAF) window of the Reserve Bank may prefer to lend at rates lower than their respective Base Rates. The Group is of the view that the need for such lending may arise as an exception only for very short-term periods and not as a rule on a regular and long-term basis. Accordingly, the Base Rate system recommended by the Group will be applicable for loans with maturity of one year and above (including all working capital loans). Banks may give loans below one year at fixed or floating rates without reference to the Base Rate. That is, short-term loans with less than one year could technically be priced below the Base Rate. However, in order to ensure that sub-Base Rate lending does not proliferate, the Group recommends that such sub-Base Rate lending in both the priority and non-priority sectors in any financial year should not exceed 15 per cent of the incremental lending during the financial year. Of this, non-priority sector sub-Base Rate lending should not exceed 5 per cent. That is, the overall sub-Base Rate lending during a financial year should not exceed 15 per cent of their incremental lending, and banks will be free to extend entire sub-Base Rate lending of up to 15 per cent to the priority sector.

3.32 The Group recommends that the Base Rate could also serve as the reference rate for floating rate loan products, in which case actual lending rate charged to the borrower will vary in line with the changes in the Base Rate. The Base Rate can also be used for pricing fixed rate loan products, in which case the lending interest rate (Base Rate plus variable operating expenses plus credit risk premium plus tenor premium) will not change over the tenure of the loan contract. That is, banks would not have the option to re-price these loans during the term of the loan agreed to in the original loan contracts. The borrower, however, could have the option to refinance the loan at a penalty rate mutually agreed between the bank and the borrower.

3.33 The recommendation of Base Rate will necessitate amendments in the extant provisions contained in the Master Circular on 'Interest Rate on Advances' (Section 2.4 of the Master Circular on Interest Rate on Advances). As per the extant regulations in the Master Circular certain categories of loans/advances are exempted from the purview of pricing based on BPLR. At present, the following categories are without reference to PLR and regardless of the size: (i) loan for purchase of consumer durables (including credit card dues); (ii) non-priority sector personal loans; (iii) finance granted to intermediary agencies for on-lending to ultimate beneficiaries and agencies providing input support; and (iv) finance granted to housing finance intermediary agencies for on-lending to ultimate beneficiaries; (v) advances / overdrafts against domestic / NRE / FCNR (B) deposits with the bank, provided that the deposit/s stands / stand either in the name(s) of the borrower himself / borrowers themselves, or in the names of the borrower jointly with another person; (vi) discounting of bills; (vii) loans / advances / cash credit / overdrafts against commodities subject to selective credit control; (viii) loans to a cooperative bank or to any other banking institution; (ix) loans to its own employees' and (x) loans covered by participation in refinancing schemes of term lending institutions. Under the proposed system, all the above categories of loans referred to in the Master Circular be linked to the Base Rate, except interest rates on (a) loans relating to selective credit control; (b) credit card receivables; and (c) loans to banks' own employees. Credit card loans are not in the nature of regular lines of credit and interest rates charged on credit card dues must reckon the risk inherent in unsecured nature of such advances.

3.34 The Group recommends that DRI scheme, which constitutes a very small part of banks' lending, should continue in its existing form for the benefit of the deprived sections of the society.

3.35 Furthermore, the Group recommends that the proposed system would be applicable for all new loans and for those old loans that come up for renewal. However, if the existing borrowers want to switch to the new system before the expiry of the existing contracts, in such cases the new/revised rate structure should be mutually agreed upon by the bank and the borrower.

Dissemination of Information

3.36 It is possible that some banks charge unduly high product specific operating expenses, credit risk and term premia from some borrowers. In order to avoid such unhealthy practices, the banks should continue to provide the information on lending rate to the Reserve Bank and disseminate information on the Base Rate In addition, banks should also provide information on the actual minimum and maximum interest rates charged to borrowers. This would give both existing and prospective borrowers a broad idea of variable operating cost, credit risk and term premia charged by different banks. The Group is of the view that greater dissemination of information on lending rates would enhance the transparency of the loan pricing system.

Transparency in Lending Rates

3.37 On this issue of reference rates and transparency in lending rates, it may be noted that the Banking Codes and Standards Board of India (BCSBI) has evolved two Codes *viz.*, the Code of Bank's Commitment to Customers (Code) and the Code of Bank's Commitment to Micro and Small Enterprises (MSE Code). These Codes are voluntary and aim at achieving increased transparency in the operations of banks and set minimum standards of banking practices which member banks of BCSBI are committed to follow in their dealings with their customers. The Code for Customers addresses individual customers and excludes corporate and firms, while the Code for MSEs is exclusive to Micro and Small Enterprises.

Code of Bank's Commitment to Customer (Code)

3.38 The Code contains a number of provisions having a direct bearing on transparency in banks' dealing with retail depositors and borrowers. At the time of sourcing the loan, the Code provides for the following information to be made available to facilitate customers to take informed decisions –

- information about the interest rate applicable – whether floating rate or fixed rate;
- the reference rate to which the floating rate of interest is linked; the reference rate will remain uniform for customers contracting the loan at different points of time;
- the premium / discount applied to the reference rate for determining the rate of interest on the loan;
- fees/charges payable for processing, the amount of such fees refundable if loan amount is not sanctioned / disbursed;
- pre-payment options and charges, if any;
- penal rate of interest for delayed repayments, if any;
- conversion charges for switching a loan from fixed to floating rates or vice-versa;
- existence of any reset clause;
- existence of minimum rate of interest clause, if any;
- method of calculation of interest and the date and mode of its application; and
- any other matter which affects the interest of the borrower.

3.39 On sanction of a credit facility

- a sanction letter in writing detailing particulars of amount sanctioned, terms and conditions attached to the loan, etc. would be issued to the borrower.
- an amortization schedule in respect of the loan would be provided to the borrower.
- the Most Important Terms and Conditions (MITC) governing the credit facilities availed would also be conveyed to the borrower.
- authenticated copies of all the loan documents executed by the borrower along with a copy each of all enclosures (quoted in the loan document) would be provided to the borrower free of cost.
- the borrower will be advised whether he has an option to let equated monthly instalments stay constant and increase tenure or vice-versa when the interest rate changes.

3.40 If a loan application is rejected, the reasons for such rejection would be conveyed in writing to the applicant irrespective of the amount of loan applied for. Even guarantors are treated as customers under the Code. Banks are committed to inform a person to be considered as a guarantor to a loan (i) of his financial liability under the proposed guarantee; (ii) circumstances under which he may be called upon to discharge the same; and (iii) the recourse which the bank may have if he fails to honour the guarantee. Banks will also inform the guarantor of any material adverse change/s in the financial position of the borrower whose loan has been guaranteed by him.

Code of Bank's Commitment to Micro and Small Enterprises (MSE Code)

3.41 A simple, standardized and easy to understand application form for loans has been devised by IBA in consultation with BCSBI and circulated among banks for adoption. This form, which will be provided free of cost to MSEs, will be used across member banks for sanction of loans to MSEs irrespective of the amount of loan applied for.

3.42 A checklist of requirements will be provided along with the application form at the time of making available the application form banks will provide information about

- the interest rates applicable;
- fees/charges, if any, payable for processing the application;
- pre-payment options, if any, etc.
- checklist of documents / information to be submitted along with the application form.

3.43 Loan applications will be acknowledged and all particulars required in connection with the processing of the loan application would be received at the time of application. If any additional information is needed, banks would contact the applicant MSE within 7 days. When a credit limit is sanctioned, terms and conditions governing the credit facilities agreed to would be put down in writing and a copy of the same given to the borrower; authenticated copies of all loan documents executed, along with copies of the enclosures referred to therein will be provided to the borrower.

3.44 The Group recommends that all the banks should follow both the commitment codes scrupulously. The Group also recommends that the Reserve Bank may require banks to publish summary information relating to the number of complaints and compliance with the codes in their annual reports.

4. Benchmarks for Floating Rate Loans

4.1 In the annual policy statement for 2000-01, banks were allowed to charge fixed/floating rate on their lending for credit limit of over Rs. 2 lakh. In terms of the extant guidelines on "Interest Rates on Advances", banks should use only external or market-based rupee benchmark interest rates for pricing of their floating rate loan products, in order to ensure transparency. The guidelines further state that the methodology of computing the floating rates should be objective, transparent and mutually acceptable to counterparties. Banks should not offer floating rate loans linked to their own internal benchmarks or any other derived rate based on the underlying. The major advantage of external market benchmark rate is that the customer has the access to information of these rates, as it is available publicly. Further, this will also help the customer in evaluating the benefits of fixed and floating interest rates, while choosing to apply for loans.

4.2 Banks are finding it difficult to use external benchmarks for pricing their loan products, as the available external market benchmarks (MIBOR, G-Sec) are mainly driven by liquidity conditions in the market, and do not reflect the cost of funds of the banks. Various representations from the banks and IBA have been received in this regard to allow them to continue to use their respective bank's BPLR as the reference rate for pricing the floating rate loan. Banks have also pointed out that BPLR is not changed frequently as the external rupee market benchmarks, viz. MIBOR, G-Sec, Repo Rate, CP and CD rates which are volatile given that many of these products can be traded in the secondary market. Besides, the yields on some of the instruments may not suggest any representative pricing yardsticks given that they have limited volumes compared to the overall size of the financial market. The linkage of interest rates with external market benchmarks may create operational difficulties for banks keeping in view the large geographical spread of branches, particularly in to rural regions that having poor connectivity and awareness amongst people.

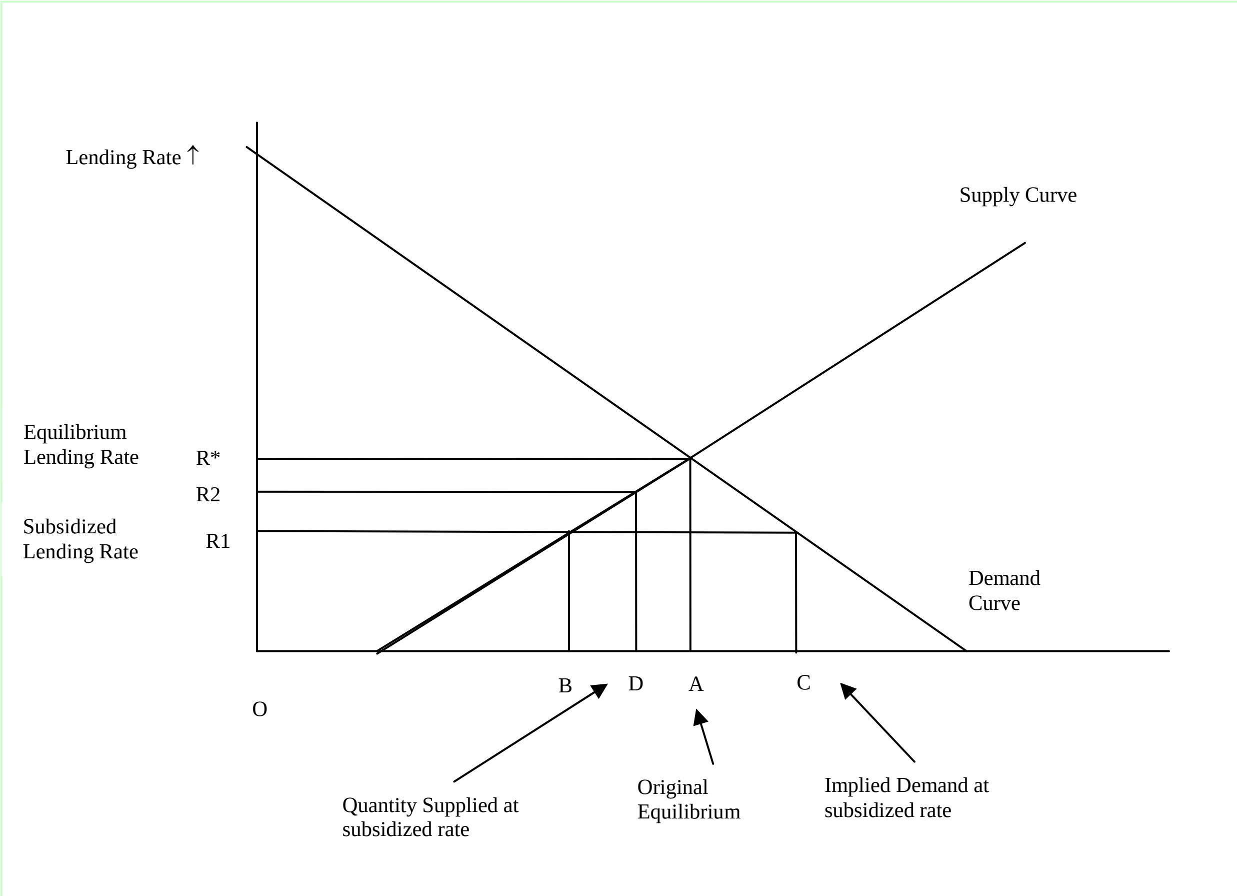
4.3 The IBA was earlier of the view that interest rate on advances may be linked to BPLR as it may be considered a floating rate in view of its re-fixation on periodic basis. The flexibility to price a floating product using market benchmarks is an option given to banks in addition to pricing with reference to BPLR. With the new Base Rate system proposed by the Group, the determination of the Base Rate would be much more transparent and flexible which can serve as a credible reference rate for floating rate loan products. In addition, banks may choose other market benchmarks to price floating rate loans, although the Group expects that Base Rate would be much more flexible akin to a floating benchmark. The Group, therefore, recommends that banks can offer floating rate loans by using external market-based benchmarks, apart from the Base Rate. However, while the floating interest rate based on external benchmarks (other than the Base Rate) can be set below the Base Rate for advances of tenure up to or lower than one year, all other floating rate advances (more than one year) would be charged lending rates equal to or above the Base Rate at the time of sanction.

5. Review of Administered Lending Rates

5.1 Removal of interest rate distortions is an important objective of financial sector reform programmes in several countries. Since it is in the interest of economies to improve efficiency of resource allocation, it is important that interest rate distortions such as in the form of large interest rate subsidies, pervasive interest rate controls, or policies that cause extremely high interest rates, are minimized, if not regulated altogether.

5.2 Analytically, subsidies are inefficient to both the provider and receiver of subsidies. For example, if banks are forced to provide a subsidy to a particular segment in an environment of less than competitive or supply constrained credit market, they will reduce the supply of loans to the subsidised segment to reduce their losses. The subsidised segment is also not benefitted, since it is not getting adequate funds demanded at the subsidized rate. Thus, because of the introduction of subsidy, the allocative efficiency is distorted. The effect of subsidy on supply is illustrated in Chart 8. The equilibrium lending rate is determined at the intersection of demand and supply curve. At the equilibrium lending rate, the loan supplied is OA. Now suppose banks are required to subsidise the lending rates. At this subsidised rate, the borrowers will demand OC amount of loans from the banks. But the banks will reduce their supply of loans at the subsidised rate, in order to reduce their losses. They will be providing only OB amount of loans, which is less than the amount supplied under the equilibrium rate of interest. Thus, under the subsidised interest rate, the level of supply will be reduced. Even when the banks are compensated by interest subvention, the loan supply OD would still remain below the loan demand at OC. Hence availability of credit will be constrained by prescription of low interest rate unrelated to the cost of funds.

Chart 8: Lending Rates and Subsidy



5.3 Provision of this extra credit requires resources that have higher opportunity costs than that of the extra credit. Economic opportunity cost is the value that must be forgone in order to provide one more unit of subsidised credit, and this cost exceeds the cost of the credit with the subsidy. The subsidy causes banks to divert more economically valuable resources and to transform them into less valuable resources. Since there is a waste in this process, it is reckoned in the form of "welfare loss".

Review of Administered Lending Rates for Small Loans up to Rs. 2 lakh

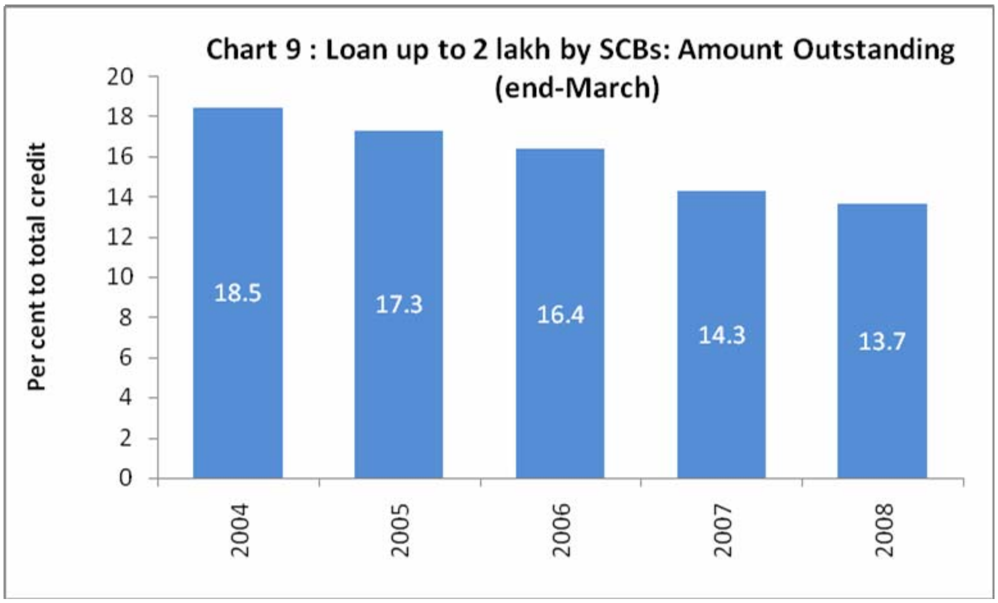
5.4 In a major step towards deregulation of lending rates, it was decided in October 1994 that banks would determine their own lending rates for credit limits over Rs.2 lakh. Interest rates on small loans upto Rs. 2 lakh continued to be administered. Initially, PLR acted as a floor rate for credit above Rs. 2 lakh. In order to remove the disincentive to the flow of credit to small borrowers below Rs.2 lakh, instead of prescribing a specific rate uniformly for all banks, PLR was converted as a ceiling rate on loans up to Rs.2 lakh in April 1998. Keeping in view the international practice and to provide further operational flexibility to commercial banks in deciding their lending rates, it was decided to make PLR a benchmark rate. Accordingly, commercial banks were allowed to lend at sub-PLR rate for loans above Rs.2 lakh effective April 19, 2001. Nevertheless, PLR remained the ceiling rate for loans up to Rs.2 lakhs.

5.5 In April 2006, the Reserve Bank requested the Indian Banks' Association (IBA) to undertake a comprehensive review of the interest rate on savings bank deposits and lending rates on small loans up to Rs.2 lakh. In January 2006, Indian Banks' Association submitted a technical paper on deregulation of interest rates on small loans upto Rs. 2 lakhs. The IBA in its technical paper opined that "by deregulating the interest rates for advances upto Rs. 2 lakhs, there may not be any major change as these interest rates have stabilised. On the contrary, it may help in creating more competitive market for such advances and would increase the reach of the banks".

5.6 The various committees such as the High Level Committee on Flow of Credit (Chairman: Shri R.V. Gupta), the Expert Committee on Rural Credit (Chairman: Shri V.S. Vyas) and the Committee on Issues Pertaining to Rural Credit (Chairman: Shri Anant Geete), which had gone into the issues of rural credit, were all in favour of removing the stipulation on interest rate on small loans.

5.7 The Report of the Committee on Financial Sector Reforms (Chairman: Shri Raghuram G. Rajan) had also deliberated on issue of interest rate ceilings for small loans. The Committee was of the opinion that low interest rate ceilings on small loans, in a scenario of substantial unfulfilled demand for credit, could only result only in corruption in loan disbursements and exclusion of the very high-credit risk poor. Furthermore the increased bureaucratic norms imposed to avoid the same results in making small loans less flexible and attractive.

5.8 The Group is of the view that regulation of interest rate on small borrowers has not served the desired purpose. If any, such regulation has reduced the flow of credit to small borrowers. The whole idea of administering interest rates on loans up to Rs. 2 lakh is that the small borrowers are not able to manage interest rate risk and that given the high transaction cost of small ticket loans, banks otherwise might be reluctant to extend loans to such borrowers. However, the actual experience reveals that lending rate regulation has dampened the flow of credit to small borrowers and has imparted downward inflexibility to the BPLRs. It may be mentioned that the share of small loans up to Rs. 2 lakh has declined steadily in the recent years (Chart 9).



5.9 Small borrowers have also not benefitted from the general reduction in interest rates as is reflected in the large share of sub-BPLR lending, while BPLRs have remained relatively sticky. The administered lending rate for small borrowers has also imparted downward rigidity to BPLR. One of major reasons for the high share of sub-BPLR lending is the reluctance on the part of banks to reduce interest rates on small borrowings and export credit. Banks, therefore, have preferred to reduce interest rates for other borrowers and extend such facilities on an increasingly large scale rather than bring down their BPLRs. The linkage of concessional administered lending rates for small borrowers and exports to banks' BPLRs makes overall lending rates less flexible, constrains credit flows and hinders monetary policy transmission to the credit market. That the banks are reluctant to lend to those sectors where credit pricing is fixed is also borne out by the empirical analysis, which postulates the link between small loans and BPLR. The analysis reveals that although the demand for credit for small loans is sensitive to changes in the ceiling rate, viz., BPLR, the supply of credit by banks to this sector remains insensitive to changes in the BPLR[4]. In other words, supply of credit of small loans does not increase/decrease on account of changes in BPLR. This suggests that banks may be reluctant to increase their exposure to small borrowers.

5.10 The credit market over the years has become competitive. It, therefore, should be possible for all categories of borrowers to obtain credit at a price consistent with their risk profiles. It may be noted that RRBs and co-operative banks, which cater to small borrowers are free to determine their lending rates and there are no restrictions on lending rates of micro-finance institutions (MFIs). The experiences of several successful self-help groups (SHGs) in India suggest that they charge relatively higher interest rates on loans to beneficiaries (Table 13). Despite charging higher interest rates, MFIs they are able to keep their delinquencies at low levels. Besides, successful cross-country experiences in micro and rural credit also underline that the timely availability to credit is more important then the cost of credit.

Table 13: Charges by Micro Finance Institutions (March 2006)

(per cent)

State	Range of cost to the borrower
Andhra Pradesh	17.0 to 32.5
Karnataka	12.0 to 40.0
Orissa	14.0 to 24.5
Rajasthan	16.0
Uttar Pradesh	13.0 to 26.0

Source: Report on Costs and Margins of Micro Finance Institutions, College of Agricultural Banking, Reserve Bank of India, Pune, January 2007.

5.11 Given that the existing system has not served the desired purpose and the large benefits that would accrue from a simple and flexible system as proposed, the Group recommends that the interest rate for loans up to Rs. 2 lakh may be deregulated. That is, banks should be

[4] A demand –supply for small loans (up to 2 lakh) estimated using the standard Two Stage Least Squares (TSLS) for the period March 1999 to March 2007 is given below: The variables considered for the analysis were annual Growth in Small Loans (GSL), the BPLR of SBI (SBI PLR), Growth of Non-Food Credit (NFCG) and Service sector output growth (SERV GROWTH)

GSL = 56.83 -4.93SBIPLR + 2.52 SERV GROWTH (-1)- 0.52GSL(-1) **Demand Equation**

(1.81) (-1.96**) (2.52*) (-1.71)

DW 2.91 SEE 4.86

SBIPLR = 12.98 - 0.04 GSL -0.05 NFCG **Supply Equation**

(13.20) (-0.50) (-0.90)

DW 1.17 SEE 5.03

Note : Figures in parentheses represent ‘t-statistics’

* and ** denote that the coefficient is significant at 5 and 10 per cent level, respectively.

free to lend to small borrowers at fixed or floating rates, which would include the Base Rate and sector-specific operating cost, credit risk premium and tenor premium as in the case of other borrowers. As the Group expects the Base Rate of the banks to be lower than their current BPLRs, the effective lending rate for low risk small borrowers could turn out to be lower. In addition, the flow of credit is also expected to improve. The availability of credit is important for small borrower as they lack access to alternative sources of funding. If the recommendation of the Group is implemented, it would lead to increased flow of credit to small borrowers at competitive rates.

Administered Lending Rates for Exporters

5.12 Prior to May 2001, export credit was provided at specific rates of interest in respect of pre-shipment credit and mostly as a ceiling in the case of post-shipment credit. Subsequently, the rupee export credit interest rate structure was rationalised by prescribing ceiling rates linked to the relevant prime lending rates (PLRs) of banks. Accordingly, the ceiling rates in respect of first slab of pre-shipment rupee export credit up to 180 days and post-shipment credit up to 90 days was fixed at PLR minus 1.5 percentage points beginning May 2001. Similarly, the ceiling in the interest rate on the second slab of pre-shipment rupee export credit beyond 180 days and up to 270 days and post- shipment credit for beyond 90 days and up to six months (from the date of shipment) was fixed at PLR plus 1.5 percentage points. Under the system, banks were permitted to charge interest rates up to or within the ceiling rate specified for the purpose. One advantage of a 'ceiling' rate instead of a fixed 'rate' was that it permitted banks to price credit below the ceiling rate in case their cost of fund permitted them to do so, thereby helping market based price discovery of interest rates. The deregulation of the interest rates on rupee export credit was expected to introduce healthy competition and provide exporters a greater choice to avail banking services in terms of interest rates, quality of services and transaction costs. The PLR linked interest rate ceiling on export credit was a part of the deregulation programme that was expected to provide flexibility to both bankers and exporters and respond to monetary policy stance and actions.

5.13 The ceiling interest rates have been altered according to evolving macroeconomic circumstances, global developments and movements in Indian trade. Accordingly with effect from September 26, 2001, the ceiling interest rates on pre-shipment and post-shipment rupee export credit were reduced across the board by 1 percentage point, *i.e.*, PLR minus 2.5 percentage points for the first slab of the pre and post shipment rupee export credit and PLR plus 0.5 percentage points second slab of rupee export credit.

5.14 Interest rate regulation on export credit has been favoured for making available credit to exporters at internationally competitive rates. In the monetary policy announcement made on April 29, 2002, the Reserve Bank had observed that linking of domestic interest rates on export credit to PLR did not serve much purpose in circumstances where effective rupee export credit interest rates were in any case substantially lower than the PLR related ceiling rate. In the Mid-term review announced on October 29, 2002, the Reserve Bank indicated that the PLR-linked ceiling rate lost its significance in view of the freedom given to banks for lending at sub-PLR rates to creditworthy borrowers. The Mid-term Review also mooted deregulation of interest rate on rupee export credit in phases to encourage greater competition in the interests of exports. Accordingly, the ceiling rates of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days was deregulated effective May 1, 2003. With the switchover of PLR to BPLR system by banks, the ceiling interest rate on rupee export credit was changed to BPLR minus 2.5 percentage points with effect from May 1, 2004.

5.15 The mid-term Review of October 2002 had mooted deregulation of interest rate on rupee export credit in phases to encourage greater competition in the interest of exports. A view was that in the light of competitive lending rates in the economy, it is important to ensure that regulated interest rates should not restrict credit flow to all segments of exporters with different risk profiles. However, the Annual Policy Statement for 2005-06 released in April 28, 2005 proposed to continue with *status quo* as various issues pertaining to above regulations on interest rates were being debated.

5.16 The Working Group to review export credit (Chairman: Shri Anand Sinha), which submitted its report in May 2005, had noted that under the deregulated interest rate regime, the small exporters have been at disadvantage, while large corporate exporters got the benefit. It was practically very difficult for exporters to shift from one bank to another bank, which charged lower rates of interest. As a result they were unable to take advantage of the competition among banks in lowering the interest rates. Therefore, the Working Group recommended that the present interest rate prescription by Reserve Bank for the first slabs of the rupee export credit (both pre and post shipment) may continue for the time being in the interest of the small and medium exporters.

5.17 In view of the difficulties being faced by exporters on account of the weakening of external demand, the Reserve Bank on November 15, 2008 extended the period of entitlement of the first slab of pre-shipment rupee export credit, which was available at a concessional interest rate ceiling of BPLR minus 2.5 percentage points, from 180 days to 270 days. Furthermore, on November 28, 2008 the period of entitlement of the first slab of post-shipment rupee export credit was extended from 90 days to 180 days for availing concessional interest rate ceiling of the BPLR minus 2.5 percentage points. Further, on December 8, 2008, the Reserve Bank extended the concessional interest rate ceiling of BPLR minus 2.5 percentage points to overdue bills up to 180 days from the date of advance. The validity of the reduction in the interest rate ceiling to 250 basis points below BPLR on pre-shipment rupee export credit up to 270 days and post-shipment rupee export credit up to 180 days is extended up to October 31, 2009.

5.18 The export sector is an important segment of the economy and it is important that the export sector also obtains adequate credit at competitive rates. As in the case of small borrowers, the Group feels that administered lending rates on export credit may also be deregulated. As the tenure of both pre and post shipment rupee export credit is less than one year, interest rates charged to exporters can now be without reference to the Base Rate. In fact, under the Base Rate system proposed by the Group, it should be possible for exporters to obtain credit at rates lower than Base Rate when there is a surplus liquidity in the system. However, recognising that not all exporters may be able to obtain lower and competitive rates on export credit, the Group recommends that the interest rates charged to exporters should not exceed the Base Rate of individual banks. This is based on the logic that export credit is of short-term in nature, exporters are generally wholesale borrowers and would need incentive to be globally competitive. Under the proposed system, the Base Rate is envisaged to be significantly lower than the existing BPLR. An illustrative estimate of the Base Rate based on the methodology suggested in Section 3 works out to 8.55 per cent (refer Table 12 in Chapter 3). The Base Rate based on the methodology suggested by the Group is thus comparable with the present lending rate of 9.5 per cent (PSBs modal BPLR of 12 per cent as on June 2009 minus 2.5 per cent) charged by the banks to most exporters. Going by the actual lending rates charged to exporters, the export credit provided under the proposed Base Rate system would continue to remain more competitive (Table 14). The Group is of the view that the proposed system of providing export credit under the proposed system will be more flexible and competitive. If any special dispensation is considered necessary it should come explicitly from the Government in the form of interest rate subvention.

Table 14: Interest Rate on Pre-Shipment Rupee Export Credit up to 180 days June 2009

(per cent)

Bank Categories	Advances at which at least 60 per cent of the business has been contracted	
	Actual Rate	Median Rate
1	2	3
Public Sector Banks	7.00-10.50	9.25-9.50
Private Sector Banks	7.50-14.00	10.38-10.50
Foreign Banks	6.00-13.50	8.75-9.88

Education Loans

5.19 At present, BPLR serves as the ceiling rate for interest rate on education loans up to Rs. 4 lakh. Interest rates on educational loans in excess of Rs. 4 lakh are prescribed as BPLR+1 per cent. Education loans are intended to enable the borrowers, *i.e.*, students to develop their skills so that they are employed gainfully and able to service the loans easily. In view of the critical role played by education loans in developing human resource skills, the Group felt that interest rates on education loans may continue to be administered. However, in view of the fact that the Base Rate is expected to be significantly lower than BPLR, the Group recommends that there is a need to change the mark-up. Accordingly, the Group recommends that interest rate on all education loans may not exceed the Base Rate plus 200 basis points. Illustratively, based on the proposed methodology, loans above Rs. 4 lakh will be available at 8.55 per cent plus a maximum of 200 basis points as against the existing rate of 13 per cent (Modal BPLR of PSBs plus 1 per cent). In order to provide greater uniformity in the lending rates across banks, the Base Rate for pricing educational loans by all banks may be set as the average Base Rate of the five largest banks. Even with this stipulation, the actual lending rates for education loans would be lower than the current rates prevailing. In this regard, the Reserve Bank may require IBA to (i) collect the information on the base rates of five largest banks based on the size of deposits; and (ii) disseminate the information on the average base rate of these five banks on a quarterly basis for ensuring uniformity in base rates charged by all banks.

6. Recommendations of the Working Group

6.1 The findings, views and major observations/recommendations of the Working Group are summed up below:

Findings of the Working Group

6.2 The bank group-wise trends in the modal BPLR since March 2004 show three distinct phases. In the first phase between March 2004 and March 2006, the modal BPLRs of public sector banks and private sector banks remained almost steady and range bound, though the modal BPLRs of private sector banks were about 100 bps higher than those of public sector banks. Modal BPLRs of foreign banks showed some variations, but converged to modal BPLR of public sector banks by March 2006. During March 2006 to June 2007, modal BPLRs of all three bank groups showed sharp upward movement in line with the general tightening of monetary conditions. Even in this phase, modal BPLRs of private sector banks remained at around 100 bps higher than those of public sector bank. Modal BPLRs of foreign banks remained close to those of public sector banks. In the next phase from June 2007 to September 2008, the divergence in the modal BPLRs of public sector banks and private sector banks widened somewhat; modal BPLRs of foreign banks converged to the modal BPLR of private sector banks. However, since September 2008, modal BPLRs of private and public sector banks have diverged significantly. The modal BPLRs of public sector banks have shown a significant decline since September 2008, while those of private banks' after showing an upward movement till March 2009, have exhibited a downward movement (Para 2.16).

6.3 An empirical exercise carried out to ascertain the responsiveness of modal BPLR to the changes in the Reserve Bank's policy rates (repo rate) for the period from Q1:2004 to Q1:2009 suggests a mixed picture across the bank groups and interest rate cycles. An increase in the repo rate was observed to bring about a contemporaneous change in modal BPRLs of private sector banks and major foreign banks and a lagged response in the case of public sector banks. A decrease in the repo rate had a significant contemporaneous impact only in the case of public sector banks. This asymmetric response shows that while public sector banks were slow to respond to an increase in policy rate, they were quick on the reverse. This could be attributed to the ownership structure of public sector banks which makes them more amenable to moral suasion by the authorities. Apart from the policy rate, the weighted average call money rate was also used to assess the impact on modal BPLRs. An increase in the weighted average call money rate, an indication of tightness of liquidity, was observed to have a significant contemporaneous effect across all bank groups. A decline was seen to have a significant impact, albeit with a lag in the case of public sector banks and contemporaneous as well as lagged impact in the case of private banks while in the case of five major foreign banks, no significant impact was seen (Para 2.17).

6.4 An analysis of the interest rate spreads around modal BPLR for the period March 2004 to 2009 revealed considerable variations among different bank groups. Minimum interest rates, in particular, showed relatively subdued movements suggesting that they were rather insensitive to the overall movements in BPLRs (Para 2.18).

6.5 The movements in BPLR, however, do not capture a true picture of lending interest rates in the country as banks resort to sub-BPLR lending to a varying degree. It is observed that in the case of all scheduled commercial banks, except foreign banks, periods of increase in share of sub-BPLR lending were also associated with high BPLR rates (Para 2.22).

6.6 An empirical analysis of the relationship between changes in BPLRs and sub-BPLR lending rates for select major banks showed that they were positively related. As established by the empirical results above, the co-movements in BPLR and sub-BPLR lending could be for the reason that banks are unable to reduce their BPLRs, which are worked out based on the average cost of funds, when the marginal costs declines. This resulted in incremental lending at sub-BPLR. True movements in lending interest rate of banks, therefore, are better captured in the weighted average lending rate of banks. Though there was considerable divergence in weighted average lending rates in 2004 among the various bank groups, the weighted average lending rates have tended to converge in the recent period. Furthermore, the weighted average lending rate kept coming down beginning 2002 before rising in 2008. However, the weighted average lending rate was lower in 2008 than in 2005. In 2009, the weighted average lending rates have registered a significant decline, expect in the case of private banks (Para 2.23).

Major Observations/Recommendations of the Working Group

6.7 The BPLR system was expected to be a step forward from the PLR system, which more or less represented the minimum lending rates, to that of one which stood as a benchmark or a reference rate around which most of the banks' lending was expected to take place. However, over a period of time, several concerns have been raised about the way the BPLR system has evolved. These relate to large quantum of sub-BPLR lending, lack of transparency, downward stickiness of BPLRs and perception of cross-subsidisation in lending (Paras 2.24 to 2.34).

6.8 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. More importantly, perhaps, in the present system, the BPLR has tended to be out of sync with market conditions and does not adequately respond to changes in monetary policy. The Working Group was of the opinion that until the system was modified and/or replaced with some other system, the tendency to extend loans at sub-BPLR rates on a large scale in the market would continue raising concerns on transparency. The Working Group also noted that on account of competitive pressures, banks were lending a part of their portfolio at rates which did not make much commercial sense (Para 3.15).

Need to Replace the Present BPLR System with the Base Rate System

6.9 After carefully examining the views expressed by trade and industry associations and others and international best practices, the Group is of the view that there is merit in introducing a system of Base Rate. The proposed Base Rate will include all those cost elements which could clearly be identified and are common across borrowers (Para 3.22).

6.10 The constituents of the Base Rate would include (a) the card interest rate on retail deposit (deposits below Rs.15 lakh) with 1-year maturity adjusted for current account and savings account (CASA) deposits; (b) adjustment on account of negative carry in respect of CRR and SLR; (c) unallocatable overhead cost for banks; and (d) average return on net worth. The final lending rates would include the Base Rate plus variable or product specific operating expenses, credit risk premium and tenor premium (Paras 3.23 to 3.27).

6.11 In order to make the lending rates responsive to the Reserve Bank's policy rates, the Group recommends that banks may review and announce their Base Rate at least once in a calendar quarter with the approval of their Boards. The Base Rate alongside actual minimum and maximum lending rates may be placed in public domain (Para 3.30).

Sub-Base Rate Lending to be Allowed within Limits

6.12 With the proposed system of Base Rate, there will not be a need for banks to lend below the Base Rate as the Base Rate represents the bare minimum rate below which it will not be viable for the banks to lend. The Group, however recognises certain situations when lending below the Base Rate may be necessitated by market conditions. This may occur when there is a large surplus liquidity in the system and banks instead of deploying funds in the liquidity adjustment facility (LAF) window of the Reserve Bank may prefer to lend at rates lower than their respective Base Rates. The Group is of the view that the need for such lending may arise as an exception only for very short-term periods and not as a rule on a regular and long-term basis. Accordingly, the Base Rate system recommended by the Group will be applicable for loans with maturity of one year and above (including all working capital loans). Banks may give loans below one year at fixed or floating rates without reference to the Base Rate. That is, short-term loans with less than one year could technically be priced below the Base Rate. However, in order to ensure that sub-Base Rate lending does not proliferate, the Group recommends that such sub-Base Rate lending in both the priority and non-priority sectors in any financial year should not exceed 15 per cent of incremental lending during the financial year. Of this, non-priority sector sub-Base Rate lending should not exceed 5 per cent. That is, the overall sub-Base Rate lending during a financial year should not exceed 15 per cent of their incremental lending, and banks will be free to extend entire sub-Base Rate lending of up to 15 per cent to the priority sector (Para 3.31).

6.13 The Group recommends that the Base Rate could also serve as the reference rate for floating rate loan products (Para 3.32).

Categories to be Excluded from the Base Rate

6.14 The recommendation of Base Rate will necessitate amendments in the extant provisions contained in the Master Circular on 'Interest Rate on Advances' (Section 2.4 of the Master Circular on Interest Rate on Advances). Under the proposed system, all the above categories of loans referred to in the Master Circular be linked to the Base Rate, except interest rates on (a) loans relating to selective credit control; (b) credit card receivables; and (c) loans to banks' own employees. The Group recommends that DRI scheme, which constitutes a very small part of banks' lending, should continue in its existing form for the benefit of the deprived sections of the society. Furthermore, the Working Group also suggests that the proposed system would be applicable for all new loans and for those old loans that come up for renewal. However, if the existing borrowers want to switch to the new system before the expiry of the existing contracts, in such cases the new/revised rate structure should be mutually agreed upon by the bank and the borrower (Paras 3.33-3.35).

Dissemination of the Base Rate and Range of Actual Lending Rates

6.15 It is possible that some banks charge unduly high product specific operating expenditure, credit risk and term premia from some borrowers. In order to avoid such unhealthy practices, the banks should continue to provide the information on lending rates to the Reserve Bank and disseminate information on the Base Rate. In addition, banks should also provide information on the actual minimum and maximum interest rates charged to borrowers. This would give both existing and prospective borrowers an idea of variable operating cost, credit risk and term premia charged by different banks. The Group is of the view that greater dissemination of information on lending rates would enhance the transparency of the loan pricing system (Para 3.36).

Scrupulous Adhering to the Two Codes Prescribed by BCSBI

6.16 On this issue of reference rates and transparency in lending rates, it may be noted that the Banking Codes and Standards Board of India (BCSBI) has evolved two Codes, *viz.,* the Code of Bank's Commitment to Customers (Code) and the Code of Bank's Commitment to Micro and Small Enterprises (MSE Code). The Group recommends that all the banks should follow both the commitment codes scrupulously. The Group also recommends that the Reserve Bank may require banks to publish summary information relating to the number of complaints and compliance with the codes in their annual reports (Paras 3.37 and 3.44).

Benchmarks for Floating Rate Loans in the Retail Segment

6.17 With the new Base Rate system proposed by the Group, the determination of the Base Rate would be much more transparent and flexible which can serve as a credible reference rate for floating rate loan products. In addition, banks may choose other market benchmarks to price floating rate loans, although the Group expects that Base Rate would be much more flexible akin to a floating benchmark. The Group, therefore, recommends that banks can offer floating rate loans by using external market-based benchmarks, apart from the Base Rate. However, while the floating interest rate based on external benchmarks (other than the Base Rate) can be set below the Base Rate for advances of tenure up to or lower than one year, all other floating rate advances (more than one year) would be charged lending rates equal to or above the Base Rate at the time of sanction (Para 4.3).

Administered Lending Rates for Small Loans up to Rs. 2 lakh to be Deregulated

6.18 Given that the existing system has not served the desired purpose and the large benefits that would accrue from a simple and flexible system as proposed, the Group recommends that the interest rate for loans up to Rs. 2 lakh may be deregulated. That is, banks should be free to lend to small borrowers at fixed or floating rates, which would include the Base Rate and sector-specific operating cost, credit risk premium and tenor premium as in the case of other borrowers. As the Group expects the Base Rate of the banks to be lower than their current BPLRs, the effective lending rate for low risk small borrowers could turn out to be lower. In addition, the flow of credit is also expected to improve. The availability of credit is important for small borrower as they lack access to alternative sources of funding. If the recommendation of the Group is implemented, it would lead to increased flow of credit to small borrowers at competitive rates (Para 5.11).

Credit to Exporters to be Extended at the Base Rate

6.19 The export sector is an important segment of the economy and it is important that the export sector also obtains adequate credit at competitive rates. As in the case of small borrowers, the Group feels that administered lending rates on export credit may also be deregulated. As the tenure of both pre and post shipment rupee export credit is less than one year, interest rates charged to exporters can now be without reference to the Base Rate. In fact, under the Base Rate system proposed by the Group, it should be possible for exporters to obtain credit at rates lower than Base Rate when there is a surplus liquidity in the system. However, recognising that not all exporters may be able to obtain lower and competitive rates on export credit, the Group recommends that the interest rates charged to exporters should not exceed the Base Rate of individual banks. This is based on the logic that export credit is of short-term in nature, exporters are generally wholesale borrowers and would need incentive to be globally competitive. Under the proposed system, the Base Rate is envisaged to be significantly lower than the existing BPLR. The Group feels that under the proposed system, there will not be any need to extend any concessional export credit. If any special dispensation is considered necessary it should come explicitly from the Government in the form of interest rate subvention (Para 5.18).

Education Loans to be Provided at Rates not Exceeding Base Rate Plus 200 Basis Points

6.20 At present, BPLR serves as the ceiling rate for interest rate on education loans up to Rs. 4 lakh. Interest rates on educational loans in excess of Rs. 4 lakh are prescribed as BPLR+1 per cent. Education loans are intended to enable the borrowers, *i.e.,* students to develop their skills so that they are employed gainfully and able to service the loans easily. In view of the critical role played by education loans in developing human resource skills, the Group felt that interest rates on education loans may continue to be administered. However, in view of the fact that the Base Rate is expected to be significantly lower than BPLR, the Group recommends that there is a need to change the mark-up. Accordingly, the Group recommends that interest rate on all education loans may not exceed the Base Rate plus 200 basis points. In order to provide greater uniformity in the lending rates across banks, the Base Rate for pricing educational loans by all banks may be set as the average Base Rate of the five largest banks. Even with this information, the actual lending rates for education loans would be lower than the current rates prevailing. In this regard, the Reserve Bank may require IBA to (i) collect the information on the base rates of five largest banks based on the size of deposits; and (ii) disseminate the information on the average base rate of these five banks on a quarterly basis for ensuring uniformity in base rates charged by all banks (Para 5.19).

Annex - 1

Chronology of Policy Changes with Regard to PLR

October 1994	Banks would determine their own lending rates for credit limits over Rs. 2 lakh. However, banks were required to declare their Prime lending rate (PLR) with the approval of their Boards taking into account their cost of funds, transaction cost, etc.
February 1997	To enable a smooth transition to the loan system as opposed to cash credit system of credit delivery. PLRs for the cash credit and demand loan component might be declared separately.
October 1997	Banks allowed to announce, with the approval of the their Boards separate Prime Term Lending Rates (PTLR for term loans of 3 years and above.
April 1998	In order to remove the disincentive to the flow of credit to small borrowers below Rs.2 lakh, instead of prescribing a specific rate uniformily for all banks, PLR was converted a ceiling rate on loans up to Rs.2 lakh. Banks were allowed to charge fixed/floating rate loan at or above PLR for credit limit of over Rs.2 lakh.
April 1999	The concept of Tenor linked Prime Lending Rates (TPLRs) was introduced to give the Scheduled Commercial Banks more operational flexibility.
October 1999	Banks were given the flexibility to charge interest rates without reference to the PLR in respect of certain categories of loans/credit like discounting of bills, lending to intermediary agencies, etc.
April 2000	Banks were given the freedom to offer loans on fixed or floating basis. However, for small loans up to Rs. 2 lakh, the stipulation of not exceeding PLR (of relevant maturity) continued.
April 2001	Keeping in view the international practice and to provide further operational flexibility to commercial banks in deciding their lending rates, it was decided to make PLR a benchmark rate. Accordingly, commercial banks were allowed to lend at sub-PLR rate for loans above Rs.2 lakh.
April 2002	The Reserve Bank had indicated the intention of collecting PLR as well as the maximum and minimum interest rates on advances charged by the banks and place the same in public domain for customers' protection and meaningful competition. Accordingly, the bank-wise information on the same is disseminated in the RBI web site for each quarter starting from the quarter ended June 2002.
April 2003	In order to enhance transparency in banks' pricing of their loan products, the Reserve Bank advised banks to announce a benchmark PLR with the approval of their Boards. Banks were advised to consider their (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, while arriving at the benchmark PLR to ensure that the PLR truly reflects the actual cost. Since all other lending rates can be determined with reference to the benchmark PLR arrived at, as above, by taking into account term premia and/or risk premia, the system of tenor-linked PLR was proposed to be discontinued.
November 2003	IBA Advisory on adoption of BPLR

Annex – 2

An Analysis of the Responsiveness of BPLRs to the Policy Rates and Liquidity Conditions

An AR(1) estimation of the changes in modal BPLR to changes in policy rates and weighted average call money rate was attempted for the period 2004 Q1 to 2009 Q1. For the purpose of analysis the policy rates changes and weighted average call money rates were bifurcated into episodes of tightening and easing of policy rates. The contemporaneous and lagged impacts of an increase and a decrease in policy rates and weighted call money rates on BPLRs were estimated to analyse the responsiveness of BPLR of various bank groups to movements in policy rates.

The results of an AR(1) estimation on changes in modal BPLR with respect to changes in repo rate for the period 2004 Q1 to 2009 Q1 is given below:

Public Sector Banks			**Sample 2004Q1 - 2009Q1**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Repo Rate Change	Repo Rate Change in Previous Quarter	Repo Rate Change in two Quarters before
Increase in Repo Rate	…	0.89 (2.06)*	…
Decrease in Repo Rate	0.66 (2.96)*	…	…
DW statistic : 2.02	R bar squared : 0.47		
Private Banks			**Sample 2004Q1 - 2009Q1**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Repo Rate Change	Repo Rate Change in Previous Quarter	Repo Rate Change in two Quarters before
Increase in Repo Rate	1.05 (2.05)*	…	1.94 (2.82)*
Decrease in Repo Rate	…	…	…
DW statistic : 2.36	R bar squared : 0.33		
5 Major Foreign Banks			**Sample 2004Q1 - 2009Q**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Repo Rate Change	Repo Rate Change in Previous Quarter	Repo Rate Change in two Quarters before
Increase in Repo Rate	0.77 (2.00)*	…	…
Decrease in Repo Rate	…	…	…
DW statistic : 1.69	R bar squared : 0.17		
Note: * denotes t value at 5 per cent level of significance ... : Not significant at 5 per cent level			

The results of an AR(1) estimation on changes in modal BPLR with respect to changes in reverse repo rate for the period 2004 Q1 to 2009 Q1 is given below:

Public Sector Banks			**Sample 2004Q1 - 2009Q**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Reverse Repo Rate Change	Reverse Repo Rate Change in Previous Quarter	Reverse Repo Rate Change in two Quarters before
Increase in Reverse Repo Rate	…	…	…
Decrease in Reverse Repo Rate	…	…	…
DW statistic : 2.07	R bar squared : 0.37		
Private Banks			**Sample 2004Q1 - 2009Q1**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Reverse Repo Rate Change	Reverse Repo Rate Change in Previous Quarter	Reverse Repo Rate Change in two Quarters before
Increase in Reverse Repo Rate	…	…	…
Decrease in Reverse Repo Rate	…	…	…
DW statistic : 2.43	R bar squared : 0.02		
5 Major Foreign Banks			**Sample 2004Q1 - 2009Q**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Reverse Repo Rate Change	Reverse Repo Rate Change in Previous Quarter	Reverse Repo Rate Change in two Quarters before
Increase in Reverse Repo Rate	…	…	…
Decrease in Reverse Repo Rate	…	…	…
DW statistic : 1.69	R bar squared : 0.17		
Note: * denotes t value at 5 per cent level of significance ... : Not significant at 5 per cent level			

The results of an AR(1) estimation on changes in modal BPLR with respect to changes in weighted average call money rate for the period 2004 Q1 to 2009 Q1 is given below:

Public Sector Banks			**Sample 2004Q1 - 2009Q1**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Weighted Average Call Money Change	Weighted Average Call Market Change in Previous Quarter	Weighted Average Call Market Change in two Quarters before
Increase in Weighted Average Call Money Rate	0.38 (2.92)*	…	…
Decrease in Weighted Average Call Money Rate	…	…	0.27 (2.10)*
DW statistic : 1.73	R bar squared : 0.37		
Private Banks			**Sample 2004Q1 - 2009Q1**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Weighted Average Call Money Change	Weighted Average Call Market Change in Previous Quarter	Weighted Average Call Market Change in two Quarters before
Increase in Weighted Average Call Money Rate	0.32 (2.74)	…	…
Decrease in Weighted Average Call Money Rate	-0.30 (-2.52)	0.40 (3.42)	…
DW statistic : 2.16	R bar squared : 0. 54		
5 Major Foreign Banks			**Sample 2004Q1 - 2009Q**
Dependant Variable : Change in Modal BPLR			
Explanatory Variables	Contemporaneous Weighted Average Call Money Change	Weighted Average Call Market Change in Previous Quarter	Weighted Average Call Market Change in two Quarters before
Increase in Weighted Average Call Money Rate	0.33 (3.52)	…	…
Decrease in Weighted Average Call Money Rate	…	…	…
DW statistic : 1.99	R bar squared : 0.37		
Note: * denotes t value at 5 per cent level of significance ... : Not significant at 5 per cent level			

Annex 3: Outstanding Sub-BPLR lending of SCBs

(Percentage of share in total loans excluding small loans and export credit)

Credit Type	Mar-02	Jun-02	Mar-03	Dec-03	Sep-04	Dec-04	Mar-05	Sep-05	Mar-06	Sep-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
i) Cash Credit	**5.4**	**5.3**	**6.5**	**6.6**	**9.5**	**6.2**	**7.7**	**10.3**	**11.7**	**12.6**	**13.2**	**14.0**	**12.5**	**13.3**	**14.0**	**13.9**	**12.9**	**12.4**	**12.4**
ii) Consumer Credit	**0.6**	**1.5**	**3.3**	**8.1**	**7.7**	**6.5**	**8.7**	**10.7**	**8.1**	**10.3**	**10.7**	**9.0**	**8.9**	**10.5**	**8.9**	**8.1**	**8.7**	**7.5**	**3.7**
iii) Demand Loan (including bill discounting)	**5.9**	**8.6**	**6.9**	**7.3**	**7.6**	**5.8**	**8.2**	**7.8**	**7.4**	**5.7**	**6.4**	**6.5**	**6.4**	**8.3**	**8.5**	**11.4**	**8.2**	**6.0**	**6.9**
iv) Term Loans	**16.5**	**22.7**	**21.0**	**26.7**	**31.3**	**46.5**	**34.4**	**38.0**	**41.9**	**46.7**	**46.6**	**46.3**	**50.1**	**44.2**	**44.3**	**44.2**	**46.9**	**46.1**	**43.9**
a) 1-180 days	2.8	7.3	3.0	2.3	1.7	2.0	2.6	2.3	3.4	2.8	2.9	3.3	3.1	4.6	5.7	4.2	3.6	3.0	3.1
b) 180 days-1 year	1.0	2.9	1.0	1.3	1.8	1.5	2.1	1.6	1.9	2.0	1.9	1.7	1.7	2.0	2.3	2.1	1.9	2.0	2.2
c)1-3 years	1.6	2.9	1.9	3.0	3.4	2.7	4.6	4.5	5.6	5.8	5.2	5.3	5.3	6.3	6.1	7.7	6.3	5.8	5.3
d) 3-5 years	1.4	2.4	4.8	10.4	10.9	10.1	11.2	14.5	14.0	18.2	17.7	17.2	20.1	9.8	11.7	10.0	17.9	15.7	15.7
e)above 5 years	6.4	3.4	6.6	5.3	8.9	27.1	10.2	11.2	12.6	13.6	14.7	14.9	12.7	17.1	13.7	15.4	13.3	13.3	13.7
f) Others	3.5	3.9	3.8	4.4	4.7	3.2	3.7	3.9	4.5	4.3	4.3	3.9	7.3	4.5	5.0	4.8	3.9	6.3	4.0
Total (i to iv) as percenatage of all loans	**28.4**	**38.0**	**37.7**	**48.7**	**56.1**	**65.1**	**58.9**	**66.8**	**69.2**	**75.3**	**76.9**	**75.8**	**77.9**	**76.3**	**75.8**	**77.6**	**76.7**	**72.0**	**66.9**

Annex 4: Outstanding Sub-BPLR lending of PSBs

(Percentage of share in total loans excluding small loans and export credit)

Credit Type	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
i) Cash Credit	**14.3**	**15.6**	**13.4**	**15.4**	**15.5**	**14.3**	**12.9**	**12.6**	**12.2**
ii) Consumer Credit	**1.3**	**1.1**	**1.0**	**1.7**	**1.0**	**2.7**	**2.5**	**2.2**	**2.2**
iii) Demand Loan (including bill discounting)	**5.9**	**6.3**	**5.9**	**8.0**	**8.0**	**12.6**	**7.7**	**5.2**	**6.3**
iv) Term Loans	**51.7**	**50.2**	**54.8**	**47.5**	**46.7**	**44.3**	**50.0**	**48.7**	**43.6**
a) 1-180 days	1.9	2.5	2.0	3.3	5.3	3.1	2.8	2.3	2.6
b) 180 days-1 year	1.4	1.4	1.3	1.8	1.7	1.9	1.4	1.6	1.9
c)1-3 years	5.0	4.8	4.8	6.5	5.7	7.8	5.8	5.1	4.8
d) 3-5 years	22.4	21.3	24.9	11.3	13.3	10.1	22.2	18.4	17.3
e)above 5 years	16.0	15.5	12.7	19.0	14.7	16.1	13.2	13.6	12.6
f) Others	5.0	4.7	9.0	5.5	6.0	5.3	4.6	7.7	4.4
Total (i to iv) as percenatage of all loans	**73.2**	**73.2**	**75.0**	**72.6**	**71.2**	**73.8**	**73.1**	**68.7**	**64.2**

Annex 5: Outstanding Sub-BPLR lending of Private Banks

(Percentage of share in total loans excluding small loans and export credit)

Credit Type	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
i) Cash Credit	**11.7**	**11.0**	**11.1**	**10.2**	**11.8**	**13.3**	**13.9**	**13.3**	**16.0**
ii) Consumer Credit	**38.3**	**32.3**	**33.5**	**32.3**	**28.1**	**25.3**	**23.3**	**23.3**	**5.1**
iii) Demand Loan (including bill discounting)	**7.3**	**6.0**	**5.9**	**6.4**	**8.6**	**7.4**	**7.2**	**6.9**	**6.5**
iv) Term Loans	**33.9**	**38.7**	**37.6**	**37.5**	**40.1**	**42.9**	**45.1**	**44.5**	**55.8**
a) 1-180 days	4.2	3.6	4.4	5.3	4.6	6.5	5.5	4.7	4.2
b) 180 days-1 year	2.4	2.1	2.2	2.0	3.1	2.2	2.5	2.5	3.7
c)1-3 years	5.0	6.4	6.1	5.8	7.2	7.0	8.0	8.3	8.1
d) 3-5 years	7.1	8.6	8.0	7.5	9.5	10.4	9.6	9.9	11.2
e)above 5 years	13.0	16.0	14.8	15.1	13.3	14.1	17.1	16.2	25.7
f) Others	2.2	2.0	2.2	1.9	2.4	2.8	2.4	2.8	2.9
Total (i to iv) as percenatage of all loans	**91.2**	**88.0**	**88.2**	**86.4**	**88.7**	**89.0**	**89.5**	**87.9**	**83.5**

Annex 6: Outstanding Sub-BPLR lending of Foreign Banks

(Percentage of share in total loans excluding small loans and export credit)

Credit Type	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
i) Cash Credit	**7.1**	**7.0**	**7.8**	**5.2**	**7.6**	**9.3**	**10.3**	**6.7**	**6.8**
ii) Consumer Credit	**21.0**	**17.9**	**22.4**	**21.0**	**21.7**	**7.2**	**23.1**	**21.2**	**24.3**
iii) Demand Loan (including bill discounting)	**9.0**	**9.9**	**13.3**	**15.9**	**12.6**	**14.4**	**15.8**	**13.2**	**16.0**
iv) Term Loans	**33.5**	**31.4**	**35.1**	**35.8**	**35.8**	**50.2**	**21.2**	**20.4**	**20.5**
a) 1-180 days	8.1	9.7	10.6	13.5	13.0	12.6	5.6	6.4	7.3
b) 180 days-1 year	5.5	3.7	3.6	3.3	4.5	4.7	4.4	5.3	3.5
c)1-3 years	7.5	6.8	7.9	5.7	6.3	10.3	6.2	5.7	6.2
d) 3-5 years	3.0	3.1	3.5	3.5	3.5	3.8	1.8	1.6	1.7
e)above 5 years	6.6	5.9	6.4	6.2	5.4	9.1	1.3	1.0	1.1
f) Others	2.7	2.3	3.2	3.7	3.2	9.8	2.0	0.4	0.7
Total (i to iv) as percenatage of all loans	**70.6**	**66.3**	**78.5**	**77.9**	**77.6**	**81.2**	**70.5**	**61.5**	**67.5**

Annex 7: Spread on Interest rate excluding 5% business for term loan contracted at extreme rate

(per cent)

Year	PSBs			Private Sector Banks			Five Major Foreign Banks		
	Modal BPLR	**Max Spread**	**Min Spread**	**Modal BPLR**	**Max Spread**	**Min Spread**	**Modal BPLR**	**Max Spread**	**Min Spread**
Mar 04	11.00	5.00	-5.25	12.00	9.50	-9.00	12.75	9.25	-9.40
Jun 04	11.00	5.00	-6.20	12.00	10.25	-8..00	12.75	10.00	-7.8
Sep 04	11.00	5.00	-6.00	12.00	10.25	-8.00	12.75	10.00	-9.65
Dec 04	11.00	8.50	-7.00	12.00	11.00	-8.50	12.75	10.00	-8.05
Mar 05	11.00	4.50	-7.00	11.50	8.50	-8.50	12.75	10.00	-8.52
Jun 05	11.00	5.00	-7.00	11.50	11.44	-8.00	12.75	12.00	-7.74
Sep 05	11.00	4.50	-7.00	12.00	8.50	-8.00	12.75	12.00	-9.89
Dec 05	11.00	5.00	-7.00	12.00	7.00	-8.00	12.75	11.00	-9.89
Mar 06	11.00	5.00	-7.00	12.00	7.00	-8.00	12.75	13.25	-7.74
Jun 06	11.25	4.50	-7.50	12.50	13.50	-8.50	12.75	12.00	-7.74
Sep 06	11.50	4.50	-7.50	13.00	11.50	-8.50	12.75	10.00	-7.74
Dec 06	11.50	4.50	-7.50	13.00	11.00	-8.50	12.75	10.75	-7.74
Mar 07	12.50	4.50	-8.50	14.00	11.00	-10.50	13.50	12.75	-8.93
Jun 07	13.25	4.50	-9.25	15.00	11.00	-10.43	14.50	12.50	-8.6
Sep 07	13.25	4.50	-9.25	14.00	9.50	-11.00	14.50	12.50	-8.5
Dec 07	13.25	4.50	-9.25	15.00	7.00	-11.00	14.50	11.50	-8.5
Mar 08	13.25	5.00	-9.25	15.00	7.00	-11.00	14.25	12.50	-8.2
Jun 08	13.00	5.00	-9.25	15.25	9.75	-10.94	14.50	5.5	-8.79
Sep 08	14.00	4.50	-7.50	16.00	7.00	-11.94	15.50	4.25	-9.79
Dec 08	13.25	4.50	-6.50	15.75	13.00	-11.44	15.50	4.75	-9.29
Mar 09	12.50	4.50	-6.85	16.75	10.00	-11.44	15.25	4.75	-9.29

Annex 8

Representatives from Industry Associations

Shri Ajit Ranade	Chief Economist, Confederation of Indian Industry
Shri V.Kumaraswamy	CFO, JK Papers Ltd, Federation of Indian Chamber of Commerce & Industry
Shri. M.V. S. Seshagiri Rao	Dir(Fin), Jindal Vijaynagar Steel Ltd Associated Chamber of Commerce & Industry of India
Shri Thakkar	Co Chairman of Committee on Finance & Banking, Indian Merchant Chamber
Dr Dhananjay Samant	O-in-C, Banking & Finance Committee, Indian Merchant Chamber
Shri Sharad Kumar Saraf	VP & Chairman (WR), Federation of Indian Export Organisation
Shri Anand Ladsarya	Managing Committee Member, Federation of Indian Export Organisation
Shri Ramesh Iyer	Chairman of Bkg. & Fin. Committee, Bombay Chamber of Commerce & Industry
Dr Atindra Sen	Dir.Gen., Bombay Chamber of Commerce & Industry
Dr Shubhada M Rao	Chairman of Economic Policy & Corporate Strategy, Bombay Chamber of Commerce & Industry
Shri S.J.Balesh	Co-Chairman, Bkg.&Fin. Committee, Bombay Chamber of Commerce & Industry
Shri Ravi	Chief Fin.Officer, M&M Fin.Services, Bombay Chamber of Commerce & Industry
Shri K. Chandra Sekar	Sr. VP. Corp Fin, Bombay Chamber of Commerce & Industry
Shri Chandrakant Salunkhe	President, Small & Medium Business Development Chamber of India
Shri S.K.Sarkar	Member, Federation of Indian Micro and Small & Medium Enterprises
Shri S. S. Rathi	National President, Federation of Association of Small Industries of India
Shri Avinash Dalal	Ex Comm, Federation of Association of Small Industries of India
Shri Purushottam	Thane Small Scale Industries Association

Annex 9

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Annex 10: PLR - International Experience

	United States	Japan	Russia
1	**2**	**3**	**4**
1. % of bank lending linked to PLR	Between 10% and 25%	It is mostly for housing loans and small companies & not for small corporates	Between 10% and 25%
2. Presence of sub-PLR lending	significant lending below the US Prime Rate	Sub-BLPR lending exist	Hardly any sub-PLR lending
3. Determination of PLR	Prime Rate generally set at Fed Target plus 300bp	Cost plus	Cost plus
4. Frequency in review of PLR	As FOMC changes their Fed Target rate (approx 8 times a year)	LT rate is set monthly. ST rates are reviewed as needed	No
5. The range and dispersion of PLR amongst various players (lenders / banks)	Banks have almost the same PLR	Dispersion in a narrow range 2	Dispersion over a moderate range 3
6. Elasticity of PLR in relation to deposit costs in your country	Elasticity is very high 1	Elasticity is high 2	Moderate 3
7. Correlation of PLR to the observable interest rate market benchmarks	Low correlation 4	High correlations 2	Low Correlation 4
8. Correlation of PLR to the Central Bank's policy rates	Very high correlation 1	High Correlation 2	Moderate Correlation 3
9. Do multiple Prime lending rates exist	No	No	No
10. Is there different PLRs for wholesale borrowers		No	No
11. Tenor-wise term structure of PLR		Yes Short-term and long term	Yes
12.Is the PLR computation done bottoms-up	Fixed spread over the fed target rate (at 300bps)	Yes	No

Source : Survey by Citibank, India

Note: On a Scale of 1 to 5 - 1 implies dispersion in a tight range and 5 implies dispersion in a wide range for question 5. For Questions 6, 7, 8 on a scale of 1 to 5, 1 implies very high correlation and 5 implies very low correlation.

Annex 10: PLR – International Experiences (continued)

	Brazil	Hong Kong	Malaysia	Poland
1	**5**	**6**	**7**	**8**
1. % of bank lending linked to PLR	CDI is the interbank overnight rate	Between 10% and 25%	Between 50% and 75%	Between 10% and 25%
2. Presence of sub-PLR lending	Hardly any sub-PLR lending	Sub-PLR lending exists	Sub-PLR lending exist	Sub-PLR lending exist
3. Determination of PLR	CDI is always very close to SELIC rate, Central bank monitors CDI to avoid discrepancy between the two	Cost plus and also determined by competitive forces	PLR can be changed, however reasons for it have to be given to central bank	WIBOR determined by competitive forces. Spread takes into account mainly cost of funding, type and tenor of the loan
4. Frequency in review of PLR	No	No	No	No
5. The range and dispersion of PLR amongst various players (lenders / banks)	Dispersion is in a very tight range 1	Dispersion is in a very tight range 1	Dispersion in a tight range 2	Dispersion in a tight range 2
6. Elasticity of PLR in relation to deposit costs in your country	Very high correlation 1	High Correlation 2	Very highly correlated with corporate short-term deposit. Low correlation with retail deposit	High Correlation 2
7. Correlation of PLR to the observable interest rate market benchmarks	Very high correlation 1	Very low correlation 5	Very low correlation 5	Moderate Correlation 3
8. Correlation of PLR to the Central Bank's policy rates	Very high correlation 1	High correlation	Very high correlation 1	Moderate Correlation 3
9. Do multiple Prime lending rates exist	Yes	No	No	Yes
10.Is there different PLRs for wholesale borrowers	No	No	No	Yes
11. Tenor-wise term structure of PLR	No	Yes	No	Yes
12. Is the PLR computation done bottoms-up	No. CDI is the average rate of all overnight interbank loans	Based on funding cost, credit cost, operating cost and competition	No	Total PLR rate includes funding costs, credit costs, operational costs

Source : Survey by Citibank, India

Annex 10: PLR – International Experiences (continued)

	Singapore	Taiwan	South Africa
1	**9**	**10**	**11**
1. % of bank lending linked to PLR	Between 10% and 25%	Between 50% and 75%	Lending to individuals linked to PLR. Lending to corporate sector linked to floating rates (JIBAR) or PLR
2. Presence of sub-PLR lending	Sub-PLR lending exist	Sub-PLR lending does not exist	Banks lend at a fixed spread to PLR based on customer's credit quality
3. Determination of PLR	Cost plus as well as competitive forces	Cost plus	Industry body administers PLR, after extensive negotiations with Central Banks
4. Frequency in review of PLR	No	No	No. Linked to repo rate set by SA Reserve Bank
5. The range and dispersion of PLR amongst various players (lenders / banks)	Dispersion in a tight range 2	Dispersion in a wide range 4	Dispersion in a very tight range 1 It is same for all the banks
6. Elasticity of PLR in relation to deposit costs in your country	Low Correlation 4	Tight Correlation 2	Tight Correlation 2 Repo rate determined PLR. Deposit rates are heavily influence by repo rate , though liquidity condition also see deposit rate change
7. Correlation of PLR to the observable interest rate market benchmarks	Very Low Correlation 5	Low Correlation 4	Very Low Correlation 5
8. Correlation of PLR to the Central Bank's policy rates	Very low Correlation 5	Low Correlation 4	Very tight correlation 1
9. Do multiple Prime lending rates exist	No. Other BM like SIBOR, SOR exist for pricing loans etc.	No	No
10. Is there different PLRs for wholesale borrowers	No	Yes	No
11. Tenor-wise term structure of PLR	No	No	No PLR is an overnight rate
12. Is the PLR computation done bottoms-up	Main components are reserve cost and credit cost	Main components are deposit rate and operation cost	No It's a fixed spread to the Central Bank policy rate

Source : Survey by Citibank, India

Annex 11 : Base Rate : An illustration

	Components	
a.	One year Term Deposit rate	6.50%
b.	Less: CASA Adjustment (Factor 1 +Factor 2)	1.31%
c.	Negative Carry on CRR and SLR	0.96%
d.	Unallocated Overhead Cost	0.99%
e.	Average Return on Net worth	1.41%
Base Rate (a-b+c+d+e)		**8.55%**

Computation of the Base Rate : An illustration

1	**Assumptions**		
	Total Deposits	100	Rs. Crore
	Savings Bank Deposits (SB)	22	Rs. Crore
	Current Account Balances (CA)	10	Rs. Crore
2	**Positive Carry on CASA**		
	Savings Bank rate (SB rate)	3.50%	
	Difference (TD rate- SB rate)	3.00%	
	Proportion of Savings Bank Deposits (SBSHARE)	22.00%	
	Factor 1 (SBSHARE * Difference in TD and SB Rate)	**0.66%**	
	Proportion of Current Account (CASHARE)	10.00%	
	Factor 2 (CASHARE* TD rate)	**0.65%**	
3	**Negative Carry on CRR and SLR**		
	Interest Cost on Deposits (1 year Deposit Rate)	6.50%	
	Assuming that Total Deposits	100	Rs. Crore
	Returns required from Deposits	6.50	Rs. Crore
	CRR (as per cent of total deposits)	5.00%	
	CRR Balances	5	Rs. Crore
	SLR (as per cent of total deposits)	24.00%	
	SLR Balances	24	Rs. Crore
	Deployable Deposits	71	Rs. Crore
	Deployable Deposits (as per cent of total deposits)	71.00%	
	364 Treasury Bill Yield	5.00%	
	Return on SLR Balances	1.20%	
	Interest Cost on Deposits(1 year Deposit Rate) adjusted for SLR return	5.30%	
	Returns required from Deployable Deposits to account for deposit interest cost	7.46%	
	Negative Carry Charge on CRR and SLR	**0.96%**	
4	**Unallocated Overhead Cost**		
	Fixed Overheads comprise of HO and CO costs which cannot be allocated		
	Total Unallocatable Cost	1	Rs. Crore
	Assuming the total deposits (including CDs) are	100	Rs. Crore
	Deposits Available for Deployment	71	Rs. Crore
	Unallocated Fixed Overheads as a percentage of deployed funds	**0.99%**	
5	**Average Return on Net Worth**		
	Net Profit	1	Rs. Crore
	Capital	0.5	Rs. Crore
	Reserves (excluding Revaluation Reserves)	10	Rs. Crore
	Net worth (Infused Capital or Equity)+ Reserves	10.5	Rs. Crore
	Deposits Available for Deployment	71	Rs. Crore
	Average Return on Equity	0.10	
	Average Return on Net Worth = Return on Equity * Net Worth/Deployable Deposits	**1.41%**	