History

The Base Prime Lending Rate (BPLR) system, introduced in 2003, fell short of its original objective of bringing transparency to lending rates. This was mainly because under the BPLR system, banks could lend below BPLR. For the same reason, it was also difficult to assess the transmission of policy rates of the Reserve Bank to lending rates of banks.

The Base Rate system which replaced the BPLR system on July 1, 2010 was aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. Further, the Base Rate included all those cost elements of lending rates that are common across all categories of borrowers.

The banks were given the liberty to choose any benchmark to arrive at the Base Rate for a specific tenor and the Base Rate is calculated as follows:

Base Rate = Cost of Deposits/funds + Negative Carry on CRR and SLR + Unallocatable Overheads cost + Average return on net worth.

The final pricing for a particular advance product is fixed by adding Tenor Premium, Risk Premium and allocatable overhead costs.

The Cost of deposits calculated quarterly by many banks is on average cost of deposit/funds basis. When there is a revision in the policy rates the same is captured in the above calculation but the impact on account of the revision of policy rates is translated to the market on a slow pace under the above methodology.

New Methodology

To improve the efficiency of monetary policy transmission in a speedy manner to the ultimate borrowers, for all loans sanctioned or renewed on or after 1 April 2016, the Reserve Bank decided to implement the marginal-cost-of-funds basis for determination of cost of funds/deposits for calculation of the Base Rate. All the loans sanctioned and disbursed before 1 April 2016 will continue under the present methodology followed by the banks till these loans come up for renewal.

The marginal cost pricing of loans will help the banks become more competitive and enhance their long run value and contribution to economic growth. The step will also improve transparency in the methodology followed by banks for determining interest rates on advances and help the borrowers reap the benefit of lower interest rates. The new guidelines on marginal cost pricing makes the cost flow-through into lending rates faster. Going forward the banks will be able to make incremental loans on the marginal cost pricing while their historical or the legacy loans will be on the base rate. Further, going forward the Reserve Bank of India has made some cosmetic changes to the present system for calculating the Base rate.

Under the proposed methodology, in a falling interest rate scenario, the transmission of rates to the market will be very quick. But at the same time in a rising interest rate scenario, the impact on the market will be very sharp and this will impact the repayment capacity of the market which may result in a surge in non-performing loans.

The new methodology is discussed in the following paragraphs:

Under the new methodology the Base Rate is henceforth styled as Marginal Cost of funds based Lending Rates (MCLR) which is Internal Bench mark. The final pricing of the product (lending rates) will be MCLR which is the Internal Bench mark plus Spread which consists of business strategy costs and Credit Risk Premium. There will be no lending below the MCLR of a particular maturity for all loans linked to that benchmark.

A. Marginal Cost of funds based Lending Rates (MCLR – an Internal Benchmark)

All rupee loans sanctioned and credit limits renewed effective April 1, 2016 will be priced with reference to the MCLR which will be the internal benchmark for such purposes. The MCLR will comprise of Marginal cost of funds, Negative carry on account of Cash Reserve Ratio, Operating costs and Tenor premium.

a. What is Marginal Cost of funds?

The marginal cost of funds will comprise of Marginal cost of borrowings and return on net worth. The marginal cost of borrowings shall have a weightage of 92% of Marginal Cost of Funds while return on net worth will have the weightage of 8% since currently, the common equity Tier 1 capital is (5.5% +2.5%) 8% of risk weighted assets.

1. Marginal cost of borrowings

Marginal cost of borrowings is calculated by multiplying the rates offered on deposits on the date of review or rates at which funds were borrowed with the percentage of balance outstanding as on the previous day of review to total funds excluding equity. The borrowings will include Current deposits, Savings Bank deposits, Fixed and floating rate term deposits, Foreign currency deposits, Short term and long term rupee borrowings and foreign currency borrowings including Head Office borrowings by foreign banks (other than those forming part of Tier-1 capital).

In the case of current and savings bank deposits, the core portion identified using behavioral study should be reckoned while arriving at the balance outstanding.

In the case of fixed rate term deposits, term deposits of various maturities including those on which differential interest rates are payable should be included in the balance outstanding and in the case of floating rate term

deposits, the rate should be arrived at based on the prevailing external benchmark rate on the date of review.

In the case of foreign currency deposits, those deposits which are deployed for lending in rupees should be included in computing marginal cost of funds. The swap and the hedge cost of such deposits should be reckoned for computing marginal cost.

In the case of short term rupee borrowings, interest payable on each type of short term borrowing should be arrived at using the average rates at which such short term borrowings were raised in the last one month.

In the case of long term rupee borrowings, either interest payable on each type of long term borrowing should be arrived at using the average rates at which such long term borrowings were raised or the appropriate benchmark yield for bank bonds published by FIMMDA for valuation purposes should be used as the proxy rate for calculating marginal cost.

In the case of foreign currency borrowings, to the extent it is deployed for lending in rupees, should be included in computing marginal cost of funds. The all-in-cost of raising foreign currency borrowings including swap and hedge cost would be reckoned for computing marginal cost of funds.

2. Return on net worth

The amount of common equity Tier 1 capital required to be maintained for Risk Weighted Assets as per extant capital adequacy norms should be included for computing marginal cost of funds. In case of newly set up banks (either domestic or foreign banks operating as branches in India) where the lending operations are mainly financed by capital, the weightage for this component should be in proportion to the extent of capital deployed for lending. This special dispensation will be available for a period of three years from the date of commencing operations.

The cost of equity will be the minimum desired rate of return on equity computed as a mark-up over the risk free rate. The pricing model such as Capital Asset Pricing Model (CAPM) can be used to arrive at the cost of capital. This rate can be reviewed annually.

b. What is Negative Carry on Cash Reserve Ratio (CRR)?

The banks have to necessarily maintain a specific percentage of borrowed funds with Reserve Bank of India in cash form as Cash Reserve Ratio and this will not carry any interest (return is nil). The cost of this cash reserve needs to be recovered through lending and this phenomena is known as Negative Carry.

Negative carry on the mandatory CRR is calculated as - Required CRR multiplied marginal cost divided by (1- CRR). The marginal cost of funds as arrived in the earlier paragraphs should be used for arriving at negative carry on CRR.

c. What is Operating Costs?

All operating costs associated with providing the loan product including cost of raising funds should be included under this head. It should be ensured that the costs of providing those services which are separately recovered by way of service charges do not form part of this component.

d. What is Tenor premium?

The costs arising out of loan commitments with longer tenor is tenor premium. This is basically a cost to cover the liquidity risk which may arise on account of tenor mismatch. The change in tenor premium should not be borrower specific or loan class specific. The tenor premium will be uniform for all types of loans for a given residual tenor.

Since MCLR will be a tenor linked benchmark, banks should arrive at the MCLR of a particular maturity by adding the corresponding tenor premium to the sum of Marginal cost of funds, Negative carry on account of CRR and Operating costs.

The banks should publish the internal benchmark for the following maturities:

- Overnight MCLR,
- One-month MCLR,
- Three-month MCLR,
- Six month MCLR,
- One year MCLR.

In addition to the above, banks have the option of publishing MCLR of any other longer maturity.

B. *Spread*

Banks should have a Board approved policy delineating the components of spread charged to a customer. The policy shall include the principles to determine the quantum of each component of spread, to determine the range of spread for a given category of borrower / type of loan and to delegate powers in respect of loan pricing.

The banks should adopt the following broad components of spread:

a. *Business strategy*

The component will be arrived at taking into consideration the business strategy, market competition, embedded options in the loan product and market liquidity of the loan.

b. *Credit risk premium*

The credit risk premium charged to the customer representing the default risk arising from loan sanctioned should be arrived at based on an appropriate credit risk rating/scoring model and after taking into consideration customer relationship, expected losses and collaterals.

The spread charged to an existing borrower should not be increased except on account of deterioration in the credit risk profile of the customer. Any such decision regarding change in spread on account of change in credit risk profile should be supported by a full-fledged risk profile review of the customer. However, this will not be applicable to loans under consortium / multiple banking arrangements.

C. *Interest Rates on Loans*

Actual lending rates will be determined by adding the components of spread to the MCLR. Accordingly, there will be no lending below the MCLR of a particular maturity for all loans linked to that benchmark

The reference benchmark rate used for pricing the loans should form part of the terms of the loan contract.

D. Exemptions from MCLR

a. Loans covered by schemes specially formulated by Government of India wherein banks have to charge interest rates as per the scheme, are exempted from being linked to MCLR as the benchmark for determining interest rate.

b. Working Capital Term Loan (WCTL), Funded Interest Term Loan (FITL), etc. granted as part of the rectification/restructuring package, are exempted from being linked to MCLR as the benchmark for determining interest rate.

c. Loans granted under various refinance schemes formulated by Government of India or any Government Undertakings wherein banks charge interest at the rates prescribed under the schemes to the extent refinance is available are exempted from being linked to MCLR as the benchmark for determining interest rate. Interest rate charged on the part not covered under refinance should adhere to the MCLR guidelines.

d. The following categories of loans can be priced **without** being linked to MCLR as the benchmark for determining interest rate:

1. Advances to banks' depositors against their own deposits.
2. Advances to banks' own employees including retired employees.
3. Advances granted to the Chief Executive Officer / Whole Time Directors.
4. Loans linked to a market determined external benchmark.
5. Fixed rate loans granted by banks. However, in case of hybrid loans where the interest rates are partly fixed and partly floating, interest rate on the floating portion should adhere to the MCLR guidelines.

E. ***Review of MCLR***

Banks shall review and publish their **MCLR** of different maturities every month on a pre-announced date with the approval of the Board or any other committee to which powers have been delegated. However, banks which do not have adequate systems to carry out the review of MCLR on a monthly basis, may review their rates once a quarter on a pre-announced date for the first one year i.e. upto March 31, 2017. Thereafter, such banks should adopt the monthly review of MCLR.

F. ***Reset of interest rates***

Banks may specify interest reset dates on their floating rate loans. Banks will have the option to offer loans with reset dates linked either to the date of sanction of the loan/credit limits or to the date of review of MCLR. The MCLR prevailing on the day the loan is sanctioned will be applicable till the next reset date, irrespective of the changes in the benchmark during the interim. The periodicity of reset shall be one year or lower. The exact periodicity of reset shall form part of the terms of the loan contract.

G. ***Treatment of interest rates linked to Base Rate charged to existing borrowers***

Existing loans and credit limits linked to the Base Rate may continue till repayment or renewal, as the case may be. The Banks will continue to review and publish Base Rate as hitherto. The existing borrowers will also have the option to move to the Marginal Cost of Funds based Lending Rate (MCLR) linked loan at mutually acceptable terms and this should not be treated as a foreclosure of existing facility.

<u>Current Methodology Vs New Methodology</u>

Under the *current methodology* the Base rate is worked out using the formula:

- Base Rate = Cost of Deposits/funds + Negative Carry on CRR and SLR + Unallocatable Overheads cost + Average return on net worth.

- Final Pricing = Base Rate + Tenor Premium + Risk Premium + Allocatable Overhead Costs

Under the *new methodology* the Base Rate (MCLR) is worked out using the formula:

- MCLR = Marginal Cost of funds + Negative carry on account of CRR + Operating Costs + Tenor Premium

- Final Pricing = MCLR + Spread

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