Dynamic base-rate pricing to help new borrowers

RBI to allow computation of banks' base rates on the basis of marginal cost of funds

Nupur Anand & Anup Roy | Mumbai
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In a move aimed at ensuring faster transmission of rate revisions, the Reserve Bank of India (RBI) is set to release its final guidelines on computation of banks' base rates on the basis of marginal cost of funds. These guidelines, allowing dynamic pricing of loans as suggested by banks, are likely to benefit new customers.

One suggestion made by the bankers' lobby — there are indications that RBI has taken it seriously — is that pricing of loans should be changed on the basis of market-linked yields, with a clause for reset every quarter or year. While it is not yet clear whether the yields taken into consideration will be on a daily basis or an average, dynamic pricing of loans will be tricky business for borrowers, who will also have to time their borrowings according to money markets and the view on interest rates. That is because the rate could be reset only after a quarter or a year of a loan being taken, say sources familiar with the proposal. While retail customers might still have some uniform pricing protection, big loans will shift to this variable-rate regime.

However, not all banks have an equal exposure to the money market and, as such, the cost of deposit will also differ among banks, making competition stiffer.

For example, say a bank's cost of deposit on January 1 is eight per cent, and the bank decides to add a spread of two percentage points for loans given to a customer, at 10 per cent. Now, on February 1, if the bond yields have fallen and the bank's cost of deposits has fallen to 7.50 per cent, keeping the spread intact at two percentage points, the bank will give a fresh loan to another customer at 9.50 per cent.

The old customer cannot avail of the rate benefit as the loan will be reset only after a quarter. However, both customers will not have to wait for the bank to lower its base rate.

Some lenders have also recommended that the base rate be allowed to stay and a new dynamic reference rate be introduced. And, new loans be priced according to the new dynamic reference rate. Banks, however, have asked that the re-pricing of old loans according to the new rate should be done only after a year. Since the new reference rate is likely to change frequently with cost of funds coming down, banks have suggested that the reference rate should also be fixed and the loans be priced after adding the spread on the basis of the customer's risk profile. This calendar year, RBI has already lowered the repo rate by 125 basis points. But banks have cut their lending rates by only 60-70 basis points. The central bank believes moving to marginal cost of funds for calculating the base rate would ensure faster transmission.

Marginal cost of funds are an incremental cost of borrowing more money to fund assets or investments. Banks had earlier expressed hesitation on such a shift. They had been taking the average cost to calculate the cost of funds. Of that, a significant part are low-cost current and savings account deposits. Most banks pay four per cent on savings account deposits, which account for 20-40 per cent of their total deposits.

In this financial year's first bi-monthly policy review, RBI had asked banks to use marginal cost of funds for their base rate calculation. "A base rate linked to marginal cost of funds should be more sensitive to changes in policy rates. To improve the efficiency of monetary policy transmission, (we) will encourage banks to move in a time-bound manner to determination of their BR (base rate) on the basis of marginal cost of funds," RBI had said.

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Recently, State Bank of India Chairman Arundhati Bhattacharya had questioned the draft guidelines on computation of banks' base rates by marginal cost of funds, saying these were not feasible. Last week, she had also suggested that lenders should be allowed to immediately charge lower interest only for new loans, and the new rates could apply to old loans only after a year.

NEW GUIDELINES IN THE WORKS

Dynamic pricing

- Banks have proposed that pricing of loans be linked to market yields, with a clause for reset every quarter or year
- While it is not yet clear if the yields taken into consideration will be on a daily basis or an average, dynamic pricing of loans will be tricky for borrowers, too

Dynamic reference rate

- It has been recommended that base rates be allowed to stay and a new dynamic reference rate be introduced
- New loans should be priced according to the new dynamic reference rate

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