External Benchmark - Loan Pricing

Why in news?

\n\n

An internal Study Group constituted by the RBI has recommended basing external benchmark for setting bank interest rates.

\n\n

What are the drawbacks of current practise?

\n\n

\n
- The present loan pricing regime is based on marginal cost of fund based lending rate (MCLR). Click here to know about MCLR.
\n

\n\n

\n
- The Study Group has noted that MCLR is calculated based on banks' internal factors such as cost of funds.
\n
- These internal factors are insensitive to changes in the policy interest rate or repo rate.
\n
- Though MCLR includes repo rate, the effect of change in repo by RBI is not fully translated to the public.
\n
- It has also been found that banks deviated from the specified methodologies for calculating the rates.
\n
- Arbitrariness in calculating the MCLR and spreads charged over them has thus undermined the integrity of the interest rate setting process.
\n

\n\n

What are the suggested measures?

\n\n

\n

- **Benchmark -** The study group has cited some 13 possible options as external benchmarks for determining interest rates.
\n
- The group has shortlisted 3 among these, one of which is to be selected by the RBI. Those are-
\n

\n\n

\n
1. T-Bill rate
\n
2. Certificates of Deposit (CD) rate
\n
3. RBI's policy repo rate
\n

\n\n

\n
- It has been recommended that all floating rate loans extended beginning April 1, 2018 could be referenced to the selected external benchmark.
\n
- Banks may be advised to facilitate existing loans to shift to new benchmark without any conversion fee or any other charges within one year of its introduction.
\n
- **Duration -** It suggested that lending rates should be reset once every quarter, from the current practice of once a year.
\n
- **Interest Rate Spread -** Also, the decision on the interest rate spread over the external benchmark should be left to the commercial judgment of banks.
\n
- However, the spread fixed at the time of sanction of loans to all borrowers should remain fixed all through the term of the loan.
\n

\n\n

Quick Facts

\n\n

Interest rate spread

\n\n

\n

- Spread refers to the difference in borrowing rates and lending rates of financial institutions.
  \n
- In other words it is the interest yield on earning assets such as a loan minus interest rates paid on borrowed funds.
  \n

\n\n

T-Bill Rate

\n\n

\n

- Treasury Bills are government bonds or debt securities with maturity of less than a year.
  \n
- T-Bill Rates are determined by the central bank and used as a primary instrument for regulating money supply and raising funds.
  \n

\n\n

Certificate of Deposit

\n\n

\n

- A certificate of deposit (CD) is a savings certificate with a fixed maturity date and specified fixed interest rate.
  \n
- A CD restricts access to the funds until the maturity date of the investment.
  \n

\n\n

\n\n

Source: The Hindu

\n