FICCI SURVEY ON BASE RATE IMPLEMENTATION

– JUNE 2010

Background

Pursuant to the recommendations of the Working Group on Benchmark Prime Lending Rate (BPLR) constituted in the Annual Policy Statement of 2009-10 to review the BPLR system and suggest changes to make credit pricing more transparent, the Reserve Bank of India (RBI) has decided that banks switch over to the system of Base Rate with effect from July 01, 2010.

The committee headed by Mr. Deepak Mohanty which submitted its report on October 2009 was assign the task the following task:-

- To review the concept of BPLR and the manner of its computation;
- To examine the extent of sub-BPLR lending and the reasons thereof;
- To examine the wide divergence in BPLRs of major banks;
- To suggest an appropriate loan pricing system for banks based on international best practices;
- To review the administered lending rates for small loans up to Rs 2 lakh and for exporters; and
- To suggest suitable benchmarks for floating rate loans in the retail segment.

The committee recommended to the apex bank that banks switch over to the system of Base Rate aimed at **bringing transparency to lending rates and enabling better assessment of transmission of monetary policy.**

As per the analysis done by the Working Group committee - 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 has advocated for the introduction a system of Base Rate to replace the existing BPLR system - a rate that includes all those cost elements which can be clearly identified and are common across borrowers. 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.

In addition to promoting transparency the Base Rate methodology does allow banks to charge borrowers Base Rate plus borrower-specific charges, which will include product-specific operating costs, credit risk premium and tenor premium. Besides concessions are made in certain cases like education loans, credit to small borrowers (up to Rs. 2 Lakh), loans below one year. So, as the Judgement day approaches and banks make final adjustments to their calculations, FICCI asked bankers and economist about the their view as to how things would pan out post base–rate regime is implemented wef July 1, 2010 and what impact will it have on both, small and big companies.

Survey highlights

On whether banks see an upward pressure on lending rates once base rate is implemented and what is the range around which they see base rate settling

- ♣ Majority of the bankers surveyed did express the feeling that there is a high probability of a 'slight' upward bias as far as lending rates are concerned. However, the degree of impact will differ from borrower to borrower and across sectors. **While an upward pressure on rates for corporates availing at ultra-low rate is imminent, the retail, priority and SME products will most-likely be able to get a relatively lower rate.** Needless to mention, irrespective of the category, borrowers with better credit rating will be able to negotiate a good deal for themselves.

- ♣ Apart from the base rate, other important determinants of future lending rates will be RBI's monetary policy stance and pick-up in credit demand. While the bankers are optimistic about the credit demand, they are apprehensive of monetary policy. If the policy indicates further tightening there could be a consequent squeeze on liquidity, which will have an upward bias on base rate.

- ♣ Although the base rate range given by public sector banks is 8.0-9.5%, private sector banks could settle at higher end of the range. However, most banks feels that base rate will be governed by the liquidity conditions in the market and each bank's cost of raising funds.

What are the areas banks would resort to negate the adverse impact on bank's bottom-line, if any

- ♣ In order to negate the adverse impact on bank's bottom-line, they are expected to expand their fee-based income business. They would also pursue more low cost borrowings. Some respondents also foresee an aggressive treasury operations and levying of service charges to cancel out any negative impact arising out of squeeze in profitability as banks could end up paying more to depositors without a corresponding increase in their earnings once base rate is implemented

Will (Current Account and Saving Account) CASA heavy banks be at an advantage in the new regime?

- ♣ Bankers were unanimous in their view of CASA heavy banks having an advantage in the new regime. Higher proportion of CASA in total deposit would certainly offer more flexibility in maintaining a relatively lower base rate and hence will also play a decisive role in improving margins. There can't be a second thought on the fact that CASA heavy banks will have an upper hand in base rate pricing as cost of deposit is the single most determinant in the base rate calculation.

Do private sector banks have an edge over public sector banks in offering a more competitive rate?

- Public sector banks will have an edge over private sector banks in offering a more competitive rate as they have a larger deposit base which gives them access to cheaper sources of stable financing. Public sector banks have access to the government/treasury funds and thereby their cost of fund works out to be lower than private sector banks.

Does the introduction of base rate make borrowing by large corporates difficult, which were able to negotiate at sub-PLR rates, earlier?

- Bankers were clearly of the view that post base rate regime highly rated corporates will find it costlier to raise money through banks. Hence, banks may find it difficult to retain the high-rated corporate portfolio. These corporates might resort to other low-cost financing options like Commercial Paper (CP), Qualified Institutional Placement (QIP), External Commercial Borrowing (ECB) etc. which could result in lower credit off-take of banks.

Will small companies be able to negotiate a good deal for themselves in terms of lending rate in this new transparent base rate regime?

- The most important aspect highlighted by bankers with respect to small scale companies across the board was the '**ability to negotiate'**. Bankers said that the new system is transparent and the small borrower should be able to 'negotiate the rates' to their advantage. As the base rate of all the banks would be publicly available, companies will be able to compare the rates charged by banks; hence the skill to negotiate will have a greater role to play.