Banking

IMPACT ANALYSIS

Base rate regime to benefit small borrowers

Summary

CRISIL Research expects the transition from the benchmark prime lending rate (BPLR) to the base rate system from July 1, 2010 to increase transparency in lending rates and help small borrowers negotiate better rates with banks. As a result of greater transparency and increased competition, average yield on banks' advances is expected to decline by 10-15 basis points (bps) over the next 2 years.

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About CRISIL Limited

CRISIL is India's leading Ratings, Research, Risk and Policy Advisory Company.

CRISIL offers domestic and international customers a unique combination of local insights and global perspectives, delivering independent information, opinions and solutions that help them make better informed business and investment decisions, improve the efficiency of markets and market participants, and help shape infrastructure policy and projects. Its integrated range of capabilities includes credit ratings and risk assessment; research on India's economy, industries and companies; global equity research; fund services; risk management and infrastructure advisory services.

About CRISIL Research

CRISIL Research is India's largest independent, integrated research house. We leverage our unique, integrated research platform and capabilities spanning the entire economy-industry-company spectrum to deliver superior perspectives and insights to over 750 domestic and global clients, through a range of subscription products and customised solutions.

Base rate regime to benefit small borrowers

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The final interest rate charged to borrowers, under the base rate regime, would be a function of the base rate plus borrower-specific charges, which would include product specific operating costs, credit risk and loan tenure.
Impact of shifting to the base rate system

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Yield on advances to decline: The base rate system would require banks to be more transparent in their loan pricing methodology which, CRISIL Research believes, will enable more effective transmission of policy rate changes than the BPLR system did. The greater transparency will also increase competition among banks to acquire and retain customers. Borrowers with healthy credit profiles will now negotiate for finer pricing. Small and medium enterprises (SME) and retail borrowers, who constitute a significant share of outstanding bank advances, at around 33 per cent, will be the biggest beneficiaries. As a result, CRISIL Research projects average yield on advances to drop by 10 bps to 15 bps over the next 2 years.

Impact on different customer segments:

Retail customers to benefit in long term: Rates charged to retail customers will not be significantly impacted in the near term. However, over a period of time, increased transparency in lending rates should help retail borrowers with a good credit history bargain for lower interest rates.

Furthermore, opaque pricing adopted by banks under the BPLR system, especially in segments like home loans, will get corrected. For example, banks do not pass on the full benefit of reduction in interest rates to existing customers while offering lower rates to attract new customers.

SMEs would have better bargaining power: Since the new system would be transparent and the base rate would be publicly available, SMEs with healthy credit profiles would be able to negotiate for better rates with banks.

Increased credit flow to small borrowers: The earlier stipulation of BPLR as the ceiling rate for loans up to Rs 2 lakh would be withdrawn. Deregulation of the lending rate is expected to increase the credit flow to small borrowers. The interest rate could be higher than BPLR but is expected to be lower than other forms of high cost credit (eg money lenders).

Short-term loans to become costlier for highly rated corporates: Over the last 2 years, the highly rated corporates, which have access to various sources of cheap funds, have been able to negotiate with banks for rates as low as 5-6 per cent to fulfill their short-term fund requirement. In the base rate system, interest rate on short term lending to large corporates will increase since banks would not lend below the base rate. CRISIL Research believes that the change in interest rates will lead such corporates to increase their reliance on alternative sources such as the commercial paper (CP) and short term debentures, where funds are currently available below the base rate. The outstanding in the commercial paper market as of April 2010 was about Rs 831 billion. As CP market is small in size and lacks depth, only highly rated corporates would be able to source short term funds from CP market.

Base rate and BPLR would co-exist for some time: The RBI has stated that the base rate system would be applicable for all new loans and for old loans that come up for renewal. Existing loans based on the BPLR system can be continued till their maturity. RBI has mandated that, in case existing borrowers want to shift to the new system before expiry of the existing contracts, an option may be given to them on mutually agreed terms and banks should not charge any fee for the switch-over.

There could be cases in which the final rate linked to the base rate could be higher than the effective rate the customer pays in the current BPLR system. Customers would prefer to wait and watch the behaviour of the BPLR and the base rate system before deciding if they want to shift to the new system. This means that the base rate and BPLR would co-exist for at least the next few years. While the interest rate for new borrowers would be linked to the base rate, existing customers such as home loan customers and corporates with project finance loans outstanding where interest rates are linked to BPLR, will continue to pay interest at their contracted rates.

What is base rate?

The base rate is expected to replace the current BPLR system from July 1, 2010. The base rate would be the minimum lending rate for all loans except for:

- loans to banks' own employees
- loans to banks' depositors against their own deposits
- borrowers under the differential interest rate (DRI) scheme

While the RBI has specified a methodology factoring in the cost of deposits and average return on net worth for calculation of the base rate, banks have been given the freedom to use any other methodology provided it is consistent and is made available for supervisory review, as and when required.

The RBI has specified the following illustrative methodology for calculating the base rate:

Base rate = a + b + c + d

a) Cost of deposits/funds
b) Adjustment for the negative carry in respect of cash reserve ratio (CRR) and statutory liquidity requirement (SLR) - This arises because the return on CRR balances is nil, while the return on SLR balances is lower than the cost of deposits
c) Unallocable overhead cost - Calculated by taking the ratio (expressed as a percentage) of unallocated overhead cost and deployable deposits (defined as total deposits less share of deposits locked as CRR and SLR balances)
d) Average return on net worth - Computed as the product of net profit to net worth ratio and net worth to deployable deposits ratio expressed as a percentage

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