INDIAN Bank Base Rate:An Overview

Dash, Debasis Kumar

IIM Kozhikode

21 September 2010

Indian Bank Base Rate: An Overview

Name- Debasis Kumar Dash

Address- INDIAN INSTITUTE OF MANAGEMENT,KOZHIKODE

Hostel E, ROOM NO-31,

Kunnamangalam , Calicut

Pincode-673570

E-mail- debasiskd13@iimk.ac.in

Phone- (+91) 9539011899

Abstract

The paper deals about the issues arising out of implementing base rate for Indian banks. With effect from July 1st, 2010, all banks are supposed to lend at base rate or minimum level of interest rate to customers. The net impact of this for retail customer will not be much as cost of funds for banks are not going to change much and cost of funds determine base rate. Big corporates will be biggest losers as they had advantage of getting loans at sub-base rates. Biggest gainers will be small and medium firms who were getting raw deal earlier from banks. Banks may lose market share in short term but there is going to be greater transparency and trickling down of policies made by RBI across banks due to base-rate system. Game theory has been applied to explain the base rate transition scenario in the paper.

Keywords- Base Rate, Private Bank, BPLR, Game Theory, Net Income Margin(NIM)

Biographical Notes- Debasis Kumar Dash is a post Graduate from IIT Madras in field in Micro-electronics and VLSI. He is currently doing his MBA from IIM Kozhikode with Majors in finance. His major areas of interest are financial derivatives, Valuation models, risk management and banking sector. He has undertaken several finance projects in field of risk management, corporate finance and financial services. He worked as an intern in KPMG Global Services where he developed a model for Customer acquisition strategy for a financial services firm

Introduction

The base rate will be the new reference rate for determining lending rates for banks, and will be implemented three months later than earlier planned. It was implemented from July 1 across banks in India.

What is the base rate-

If you borrow money to buy a Mercedes car or computer or plush bungalow in Mumbai suburbs, you need to pay interest rate that you have to pay to the lender. The base rate is the minimum rate that a bank will offer money at. It is like a floor below which RBI will not allow banks to lend to you. *Reserve Bank of India Draft Cicrcular [February, 2010]* on base rate clearly defines it as floor beyond which any bank coming under purview of Central bank in India cannot lend.

Previously, banks used to give the loans based on a complex system called benchmark prime lending rate (BPLR). Each bank has its own BPLR calculation system which made it difficult for borrowers to compare rates across banks.

Why Base Rate Was Introduced-

Banks in India charge their largest corporate borrowers less than published prime rates, which they cannot do on new loans from July 1st,2010.

Several papers in the past have been published to investigate the factors affecting the setting up of interest rates by banks. *Craig and Dinger [March, 2010]* in their working paper have investigated the microeconometric timing of retail interest rate and the sources on the changes on interest rate. They found out that US banks in retail sector initially go for interest rate increase in short term but as time passes, the rate becomes stabilized. Similar views were echoed by Serensen and Werner [January, 2006].

Ila Patnaik in IMF Working paper[January,2004] has come up with comparison of volatilities of interest rates in various countries based on historical data. India showed the maximum volatility in interest rates and hence banks face significant problem in net interest income due to the volatility. Inflation rates and monetary policies of Government also affected the interest rates set up by banks. Hence many banks used to twist the rates to suit their needs and hence there was large scale ambiguity in lending norms.

The RBI had expressed concern over banks offering short-term loans well below their prime rates to companies and mortgage borrowers. Similar pattern had given rise to Sub-prime crisis in 2008 which had led to financial downturn. Due to competition, banks have been offering loans to first class borrowers with high credit rating at rates much below the BPLR in a non-transparent manner.

Banks were charging higher rates from small borrowers in the retail, small business and agriculture segments. This resulted in cross- subsidization.RBI has been concerned about the lack of transparency in BPLR setting. There have been cases when SMEs faced discrimination due to credit policies of Private Banks.

Trend has been whenever RBI raises policy rates and reserve ratios, banks are quick to increase their loan rates. But, when RBI reduces policy rates and reserve ratios, banks respond very slowly. This leads to downward stickiness in rates. It adversely impacts the monetary transmission mechanism in the banking system.
One important aspect also is BPLR was set on historical market rates. It was backward looking rather than forward looking. It was not able to capture the present market condition and interest rates. Cost of Deposits prevalent in current market scenario was neglected in fixing the rate.

Standardization of rates was another issue for RBI .The 3 major players in Banking Industry in India are- Public Banks, Private Banks and Foreign Banks. The Public banks were lending in range of 11-12 %, private players were lending at 14-17% whereas foreign banks used to lend in the range of 14-16%. Now major corporates were still prefering private banks due to better customer service, credit policies and sub-prime lending for big projects.

One huge reason with the introduction of BRS as explained by experts is that it will help the Reserve Bank of India to transfer the changes in policy rates (Repo and Reverse Repo under LAF) in a better manner to banks. Under the BPLR, monetary policy transmission is weak due to lack of transparency. This has been detailed out elaborately by Deepak Mohanty Committee's Report. Now, with the BRS, RBI expects that banks will respond immediately to RBI's policy rates

Base Rate Implementation and Impacts-

After the implementation of the new loan pricing system, existing borrowers would continue to pay at existing rates, while the base rate would apply to new customers.

The actual lending rate charged to borrowers would be the base rate+ borrower-specific charges including operating costs, according to draft guidelines on the RBI website. The base rate will be more transparent in so far as it will be a function of the banks' costs on its capital (or cost of deposits), operating costs, statutory requirements (CRR, SLR etc), credit-risk of the borrower, and the allowable profit margin. The graphs below give trends across the various players in banking sector with respect to cost associated with deposits.

Fig-1- Variation of Cost of Deposits

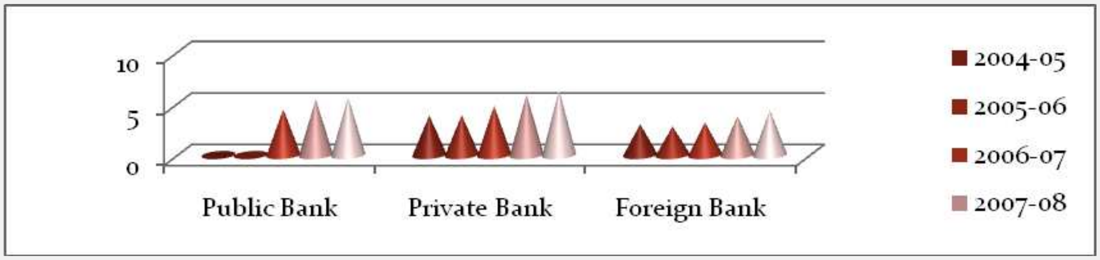
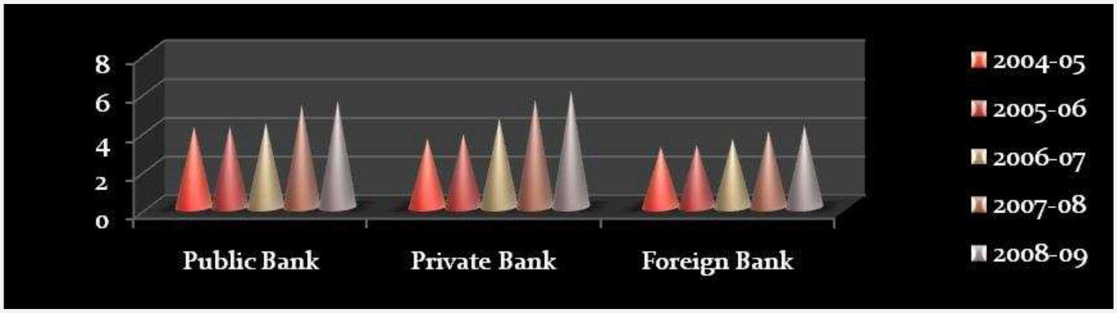


Fig 2- Variation of Cost of Funds



The trend clearly shows that Cost of deposits is highest for old private banks. Thus by logic, the base rate should be highest for these banks. Similarly, the base rate can be expected to be low for foreign and public banks.

The biggest impact is that the new Base Rates from private banks may be lower than the existing Benchmark Prime Lending Rates (BPLR). Due to heavy competition in the industry, some aggressive public banks, whose cost of deposits/funds is lower compared to industry levels, may peg their Base Rates very low. However the RBI Governor as well as several Banks heads are of the opinion that base rate is not going to vary much for retail customers from BPLR.

The following graphs show the base rate, BPLR and differences between the rates for the 3 major players.

Fig-3- Variation of Rates across Private Banks

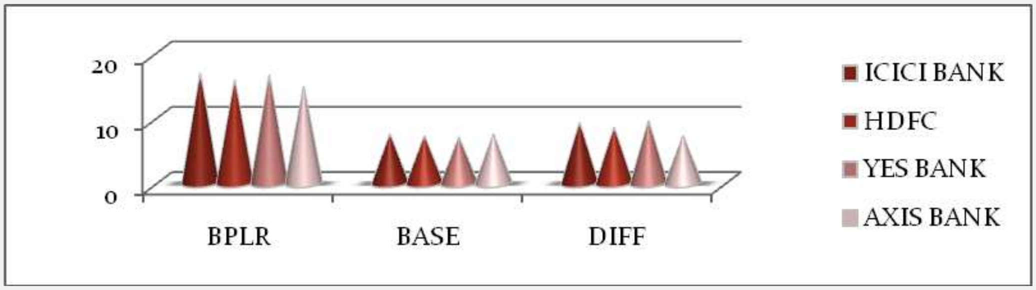


Fig-4- Variation of Rates across Public Banks

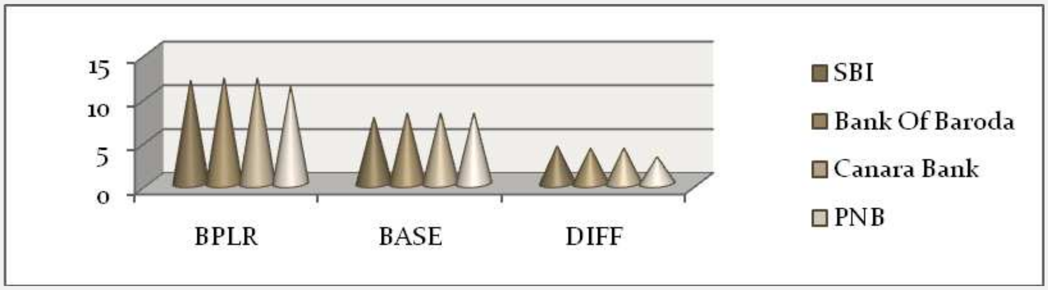
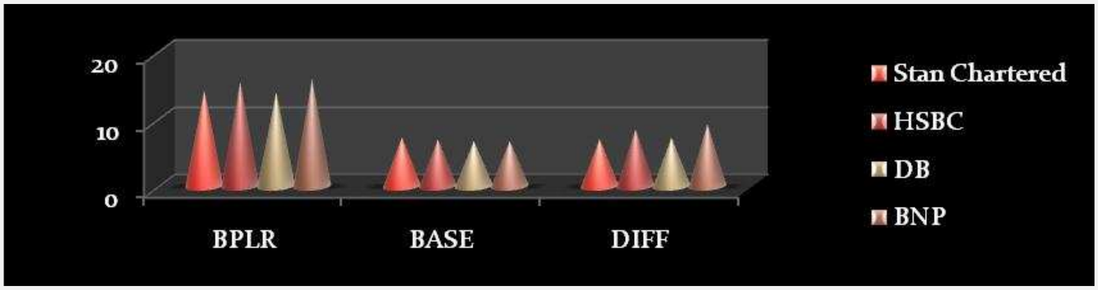


Fig-5- Variation of Rates across Foreign Banks



Effects on Banks

The major categories of Banks mentioned above are expected to be expected in different ways. The graphs shown above indicate that the difference between BPLR and Base rate is maximum for Private banks. Clearly they are at a loss compared to Public and foreign Banks. The problem for private banks is their high cost of Funds and Deposits. So ideally their base rates should be higher compared to Public banks. But if they would have set base rates higher, it would have resulted in loss of customers. So the Net Interest Margin(NIM) for private banks will be affected in short term. The biggest gainers definitely are foreign banks who have the least difference between BPLR and Base rate. Customer attrition should be at a minimum for these banks as change is not significant. Public Banks normally have lower cost of funds and thus can afford low base rates. There is not much change in NIM expected for them due to changing rates.

Private Banks can cut competition by offering premium service levels. They can attract corporates by offering value added services and concessions. The other strategy can be to give priority to clients who are financing for projects for national importance and concessions to pay in smaller installments for longer duration.

Effects of Base-Rate Loans for Customers-

Let us see three major players in customer segment- Retail, Corporate and SME .

The critical thing is interest rates are not going to change much for retail customer. The method of calculating interest rates will be clearer to a retail customer but not much effect on EMI for a retail customer. There will not be much impact on banks interest spreads. Banks will have flexibility in controlling loan-pricing elements, like credit risks premium and product specific operating costs. As per various analysis done by experts, Cost of borrowing for Retail customer may decrease in short term but not significantly.

Large private corporates will be biggest losers in this process. They were able to get away with sub-prime lending rates in the past due to higher negotiating skills. But with BRS, the corporate might have to go for Bond markets in short term. The other alternatives before them are ECB which have lower borrowing costs. Use of Commercial paper has shown significant growth in the first quarter of this year. It clearly indicates banks losing high networth customers to cheaper sources of finance. Long term impact will be that higher rating companies will have more negotiating power.

Let us say Bank A offered loans at 6% previously to Corporates. Now base rate becomes 7.5%. So they now can't be given short term loans below say 8% for a period of 2 years. Previous loans which were given before base rate stays. Now say in money market, CP(Commercial Paper) is being offered at rates of 6.5%. So big corporates will move towards debt market. It will result in loss of market share and credit loans for banks. It will also lead to intense competition.

SME's will be biggest beneficiaries of this project. SME's will be better compensated than before. They were getting short-changed because of better deals for big corporates. Now they will be willing to go to banks for getting loans. As SME's form substantial market, so market share of banks will increase.

Game Theory Applied to Base Rate Implementation-

Allen [October, 2000] has demonstrated the various applications of game theory in finance related matters. Specifically, he looks at payoff matrix applied to investment financing. Here we look at application of game theory to banking interest rate.

Below are Payoff Matrix applied to 3 categories of Bank and 3 categories of Customer.

1.

		Customer		
		Retail	Corporate	SME
Public Bank	BPLR	10,8	10,10	10,5
	Base	10,9	8,5	8,10

The retail customer is having higher payoff but it is not significant. SMEs are largest beneficiary. Corporates are leaving public bank, thus payoff of banks decreasing whereas larger base rate means lesser payoff for corporate.

2.

		Customer		
		Retail	Corporate	SME
Private Bank	BPLR	10,8	10,10	10,5
	Base	8,9	5,5	5,10

The retail customer is having higher payoff but it is not huge. Significantly, there is lower payoff for Private banks due to high cost of funds and rising competition from debt market. SMEs are *largest beneficiary. Corporates are looking for alternatives to higher base rate , thus payoff of corporate decreases.*

3.

		Customer		
		Retail	Corporate	SME
Foreign Bank	BPLR	10,8	10,10	10,5
	Base	10,10	7,7	10,5

The retail customer and SME are not affected.SME are not big market-share holders of foreign banks and hence do not affect payoff. Corporates are leaving foreign bank, thus payoff of banks decreasing whereas larger base rate means lesser payoff for corporate who are staying with public banks. The decrease however is not as significant as of private banks due to reasons explained earlier in the paper.

Main advantages of Base rate syatem-

- Greater control for RBI in transferring effects of Repo rates to banks
- More transparency for customers in knowing about base rate as it is based on cost of funds.
- Stoppage of sub-prime loans to bigger corporate.
- Small and Medium Enterprises (SMEs) may get better rates. The SMEs and small borrowers are subsidizing the corporate loans.
- Deregulation of interest rates as banks will stop lending at lower rates to loans below Rs 2 lakhs. RBI has given freedom to banks to charge commercial rates for loans below Rs 2 lakh at rates linked to base rate. With this, RBI wants to increase the credit flow to small borrowers.
- Increase in liquidity of banks. As loans are not doled out on sub-prime rates, more money is left with banks.

Conclusion

Banks have to adjust to new system as quickly as possible. Cost of funds will play huge role in determination of base rates. Banks also need to look into new avenues for service quality in order to retain old customers. Old private banks face stiff competition from foreign and public banks. The need of hour for bank is product innovation and better customer service to differentiate itself from the rest of banks.

References-

1. Craig and Dinger, "**Microeconometric analysis into bank interest rate rigidity", Federal Reserve Bank of Cleveland,** March, 2010**.**

2. Allen and Morris**, "Finance Applications of Game Theory**", Wharton School ,October 2000.

3. Ila Patnaik and Ajay Shah, " **Interest Rate Volatality and Risk in Indian Banking**", IMF Paper, January, 2004.

4. Serensen and Warner, "**Bank Interest Rate pass-through in Euro Area**", European Central Bank, January, 2006.

5. Reserve Bank of India, Draft Circular, "**Base Rate for Banks**", February, 2010.

6. Vadalamudi R**, "New system of loan pricing in India",** March, 2010.