

IT'S ALL IN THE 'BASE'

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The Reserve Bank of India (RBI) released its final guidelines on the implementation of the Base Rate on April 9, 2010. Flexibility and transparency were the key themes of the final guidelines. These guidelines come into effect from July 1, 2010. Banks are now free to adopt any methodology / any benchmark and even link it to the tenor of the loans offered besides having the option to change them any time before December 31, 2010.

While at the first glance it may seem that the Base Rate is no more than another version of the Benchmark Prime Lending Rate (BPLR), we must applaud RBI's efforts to ensure transparency and consistency in the dissemination of rates and the non-discriminatory application of lending rates to all borrowers – existing and new.

Flexibility in adopting different benchmarks will enable banks to arrive at finer pricing for various products. The freedom to review rates every quarter will help banks respond better to changes in market rates.

The benchmarks are likely to be lower in order to permit maximum flexibility to banks in arriving at their final base rates. For determining the short term benchmark, most banks may reference the 91-day T-bill rates or the 90-day CP benchmark. For the medium term, the cost of deposits (Retail – one year- less than Rs. 15 lakh) and/or the one year G-sec Rate could be a useful base. In case of housing loans and infrastructure loans where the tenor of the loans ranges from 5-15 years, possible benchmarks could include a reference to the 10-year G-sec rate, the rate at which banks are able to raise capital through the issuance of Long Term instruments namely – Lower Tier II Bonds, Upper Tier II Bonds or Innovative Perpetual Debt Instruments. Banks could also decide to opt for a hybrid benchmark based on the composition of their resource profile and also the cost of each funding source.

We expect the Base Rates for the short term to be in the range of 3.75% to 4.50% while the rates for the medium term may range around 5% to 6%. Although, we do not expect these guidelines to have a huge impact on the NIMs of various banks, the actual impact of implementation of the Base Rate guidelines will begin to be visible from the second and third quarters of FY11

1. Major Changes vs Draft Guidelines

- Banks are allowed to choose **any benchmark** to arrive at the Base Rate **for a specific tenor** that may be disclosed transparently. Banks have also been given **the freedom to choose any other methodology**, as considered appropriate, provided it is consistent and made available for scrutiny, as and when required
- Banks may determine their **actual lending rates** on loans and advances with reference to the **Base Rate and** by including **such other customer specific charges as considered appropriate**
- Banks are **permitted to change the benchmark and methodology any time** during the initial six month period i.e. **upto December 31, 2010**
- The actual lending **rates charged may be transparent and consistent** and be made available for supervisory review/scrutiny, as and when required
- Banks are required to **review the Base Rate at least once in a quarter** with the **approval of the Board or** the Asset Liability Management Committees (**ALCOs**) as per the bank's practice.
- In line with the above Guidelines, banks may announce their Base Rates after seeking approval from their respective ALCOs/ Boards
- Average Return on Net Worth is now calculated using **Deployable Deposits** in the denominator **instead of Total Liabilities**, reverting to the methodology recommended by the Working Group

2. Other Terms

- The final guidelines continue to permit the following categories of loans to be priced without reference to the Base Rate :
 - (a) DRI advances
 - (b) loans to banks' own employees
 - (c) Loans to banks' depositors against their own deposits.
 - (d) Export Credit \$
- The current stipulation of BPLR as the ceiling rate for loans up to Rs. 2 lakh also stands withdrawn. It is expected that the above deregulation of lending rate will increase the credit flow to small borrowers at reasonable rate and direct bank finance will provide effective competition to other forms of high cost credit.
- The Base Rate could also serve as a reference benchmark rate for floating rate loan products, apart from external market benchmark rates (Eg. NSE Mibor). The floating interest rate based on external benchmarks should, however, be equal to or above the Base Rate at the time of sanction or renewal.

- Banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels.
- Banks are required to provide information on the actual minimum and maximum lending rates to the RBI on a quarterly basis, as hitherto.
- The Base Rate system would be **applicable for all new loans and for those old loans that come up for renewal**. Existing loans based on the BPLR system may run till their maturity. In case existing borrowers want to switch to the new system, before expiry of the existing contracts, an option may be given to them, on mutually agreed terms. Banks, however, should not charge any fee for such switch-over.
- The above guidelines on the Base Rate system will become **effective on July 1, 2010**.

\$ Update on Export Credit: According to the RBI circular dated October'09, the ceilings on interest rates on pre-shipment rupee export credit upto 270 days and post-shipment rupee export credit upto 180 days were stipulated at BPLR minus 2.5%, valid upto April 30,2010. The RBI has now extended this validity of the above dispensation upto June 30, 2010. Following the implementation of the Base Rate system w.e.f. from July 1, 2010, the interest rates on the above types of export credit have been deregulated. **Banks are now free to decide the lending rate on export credit at or above the Base Rate.** For certain employment oriented export sectors; banks can now charge interest rates not exceeding BPLR minus 4.5%, subject to a floor of 7% (i.e. the rate applicable to the Agriculture sector under Priority Sector Lending)

3. Background

- The concept of BPLR was introduced by the RBI in November 2003 for pricing of loans by commercial banks with the objective of enhancing transparency in the pricing of their loan products. However, over time the system of BPLR lost its relevance as a meaningful reference rate as the bulk of loans were advanced below BPLR. This not only made the loan pricing system non-transparent but also impeded the smooth transmission of monetary signals.
- So, following the announcement in the Annual Policy Statement for the year 2009-10, the

| Sub-PLR Lending as % to total lending ¹ | 2005 | 2006 | 2007 | 2008 | 2009 |
|--|------|------|------|------|------|
| Overall | 59 | 69 | 77 | 76 | 67 |
| Public Sector Banks | 51 | 64 | 73 | 71 | 64 |
| Private Sector Banks | 78 | 85 | 91 | 89 | 83 |
| Foreign Banks | 89 | 85 | 71 | 78 | 68 |

RBI set up a Working Group led by Shri Deepak Mohanty to review the BPLR system. The Working Group

¹ Source: RBI

suggested a switch from the BPLR system to the Base Rate system. The Base Rate represents the bare minimum rate below which it will not be viable for the banks to lend.

- Based on the recommendations of the Working Group and the suggestions received thereon, the RBI issued the draft guidelines on the Base Rate in February 2010. The Base Rate system was scheduled to replace the BPLR system from April 1, 2010. While each bank could decide its own Base Rate, some of the criteria that could go into the determination of the Base Rate are: (i) cost of deposits; (ii) adjustment for the negative carry in respect of CRR and SLR; (iii) unallocatable overhead cost for banks such as aggregate employee compensation relating to administrative functions in corporate office, depreciation, IT spending and cost incurred towards deposit insurance (iv) profit margin.
- The actual lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, namely product-specific operating costs, credit risk premium and tenor premium
- Following discussions with various bankers, the RBI deferred the implementation of the base rate system to July 1, 2010 and also agreed to exempt three kinds of loans — staff loans, loans against fixed deposits and loans under the Differential Rate of Interest scheme from being linked to the base rate.

4. Creation of a system wide LIBOR-Like Base Rate

- Ideally, the 'Base Rate' should have been a transparent system-wide risk-free reference rate which would not only be more responsive to changing market conditions but also be flexible enough to allow the each bank to incorporate product/tenor/customer specific spreads to their final lending rates – like the London Interbank Offered Rate or LIBOR.
- The LIBOR is the rate at which large international banks are willing to lend each other substantial unsecured funds on a short term basis. It is calculated on a daily basis, in 10 currencies using quotes from 8 to 16 banks having the highest credit rating and selected based on reputation, scale of market activity and perceived expertise.
- Hypothetically, a LIBOR-like Base Rate could be arrived at by considering the interbank lending rates offered by the top 10 banks (based on the amount of business and extent of capital market activity undertaken by them). These rates would mainly reflect the cost of deposits, since banks in India tend to depend on retail deposits rather than wholesale funding. The arithmetic mean of these rates could be calculated after removing outliers which could then be fixed as a system-wide benchmark rate. This rate could then be reviewed at suitable intervals – say on a weekly, if not a daily basis, considering the rather limited activity in the Indian debt markets. Each bank could then arrive at its final lending rate by adding a spread to this benchmark based on the characteristics of the loan – the tenor, the rating of the customer, the extent of security available etc.

5. Possible Methodologies

- Given the flexibility provided in the final guidelines on Base Rate and also taking into account the fact that banks will have to ensure that these rates are to be applied in a non-discriminatory manner in addition to the increased transparency (on account of display of base rates at branches and websites) we expect that the base rates will be set relatively lower. **The actual lending rates will be arrived at on a ‘Base Rate + customer specific charges’ basis rather than on a ‘BPLR – customer specific premium’ basis** which is prevalent currently.
- Instead of a single Base Rate as mooted earlier, the final guidelines permit banks to choose any benchmark for a specific tenor or even use any other methodology. We present some likely possibilities:

(a) Tenor-based Benchmark

- Since the RBI envisages that the Base Rate should also serve as the reference benchmark for floating rate loan products, we expect that **base rates for the shorter tenor would be largely driven by the need to remain competitive as also the prevailing liquidity situation. Hence, we believe that most banks may reference the yields on the 91-day T-Bill / 90-day CP benchmark while determining the Base Rate for the short term.** Since the Reverse Repo rate currently stands at 3.75% and the historical yields on the 91-day T-Bill / 90-day CP benchmark have ranged from 3% to 4.75% over the past year, **it is possible that the short term benchmark is set in the range of 3.75%-4.50%.**
- In order to determine the benchmarks **for the medium term, banks are likely to give some weightage to asset liability management and consider factors like the marginal cost of funds, the prevailing yields on the one year G-sec, the rate of interest offered on retail deposits (less than Rs.15 lakh) between the one to three year periods, the type of loan etc.** Currently the rate offered by most banks for retail deposits for this tenor range between 5.50%-7.50%. The RBI has also provided an illustrative methodology for computation of the Base Rate using the Cost of Deposits as a benchmark. According to this formula, the Base Rate is arrived at as follows:

Base Rate = a+b+c+d where:

a – Cost of Deposits/ Funds - (D_{cost})

b – Negative Carry on CRR and SLR - $\{[(D_{cost} - (SLR * T_r)) / (1 - (CRR + SLR))] * 100\} - D_{cost}$

c – Unallocable Overhead Cost – $(U_c / D_{ply}) * 100$

d– Average Return on Networth – $[(NP / NW) * (NW / D_{ply})] * 100$

Where:

D: Total Deposits = Time Deposits + Current Deposits+ Saving Deposits

D_{ply}: Deployable Deposits = $D * [1 - (CRR + SLR)]$

CRR: Cash Reserve Ratio

SLR: Statutory Liquidity Ratio

T_r: 364 T-Bill Rate

U_c: Unallocable overhead costs

NP: Net Profit

NW: Net Worth = Capital + Free Reserves

Based on the representative data for the year 2008-09, the illustrative Base Rate as calculated by the above formula stood at 8.55%. Given their low CASA base, the Base Rate for Private sector banks would tend to be on the higher side

- However, we expect **that for the medium term, the rates may be closer to the interest rates offered on retail deposits for (less than Rs.15 lakh) and be in the range of 5% to 6% leaving enough scope for banks to offer competitive lending rates after including suitable spreads to arrive at their respective lending rates.**
- In case of housing loans and infrastructure loans where the tenor of the loans ranges from 5 to 15 years, banks are likely to factor in their Asset-Liability positions, the yield on the 10-year G-sec, the rate at which banks are able to raise capital through the issuance of Long Term instruments namely – Lower Tier II Bonds, Upper Tier II Bonds or Innovative Perpetual Debt Instruments while determining a suitable benchmark.

(b) Single Simple Benchmark:

- In case a bank decides to opt for a single and simple benchmark, it would most likely be set closer to or even linked to the short-term lending rates i.e. the Reverse Repo rate or the 91-day T-Bill or the 90-day CP benchmark rate. In such case, we expect the Base Rate to be in the range of 3.75% to 4.50%.
- Having such a low Base Rate would provide increased flexibility to banks in order to arrive at a competitive lending rate – by adding specific premia for the kind of product, the tenor, the customer rating (internal or external) etc.

(c) Single Hybrid Benchmark:

- The Bank could also decide on a benchmark based on its resource profile, assigning weightages to the cost of each funding source. For instance, a bank where borrowings (Subordinated Debt, Upper Tier II Bonds, Perpetual Bonds, etc) account for 5% of the total resources, CASA deposits for 20% of the resources, bulk deposits for 15%, Time Deposits for 50% and shareholders' funds account for the rest, could arrive at a hybrid base rate based on the cost of each source weighted by its share in the resource profile. This would take into

account not only the market rates (through Borrowing costs and bulk deposit costs) but also the cost of deposits.

- The Base Rate could then be calculated as follows:

Base Rate = 5%*(Cost of borrowings#)+20%*(CASA cost)+15%*(Bulk Deposits cost)+50%*(Time Deposit Cost) +10%*(Required Return on Shareholder Funds)

#Cost of Borrowings refers to the cost of raising long term debt mainly through the issuance of Subordinated Debt, Upper Tier II instruments or Innovative Perpetual Debt Instruments

6. Conclusion

- While no single approach for the determination of base rates is perfect, the hybrid approach should be most likely to be used considering that it adequately captures the sensitivity of the cost of funds for a bank

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