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# External Benchmark - Loan Pricing

## Why in news?

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

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## What are the drawbacks of current practise?

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- The present loan pricing regime is based on marginal cost of fund based lending rate (MCLR). Click here to know about MCLR.
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- The Study Group has noted that MCLR is calculated based on banks' internal factors such as cost of funds.
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- These internal factors are insensitive to changes in the policy interest rate or repo rate.
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- Though MCLR includes repo rate, the effect of change in repo by RBI is not fully translated to the public.
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- It has also been found that banks deviated from the specified methodologies for calculating the rates.
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- Arbitrariness in calculating the MCLR and spreads charged over them has thus undermined the integrity of the interest rate setting process.
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## What are the suggested measures?

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- **Benchmark -** The study group has cited some 13 possible options as external benchmarks for determining interest rates.
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- The group has shortlisted 3 among these, one of which is to be selected by the RBI. Those are-
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1. T-Bill rate
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2. Certificates of Deposit (CD) rate
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3. RBI's policy repo rate
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- It has been recommended that all floating rate loans extended beginning April 1, 2018 could be referenced to the selected external benchmark.
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- 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.
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- **Duration -** It suggested that lending rates should be reset once every quarter, from the current practice of once a year.
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- **Interest Rate Spread -** Also, the decision on the interest rate spread over the external benchmark should be left to the commercial judgment of banks.
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- However, the spread fixed at the time of sanction of loans to all borrowers should remain fixed all through the term of the loan.
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## Quick Facts

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## Interest rate spread

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

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

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- A certificate of deposit (CD) is a savings certificate with a fixed maturity date and specified fixed interest rate.
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- A CD restricts access to the funds until the maturity date of the investment.
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## Source: The Hindu

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