

MASTER CIRCULAR ON INTEREST RATES ON ADVANCES

A. Purpose

To consolidate the directives on interest rates on advances issued by Reserve Bank of India from time to time.

B. Classification

A statutory directive issued by the Reserve Bank in exercise of the powers conferred by the Banking Regulation Act, 1949.

C. Previous instructions

This Master Circular consolidates and updates the instructions on the above subject contained in the circulars listed in **Appendix**.

D. Application

To all scheduled commercial banks, excluding Regional Rural Banks.

1. Introduction

1.1 In the context of granting greater functional autonomy to banks, interest rates on advances have been progressively deregulated by Reserve Bank of India with effect from October 18, 1994.

Banks are therefore free to determine the lending rates on the advances as per their Board approved policy subject to the following guidelines:-

2. PLR/ BPLR System

Banks were required to obtain the approval of their respective Boards for the Prime Lending Rate which was the minimum rate charged by them for the credit limits of over Rs 2 lakhs. In case of loans up to Rupees two lakh, it was decided to continue to protect these borrowers by prescribing the lending rates. With effect from April 29, 1998, it was decided that interest on Credit limit of Rs. 2 lakh and below shall not exceed PLR which was available to the best customer of the concerned bank.

In order to enhance transparency in bank's pricing of their loan products as also to ensure that the PLR truly reflects the actual cost, in year 2003, it was decided to abolish the prescription of minimum lending rate for credit limits of over Rupees two lakh and banks were given the freedom to fix the lending rates for such credit limits subject to Benchmark Prime Lending Rate (BPLR) and spread guidelines. Banks were required to obtain the approval of their respective Boards for the BPLR, which would be the reference rate for credit limits of over Rs. 2 lakh. Each bank's BPLR had to be declared and be made uniformly applicable at all branches. BPLR continued to be the ceiling rate of interest for advances upto Rs. 2 lakh.

Interest rates under the BPLR system were applicable to all loans sanctioned up to June 30, 2010. The guidelines on BPLR and Spreads and its determination for existing loans sanctioned up to June 30, 2010 are given in **Annex 2** and **Annex 3**.

3. Base Rate System

The Base Rate system was introduced with the aim of enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy.

3.1 With effect from July 1, 2010, all categories of domestic rupee loans should be priced only with reference to the Base Rate. Thus 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.

3.2 Computation of Base Rate

Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. There can be only one Base Rate for each bank. Banks may choose any benchmark to arrive at the Base Rate that may be disclosed transparently. An illustration for computing the Base Rate is set out in **Annex 1**. Banks are free to use any

other methodology, as considered appropriate, provided it is consistent and are made available for supervisory review/scrutiny, as and when required.

While computing Base Rate, banks will have the freedom to calculate cost of funds either on the basis of average cost of funds or on marginal cost of funds or any other methodology in vogue, which is reasonable and transparent provided it is consistent and made available for supervisory review/scrutiny as and when required. It is clarified here that where the card rate for deposits of one or more tenor is the basis, the deposits in the chosen tenor/s should have the largest share in the deposit base of the bank.

3.3 Review of Base Rate

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. Since transparency in the pricing of lending products has been a key objective, 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 Reserve Bank on a quarterly basis, as hitherto.

3.4 Review of Base Rate Methodology

(i) Banks that have commenced their banking operations in India after September 2, 2013 will be allowed to revise their Base Rate methodology within a year from the date of commencement of their business operations in India.

(ii) With a view to providing banks greater operational flexibility, it has been decided to allow banks to review the Base Rate methodology after three years from date of its finalization. Accordingly, banks may change their Base Rate methodology after completion of prescribed period with the approval of their Board of Directors/ ALCO.

(iii) Banks will, however, not be allowed to change their methodology during the review cycle.

3.5 Spread

(i) Banks should have a Board approved policy delineating the components of spread charged to a customer. It should be ensured that any price differentiation is consistent with bank's credit pricing policy.

(ii) Bank's internal pricing policy must spell out the rationale for, and range of, the spread in the case of a given category of borrower, as also, the delegation of powers in respect of loan pricing. The rationale of the policy should be available for supervisory review.

(iii) The spread charged to an existing borrower should not be increased except on account of deterioration in the credit risk profile of the customer or change in the tenor premium. Any such decision regarding change in spread on account of change in credit risk profile should be supported by a full-fledged risk profile review of the customer. The change in tenor premium should not be borrower specific or loan class specific. In other words, the change in tenor premium will be uniform for all types of loans for a given residual tenor.

(iv) The guidelines contained in sub-paragraph (iii) above are, however, not applicable to loans under consortium/ multiple banking arrangements.

3.6 Determining Lending Rates

Banks should 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. The actual lending rates charged should be transparent and consistent and be made available for supervisory review/scrutiny, as and when required. Since the Base Rate will be the minimum rate for all loans, banks are not permitted to resort to any lending below the Base Rate. Further, changes in the Base Rate shall be applicable in respect of all existing loans linked to the Base Rate, in a transparent and non-discriminatory manner.

Even after introduction of the Base Rate system, banks would have the freedom to offer all categories of loans on fixed or floating rates subject to conformity to the ALM guidelines. 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. Where loans are offered on fixed rate basis, notwithstanding the quarterly review of the Base Rate, the rate of interest on fixed rate loans will continue to remain the same subject to the condition that such fixed rate should not be below the Base Rate at the time of sanction. If the base rate is revised upward thereafter and in the process the fixed rate falls below the new Base Rate, it would not be construed a violation of the guidelines on Base Rate.

3.7 Exemption from Base Rate guidelines

3.7.1 The following categories of loans could be priced **without** reference to the Base Rate:

- (a) DRI advances
- (b) loans to banks' own employees including retired employees
- (c) loans to banks' depositors against their own deposits

3.7.2 In those cases where subvention is available to borrowers, it is clarified as under:

(i) *Interest Rate Subvention on Crop Loans*

a) In case of crop loans up to Rupees three lakh, for which subvention is available, banks should charge farmers the interest rates as stipulated by the Government of India. If the yield to the bank (after including subvention) is lower than the Base Rate, such lending will not be construed a violation of the Base Rate guidelines.

b) As regards the rebate provided for prompt repayment, since it does not change the yield to the banks [mentioned at (a) above] on such loans, it would not be a factor in reckoning compliance with the Base Rate guidelines.

(ii) *Interest Rate Subvention on Export Credit*

Interest rates applicable for all tenors of rupee export credit advances will be at or above the Base Rate. In respect of cases where subvention of Government of India is available, banks will have to reduce the interest rate chargeable to exporters as per Base Rate system by the amount of subvention available. If, as a consequence, the interest rate charged to exporters goes below the Base Rate, such lending will not be construed a violation of the Base Rate guidelines. (The last Rupee Export Credit Interest Subvention Scheme of Government of India was valid upto March 31, 2014).

3.7.3 *Restructured Loans*

In case of restructured loans if some of the Working Capital Term Loan (WCTL), Funded Interest Term Loan (FITL), etc. need to be granted below the Base Rate for the purposes of viability and there are recompense etc. clauses, such lending will not be construed a violation of the Base Rate guidelines.

3.7.4 In the following cases where refinance is available to banks, banks are allowed to charge interest at the rates prescribed under the schemes to the extent refinance is available. Such lending, even if it is below the Base Rate, would not be considered a violation of our Base Rate Guidelines. Interest rate charged on the part not covered under refinance should not however be below Base Rate.

(a) Extending subsidized loans to entrepreneurs under the scheme formulated by Government of India, Ministry of New and Renewable Energy (MNRE) on financing of Off-Grid and Decentralised Solar (Photovoltaic and Thermal) applications

(b) Extending financial assistance under Micro Credit scheme of National Scheduled Tribes Finance and Development Corporation (NSTFDC) and various schemes of National Handicapped Finance and Development Corporation (NHFDC)

(c) Extending financial assistance under schemes of National Safai Karmacharis Finance & Development Corporation (NSKFDC)

(d) Lending to Primary Agricultural Credit Societies (PACS) for short term seasonal agricultural operations where refinance is available from NABARD

(e) Bank Finance extended to the beneficiaries of the schemes of National Scheduled Caste Finance & Development Corporation (NSFDC)

(f) Bank Finance extended to the beneficiaries of the schemes of the Indian Renewable Energy Development Agency Limited (IREDA) supported by the National Clean Energy Funds (NCEF)

(g) Bank finance extended to the beneficiaries of the schemes of National Backward Classes Finance & Development Corporation (NBCFDC)

(h) Bank finance extended to the beneficiaries of special refinance scheme for flood affected areas of Jammu & Kashmir formulated by National Housing Bank (NHB)

4. Charging of Interest at Monthly Rests

(i) Banks have been advised to charge interest on all loans/ advances at monthly rests with effect from April 01, 2002. The interest charged should be rounded off to nearest rupee.

(ii) Instructions on charging interest at monthly rests shall not be applicable to agricultural advances and banks shall continue to follow the existing practice of charging / compounding of interest on agricultural advances linked to crop seasons. As indicated in circular RPCD.No.PLFS.BC.129/05.02.27/97-98 dated June 29, 1998, banks should charge interest on agricultural advances for long duration crops at annual rests. As regards other agricultural advances in respect of short duration crop and allied agricultural activities such as dairy, fishery, piggery, poultry, bee-keeping, etc., banks should take into consideration due dates fixed on the basis of fluidity with borrowers and harvesting / marketing season while charging interest and compounding the same if the loan / installment becomes overdue. Further, banks should ensure that the total interest debited to an account should not exceed the principal amount in respect of short term advances granted to small and marginal farmers.

5. Differential Rate of Interest for Micro and Small Enterprises (MSEs)

While pricing their loans to MSE borrowers, banks should take into account the incentives available to them in the form of the credit guarantee cover of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) and the zero risk weight for capital adequacy purpose for the portion of the loan guaranteed by the CGTMSE and provide differential interest rate for such MSE borrowers, than the other borrowers. However, banks should note that such differential rate of interest is not below the Base Rate of the bank.

6. Loans under Consortium Arrangement

Banks need not charge a uniform rate of interest even under a consortium arrangement. Each member bank may charge a rate of interest on the portion of the credit limits extended by it to the borrower, subject to the condition that such rate of interest is determined with reference to its Base Rate.

7. Withdrawals Against Uncleared Effects

As a measure of customer service, any charging of interest should not apply to the facility afforded to depositors for immediate credits in respect of cheques sent for collection.

8. Penal Rate of Interest

Banks are permitted to formulate a transparent policy for charging penal interest with the approval of their Board of Directors. However, in the case of loans to borrowers under priority sector, no penal interest should be charged for loans up to Rs. 25,000. Penal interest can be levied for reasons such as default in repayment, non-submission of financial statements, etc. However, the policy on penal interest should be governed by well-accepted

principles of transparency, fairness, incentive to service the debt and due regard to genuine difficulties of customers.

9. Zero Percent Interest Finance Schemes for Consumer Durables

Banks should refrain from offering low / zero percent interest rates on consumer durable advances to borrowers through adjustment of discount available from manufacturers / dealers of consumer goods, since such loan schemes lack transparency in operations and distort pricing mechanism of loan products. These products do not also give a clear picture to the customers regarding the applicable interest rates. Banks should, also, not promote such schemes by releasing advertisements in different newspapers and media indicating that they are promoting / financing consumers under such schemes. They should also refrain from linking their names in any form / manner with any incentive-based advertisement where clarity regarding interest rate is absent.

10. Excessive Interest Charged by Banks

Though interest rates have been deregulated, charging of interest beyond a certain level is seen to be usurious and can neither be sustainable nor be conforming to normal banking practice. Boards of banks have, therefore, been advised to lay out appropriate internal principles and procedures so that usurious interest, including processing and other charges, are not levied by them on loans and advances. In laying down such principles and procedures in respect of small value loans, particularly, personal loans and such other loans of similar nature, banks should take into account, inter-alia, the following broad guidelines:

a. An appropriate prior-approval process should be prescribed for sanctioning such loans, which should take into account, among others, the cash flows of the prospective borrower.

b. Interest rates charged by banks, inter-alia, should incorporate risk premium as considered reasonable and justified having regard to the internal rating of the borrower. Further, in considering the question of risk, the presence or absence of security and the value thereof should be taken into account.

c. The total cost to the borrower, including interest and all other charges levied on a loan, should be justifiable having regard to the total cost incurred by the bank in extending the loan, which is sought to be defrayed and the extent of return that could be reasonably expected from the transaction.

d. An appropriate ceiling should be fixed on the interest, including processing and other charges that are levied on such loans, which should be suitably publicised.