RBI makes External Benchmark Based Interest Rate mandatory for certain categories of loans from October 1, 2019

The Reserve Bank of India has been examining the feasibility of mandating the use of external benchmark for determining interest rate on floating rate loans. In August 2017 the RBI constituted an Internal Study Group (ISG) to examine the working of the Marginal Cost of Fund Based Lending Rate (MCLR) system that was put in place in April 2016. The report of the ISG, which recommended the move over to an External Benchmark based Lending rate system was placed in public domain in October 2017.

It has been observed that due to various reasons, the transmission of policy rate changes to the lending rate of banks under the current MCLR framework has not been satisfactory. The RBI therefore has issued a circular making it mandatory for banks to link all new floating rate personal or retail loans and floating rate loans to MSMEs to an external benchmark effective October 1, 2019. The banks are free to choose one of the several benchmarks indicated in the circular. The banks are also free to choose their spread over the benchmark rate, subject to the condition that the credit risk premium may undergo change only when borrower's credit assessment undergoes a substantial change, as agreed upon in the loan contract.

External Benchmark Based Lending:

(a) All new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises extended by banks from October 01, 2019 shall be benchmarked to one of the following:

- Reserve Bank of India policy repo rate
- Government of India 3-Months Treasury Bill yield published by the Financial Benchmarks India Private Ltd (FBIL)

- Government of India 6-Months Treasury Bill yield published by the FBIL
- Any other benchmark market interest rate published by the FBIL.

(b) Banks are free to offer such external benchmark linked loans to other types of borrowers as well.

(c) In order to ensure transparency, standardisation, and ease of understanding of loan products by borrowers, a bank must adopt a uniform external benchmark within a loan category; in other words, the adoption of multiple benchmarks by the same bank is not allowed within a loan category.

Spread under External Benchmark: Banks are free to decide the spread over the external benchmark. However, credit risk premium may undergo change only when borrower's credit assessment undergoes a substantial change, as agreed upon in the loan contract. Further, other components of spread including operating cost could be altered once in three years.

Reset of Interest Rates under External Benchmark: The interest rate under external benchmark shall be reset at least once in three months.

Transition to External Benchmark from MCLR/Base Rate/BPLR: Existing loans and credit limits linked to the MCLR/Base Rate/BPLR shall continue till repayment or renewal, as the case may be.

Provided that floating rate term loans sanctioned to borrowers who, in terms of extant guidelines, are eligible to prepay a floating rate loan without pre-payment charges, shall be eligible for switchover to External Benchmark without any charges/fees, except reasonable administrative/ legal costs. The final rate charged to this category of borrowers, post switchover to external benchmark, shall be same as the rate charged for a new loan of the same category, type, tenor and amount, at the time of origination of the loan. Provided that other existing borrowers shall have the option to move to External Benchmark at mutually acceptable terms. Provided that the switch-over shall not be treated as a foreclosure of existing facility.

Please find enclosed the detailed circular on External Benchmark Based Lending released by RBI for your kind reference.

Please contact for any query related to this mail to Ms. Surbhi Sharma, Associate Economist at surbhi@phdcci.in with a cc to Dr. S P Sharma, Chief Economist at spsharma@phdcci.in of PHD Chamber.

Warm Regards,

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