<u>Why do we need external benchmarks while pricing loans?</u>
9th October, 2017

An internal Study Group constituted by the Reserve Bank of India (RBI) has recommended that banks should set interest rates based on an external benchmark and not as per internal benchmarks as is the practice now.

<u>What is the need for external benchmarks</u>?

The present loan pricing regime, that is, the marginal cost of fund based lending rate (MCLR) or the base rate under the previous regime were both calculated based on banks' internal factors such as cost of funds. They are insensitive to changes in the policy interest rate or repo rate. Also, banks deviated in an ad hoc manner from the specified methodologies for calculating the base rate and the MCLR to either inflate the base rate or prevent the base rate from falling in line with the cost of funds.

<u>What external benchmarks are available?</u>

The study group has cited 13 possible candidates as external benchmarks including the weighted average call rate (WACR), collateralised borrowing and lending obligation (CBLO) rate, market repo rate. However, the report also said that no instrument in India met all the requirements of an ideal benchmark.

The group has shortlisted 3 candidates from these 13 — one of which could be selected by RBI as external benchmarks after receiving feedback from all stakeholders. The Study Group is of the view that the T-Bill rate, the CD rate and the RBI's policy repo rate are better suited than other interest rates to serve the role of an external benchmark.

<u>To be looked in UPSC Paper 3 Topic:</u> Inclusive growth and issues arising from it.