OVERVIEW OF CREDIT MANAGEMENT

CHAPTER 17 MODULE C PART 3 By Ashish Sir

Loan System for Delivery of Bank Credit

To enhance credit discipline among larger borrowers who avail of substantial working capital facilities from the banking system, the **Reserve Bank of India (RBI)** has introduced specific guidelines. These **guidelines ensure a structured delivery of bank credit** by emphasizing a **loan component** within the working capital limits.

Key Provisions of the Loan System

1. **Applicability**:
   - The guidelines apply to borrowers with **aggregate fund-based working capital limits** of **₹150 crores and above** from the banking system.
2. **Minimum Loan Component**:
   - For such borrowers, at least **60% of the sanctioned fund-based working capital limit** (including ad hoc limits and TODs) must be drawn as a **loan component (Working Capital Loan)**.
   - This ensures that a **minimum 60% of the working capital credit** is structured as a loan.

3. **Cash Credit Facility**: Drawings exceeding the 60% minimum **loan component threshold** can be allowed in the form of a **cash credit facility**.
4. **Exclusions for Bifurcation**:
   - The bifurcation of the **working capital limit** into **loan and cash credit components** will exclude:
     - **Export credit limits** (pre-shipment and post-shipment credit).
     - **Bills limit** for inland sales.
5. **Commercial Paper Investments**: **If the bank invests in** commercial papers (CPs) **issued by the borrower,** this investment will be **considered part of the** loan component, provided it is sanctioned as part of the working capital limit.

Interest Rates on Advances

Background and Evolution

- **Base Rate and MCLR System**:
  - The **Marginal Cost of Fund Based Lending Rate (MCLR)** system was introduced in **April 2016** to improve the transmission of monetary policy.

- Before this, the **Base Rate system** was used, but both systems were found to have limited effectiveness in transmitting monetary policy changes to lending rates.

Internal Study Group (ISG):

- In **August 2017**, the **RBI's Internal Study Group (ISG)** reviewed the MCLR system.
- The group noted that internal benchmarks like Base Rate/MCLR failed to deliver **effective monetary policy transmission**.

Shift to External Benchmarks:

Based on the ISG's recommendation, the RBI mandated banks to adopt an **external benchmark-based lending rate system** for floating rate loans, ensuring more transparent and effective rate-setting.

Current Guidelines for Pricing Advances

1. **Adoption of External Benchmarks:**
   - Banks must link all new floating rate loans to specific **external benchmarks**, such as:
     - **Repo Rate** (published by RBI).
     - Yield on **91-day Treasury Bills**.
     - Yield on **182-day Treasury Bills**.

- Any other **benchmark market interest rate** published by the Financial Benchmarks India Pvt. Ltd. (FBIL).

2. **Applicability of External Benchmark**:
   - The external benchmark system applies to:
     - Floating rate loans for **retail borrowers** (e.g., housing and personal loans).
     - Floating rate loans for **Micro, Small, and Medium Enterprises (MSMEs)**.
3. **Reset Frequency**: Interest rates linked to external benchmarks must be reset at least **once every three months** to ensure better transmission of monetary policy.
4. **Spread and Margins**:
   - Banks have the **freedom to determine the spread** over the benchmark rate, based on borrower-specific factors such as creditworthiness.
   - **Changes to the spread are restricted unless there is a clear deterioration in the borrower's credit profile.**
5. **Transparency**:
   - Banks are required to transparently publish:
     - Their **external benchmark rate**.
     - The **spread** over the benchmark.
     - The **reset frequency** for loans.

6. **Existing Loans**: For loans under the Base Rate or MCLR system, borrowers have the option to switch to the external benchmark system.

General Guidelines on Interest Rates on Advances

The Reserve Bank of India (RBI) has provided the following general guidelines for scheduled commercial banks regarding interest rates on advances, as outlined in the **Master Directions**:

1. **Compliance with RBI Directions**:
    - Banks must adhere to the terms and conditions specified in the **RBI Master Directions dated March 3, 2016**, when charging interest on advances.
2. **Policy Approval by the Board**:
    - Each bank is required to formulate a **comprehensive policy** on interest rates for advances.
    - This policy must be **approved by the Board of Directors** or a **delegated committee** of the Board.
3. **Floating Rate Loans Based on External Benchmarks**:
    - ***Effective dates for External Benchmark-Based Lending Rates (EBLR):***

- **October 1, 2019**: All new floating rate personal or retail loans (housing, auto, etc.) and loans to **Micro and Small Enterprises**.
- **April 1, 2020**: Floating rate loans to **Medium Enterprises**.

Other rupee loans sanctioned or credit limits renewed from **April 1, 2016**, will continue to be priced with reference to the **Marginal Cost of Funds Based Lending Rate (MCLR)** unless the bank decides to switch to EBLR for these loans as well.

4. **Choice of Fixed or Floating Interest Rates**:
   - Banks are free to offer advances with **fixed or floating interest rates**.
   - **For fixed-rate loans with a tenure below 3 years,** the interest rate must not be lower than the **benchmark rate** for similar tenures.
5. **Fair Interest on Small-Value Loans**:
   - Interest rates on small-value loans (e.g., personal loans) must be **reasonable and justifiable**.
   - The rates should consider:
     - The total cost incurred by the bank to extend the loan.
     - A fair return on the transaction.
6. **Interest Rates on Advances in Foreign Currency**:

- Banks have the **freedom to determine interest rates** on foreign currency loans.
- These rates must reference a **market-determined external benchmark**.
- The actual lending rate will be determined by adding the appropriate **spread** to the external benchmark.

MARGINAL COST-BASED LENDING RATE

- It will be used as internal benchmark all the rupee loans sanctioned and credit limits renewed w.e.f 1.4.2016 bought to be priced at MCLR.

It has four components

- **Marginal cost of funds**: it has two components a) marginal cost of borrowing b) return on net worth
- **Negative carry, on account of cash reserve ratio**: arises due to nil return on CRR balances
- **Operating cost:** relates with all the operating costs with providing the loan product
- **Tenor premium:** charge to cover the loan commitments with the longer tenor.

Banks to publish the internal benchmark for the following maturities:

a) Overnight MCLR

b) One-month MCLR

c) 3-month MCLR

d) 6-month MCLR

e) 1-year MCLR or any other longer maturity

There should be no lending below the MCLR of a particular maturity

It should be published for different maturities every month

Exemptions from MCLR

a) Loans under scheme of government of India

b) Loans as part of restructuring package

c) Loans under various refinance schemes

d) Loan to depositors against their own deposits

e) Loan to bank employees

f) Fixed rate loans

g) Loans linked to external benchmark

External Benchmark-based Lending Rate (EBLR)

The **EBLR** system, introduced by the Reserve Bank of India (RBI), is designed **to enhance transparency and ensure better transmission** of monetary policy rates. The key features of the EBLR system are:

1. **Permissible Benchmarks for EBLR**:

   Banks must benchmark their external lending rates to one of the following:

- **RBI Policy Repo Rate**.
- **Government of India 3-Month Treasury Bill Yield**, as published by the **Financial Benchmarks India Private Ltd (FBIL)**.
- **Government of India 6-Month Treasury Bill Yield**, as published by FBIL.
- **Any other market-based benchmark interest rate**, published by FBIL.

2. **Eligibility for Other Borrowers**: Banks have the flexibility to extend external benchmark-linked loans to borrowers outside the mandated categories (e.g., retail and MSME loans).

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3. **Uniform Benchmark for Loan Categories**:

- To maintain **transparency**, **standardization**, and **ease of understanding** for borrowers, banks must adopt a **single external benchmark** for all loans within a particular loan category.
- **Multiple benchmarks** for the same loan category are **not permitted** by any bank.

Treatment of Interest Rates Linked to BPLR/ Base Rate/ MCLR for Pre-EBLR Regime Borrowers

1. **Continuation of Existing Rates**:
    - Loans and credit limits linked to **BPLR (Benchmark Prime Lending Rate)**, **Base Rate**, or **MCLR (Marginal Cost of Funds-based Lending Rate)** will **continue** under the agreed terms until the loan is **repaid** or **renewed**, as applicable.
2. **Option for Switchover to EBLR**:
    - **Floating Rate Term Loans**:
        - Borrowers with floating rate loans eligible to prepay without prepayment charges can **switch to EBLR** without

incurring any charges or fees, except for reasonable **administrative or legal costs**.

- Upon switching, the **final rate of interest** for the borrower will be the same as that applicable to **new loans** of the same category, type, tenor, and amount at the time of origination of the loan.

OTHER BORROWERS

- Borrowers with existing loans (not floating rate loans) linked to BPLR/ Base Rate/ MCLR can opt to **move to EBLR** at **mutually acceptable terms**.
- This transition will **not be considered a foreclosure** of the existing facility.

- **Levying of penal rate of interest**
- From October 10th 2000, banks may formulate transparent policy for charging penal interest with approval of their board of directors. Penal interest may be levied for default in repayment, non-submission of financial statements etc.

Fixed Interest Rate	Floating Interest Rate
Higher Interest Rate	Lower Interest Rate
Not affected by financial market conditions	Affected by changes in the financial market. Rate is modified periodically on the basis of changes in the benchmark.
Fixed EMIs	EMIs change as per interest rate or MCLR
Budget planning possible	Difficult to budget or manage financials
Sense of security	Generates savings
Suitable for short/ medium term (3-10 years)	Suitable for long term (20-30 years)
Lesser risk	Higher risk

CAPITAL MARKET EXPOSURES	
Statutory limit on share shareholding in Companies.	**Sec 19(2) of the Banking Regulation Act, 1949:** No Banking company can hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.
Advances against Shares to	Rs.10 lakh if the securities are held in physical form (margin 50%) and Rs. 20 lakhs if the securities are held in demat form

Individuals from the Banking system.	(margin 25%).
Financing of Offering (IPO).	Rs.10 lakh [Restricted to 90%] (not to be extended to Corporate and NBFCs).
Bank finance to assist employees to buy shares of their own Co's under ESOP	Employee Stock ownership Plan 90% of the purchase price the shares or Rs.20 lakh, whichever is lower.