

What it means for your home loan

The Mint Money

By [Bindisha Sarang](#) on Jul 01, 2010

From today, the banking system in India has moved from operating behind steel doors to behind glass. Today the banks move to a new benchmark system called the base rate from the earlier opaque benchmark prime lending rate (BPLR) model. A base rate is the minimum rate that a bank can charge its borrowers. This change marks the end of the inherently unfair BPLR system that allowed banks to manipulate the rate such that retail borrowers lost. They paid more when interest rates rose because banks were quick to raise the BPLR, but the reserve simply would not happen—banks kept the BPLR high and allowed new customers to come in at lower rates, keeping their captive customers at rates that were two to five percentage points higher than the new customers. For instance, if you take a loan of Rs10 lakh for 10 years at 12% per annum, each percentage point adds Rs1,435 per lakh to the equated monthly instalment. The logic and promise of a flexible rate loan, specially for home loan borrowers, was broken. The new base rate system could mean that at least new customers will have a fairer deal, though the older ones may still have to fight to get to the base rate system.

One benchmark for all loans

The issue with the BPLR, apart for being non-transparent, was that BPLR rates were different for different category of loans such as corporate and retail to name just two, apart from the same bank having two prime lending rates for the same category of borrowers making a mockery of the regulation. The base rate will prevent such instances of institutional subterfuge.

C.S. Jain, head—personal banking, IDBI Bank Ltd says, “Base rate is not applicable for export advances, to staff loans and to loans to banks’ depositors against their own deposits.” This means, barring a few, all your loans, be it home loan, education loan, personal loans, including corporate loans, will be pegged to the bank’s base rate. And this base rate is same for industry and retail borrowers. Says K. Unnikrishnan, deputy chief executive, Indian Banks’ Association: “Each bank can have just one base rate at any given point of time. It is calculated by a fixed formula, and can be reviewed every quarter by the bank board.” The formula is in the public domain and can be analysed. But that was not the case with BPLR system. Says Harsh Roongta, CEO, Apnapaisa.com: “BPLR was no benchmark, it was a meaningless benchmark as it was not linked to anything. We might as well say that it was linked to growth rate of pigs in India, and we would have had the same result. There was no compulsion on banks as to why that particular BPLR was there.”

How does a base rate work

The bank will announce a base rate and then price its loans above that. If the Bank of Baroda (BoB) rate is 8% and it is lending to a large company, the loan may be priced at base rate plus 2, or 10%. A small firm may get a rate of base rate plus 6, or 14%. A home loan could be base rate plus 4, or 12%. Now if the interest rates soften, the bank will have to reduce its base rate. Suppose BoB declares 7.5% as its base rate, all loans will float down by 0.5 percentage points.

Says M.D. Mallya, chairman and managing director, BoB: “The other benefit is the transmission of policy guidelines. When interest rates change consequent to macroeconomic conditions, the transmission to the system would become faster.”

Why will it be fairer

Since all loans are pegged to it and this includes large companies that have the bargaining power, competition will ensure that the base rate is flexible downwards and not just upwards. Says Jain: "When there will be general fall in the market rates, the banks will review their base rate, because base rate is based on certain figures. When one of those figures changes, banks will have to take a review. Any bank that does not take a review will be totally out of the market."

However, there is a fair amount of disbelief on the base rate really working and off-the-record conversations ask if the Reserve Bank of India (RBI) will be able to implement the guidelines, or will the banks find some other way to manipulate this system as well. Says Roongta: "The base rate system is definitely a step in the right direction. How much right or not will we see on how it will be implemented. Let the regulator ensure that there is transparency. The regulator has shown a lot of effort in making it transparent, but it will depend on implementation."

What happens to existing customers

So people taking a fresh loan will benefit, but what if you already have a BPLR-linked loan? The rules say that you will continue to run with the old benchmark and would need to talk to your bank to move you to the new system. If the bank agrees, you will move for no fee. However, moving may not be as easy as it looks. Says a state-owned bank's officer who does not want to be named: "Even if the existing customer is permitted by RBI to switch to the new base rate system, the banks will not volunteer. It is the customer who has to approach the bank. Which bank will want a 16% interest paying customer to shift to a fairer system?"

What about new customers

The base rate system would be applicable for all new loans effective from today. In fact RBI in its notification says, "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." Which means that whenever the base rate changes in future your base rate will change as per the new rate, however the spread will remain constant.

So, does it mean that lower the base rate, better it's for you to take a loan? Adhil Shetty, CEO, Bankbazar.com says, "I do not think that base rate will help you compare as to which bank is good and which bank is not good. Second, when one bank is charging higher or lower rate, no one can go and argue and adjust your rate. While deciding on a loan, its best to look at the total cost of the loan instead of only the base rate."