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How will borrowers' EMIs be reset after RBI decision to link loans to external benchmarks?

BY PREETI MOTIANI, ET ONLINE | SEP 06, 2019, 11.47 AM IST

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From October 1, 2019, any personal, housing or auto loan etc. taken by you from a bank will be linked to any one of the 4 external benchmarks specified by the Reserve Bank of India (RBI). According to the circular issued by the central bank dated September 4, 2019, banks can benchmark the interest charged on the loans that they offer to any one of the following: (a) RBI's repo rate, (b) Government of India three-months Treasury Bill yield published by the Financial Benchmarks India Private Ltd. (FBIL), (c) Government of India six-months Treasury Bill yield published by the FBIL and (d) Any other benchmark market interest rate published by the FBIL.

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Most PSU banks have already started offering home loans, vehicle loans with interest rate linked to RBI's repo rate. Post RBI's new directive, all the private as well as public sector banks will now have to link interest rates charged on new loans to any one of the external benchmarks mentioned above.

However, the question arises how your EMI will change as and when RBI changes its key policy rate or there is a change in the external benchmark to which your loan's interest rate is linked. What are the other factors that can impact your EMI?

- **Reset period of EMI**

RBI's circular says that the interest rate linked to an external benchmark has to be reset at least once in three months. For the borrowers, this would mean that banks would now have to reprice the interest rates on loans every three months to pass on any changes in the external benchmark rate.

Aditya Kumar, Founder & CEO Qbera.com, an online lending platform says, "Banks have been directed by the RBI to reset their offered interest rates at least once in 3 months. This means that effective changes in interest rates will happen at least once every 3 months, and possibly more than once within a given 3-month period. Banks are required to adjust rates as per any external benchmark published by FBIL (Financial Benchmarks India Private Limited) or as per the RBI's repo rate. If the RBI cuts its repo rate in its bi-monthly policy statement on October 1st, interest rates don't necessarily have to be reset only on January 1st. The reset can happen anytime within the given 3-month period. It is, however, mandatory to reset interest rates at least once every 3 months, effective from 1st October 2019."

Gaurav Gupta, CEO & Founder, MyLoancare says, "RBI circular says, that the reset period should be at least once in three months, which means that the reset period should be three months or less. The objective of fixing the reset period is to ensure that policy transmission happens for majority of customers. However, there is still a possibility that transmission is done with a lag and the customer may even miss a monetary policy revision."

Gupta explains this with an example. Assuming, a borrower takes a loan on September 15 with a reset period of 3 months. Let us say then in the October monetary policy review the RBI cuts the repo rate by 25 bps. In this case, under the new rate regime, the borrower will not get immediate benefit of the rate cut as the interest rate on his loan will only get revised in December on the reset date. However, if the apex bank cuts the repo rate again in December, the borrower could benefit from both of these rate cuts.

However, if the reset date is 2 months instead of 3 months, then the borrower will be eligible for a rate cut of 25 bps from November onwards on the basis of the repo rate cut that happened in October monetary policy review.

Currently, according to State Bank of India's (SBI) website, in case of change in repo rate by the RBI, the repo rate linked rate (RLLR) will be changed from the first day of the following month. Therefore, if the RBI cuts rate in the next bi-monthly monetary policy scheduled to be held in October, then interest rate under RLLR will be reset from November 1.

How your EMI for RLLR linked loans will be impacted if RBI cuts repo rate by 25 bps

Loan Amount (Rs)	30,00,000
Tenure in years	20
Rate of Interest (% p.a.)	8.75%
EMI (Rs)	₹ 26,511
New Rate of Interest after rate cut (% p.a.)	8.50%
New EMI (Rs)	26,035
Drop in EMI (Rs)	₹ 476

Source: Qbera

- **Operating costs and credit risk**

Another thing that can have an impact on your EMI will be the spread charged over and above the external benchmark. As per the circular, the banks are free to charge a spread over the external benchmark. However, the circular strictly prohibits them from lending below the external benchmark rate.

SBI's RLLR linked home loan has a base spread of 2.25 per cent over the repo rate and additional 40-110 bps is levied depending on the risk profile of the borrower and loan amount. The RBI's circular has further said, "*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.*"

"This essentially means that a consumer's cost of borrowing, although linked to external benchmarks, can change if his credit health changes substantially. This typically means that if a consumer's credit risk has gone up, the cost of borrowing can correspondingly go up as well," adds Kumar.

Also, any changes in the operating cost of the bank can also affect the spread charged by the bank on the loan. Therefore, if the operating costs of the bank go up then such costs will be passed on to you with an increase in the spread. However, such reset can happen only once in three years.

Gupta says, "RBI has allowed banks to make adjustments to the spread every three years to take into account any changes in its future operating costs.

However, this clause can be potentially misused by banks to change the spread for existing home loan customers without adequate basis. This we think, is a loophole and RBI should plug it in with appropriate checks and guidelines."

However, remember there will be no pre-payment charges in repo-rate linked loans as RBI does not allow these charges by the banks and NBFCs on the floating rate loans taken by individuals.

Therefore, if a lending bank unreasonably increases the spread/margin it charges over and above the external benchmark some years after the borrower has taken the loan, then the borrower can prepay the loan. In order to prepay the loan, he can take a new loan from another bank on better terms.

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