Update

Bank Rate Hiked- Effect on Other Interest Rates

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Banks extend credit facilities in the form of long term loans, short term overdraft facilities and discounting of bills. The banks, in turn, look up to the apex bank to meet their finance needs. Reserve Bank of India (RBI) provides bill re-discounting facilities to the banks or simply buys the bills from the banks. ***Bank rate is the benchmark rate at which RBI buys or re-discounts bills of exchange or other commercial papers eligible for purchase under the Banking Regulation Act, 1949.***

❖ BANK RATE AND OTHER POLICY RATES:

Besides bank rate, the other policy rates are:

- *Repo Rate:* Repo transaction is one where banks borrow money from the RBI to meet short term needs, by selling securities (usually bonds) to the RBI with an agreement to repurchase the same at a pre-determined rate and date. The interest rate charged by RBI on the cash so borrowed is called repo rate. Presently, repo rate is 8.50%. Repo is a mode of infusing liquidity in the economic system.

- *Reverse Repo Rate:* In a reverse repo, the RBI borrows money from banks by lending securities. RBI then pays interest at the reverse repo rate. RBI seeks to drain liquidity through reverse repo. Presently, the reverse repo rate is 7.50%

❖ STAGNANCY IN THE BANK RATE:

RBI fixed the bank rate as 6% in April, 2003 and the rate has remained unchanged since then. The stagnancy in the bank rate may be attributed to the following:

- Repo Rates and Reverse Repo Rates acquired the dominant position for the purpose of giving effect to monetary policies by undergoing suitable alterations from time to time under the *Liquidity Adjustment Facility*[1]*(LAF)*

- *Marginal standing facility (MSF)* was introduced in the Monetary Policy for 2011-12, in line with Liquidity Adjustment Facility. Under the facility, the Scheduled banks can avail overnight, upto 1% of their respective Net

[1] Under Liquidity Adjustment Facility, reverse repo auctions and repo auctions were conducted by RBI on daily basis so that the banks can ward off their day to day mismatches in liquidity. It was in force till May 3, 2011.

Demand and Time Liabilities (NDTL) outstanding at the end of the second preceding fortnight. The rate of interest on amount availed under MSF is 100 basis points[2] above the LAF repo rate. ***Presently, the MSF rate is 9.50%.*** The MSF rate in many ways serves the purpose of the bank rate.

As we can see, from the policy point of view, the repo rate, reverse repo rate or MSF rate assume more significance than the bank rate. Earlier the stress was on providing facilities to banks under LAF, and now under MSF..

Currently, the bank rate is used as a penal rate charged on banks for shortfalls in meeting their reserve requirements viz. Cash Reserve Ratio and Statutory Liquidity Ratio. Bank rate is also used by several other organisations as a reference rate for indexation purposes. ***One important consideration is the reference to the bank rate under Section 372A of the Companies Act.***

❖ THE SUDDEN HIKE:

As mentioned earlier, the bank rate was kept unchanged at 6% since April, 2003 while there were intermittent modulations in the repo rate. Technically speaking, bank rate (also known as the discount rate) should be higher than the repo rate.

Therefore, in consultation with various organisations and stakeholders relying on the bank rate as the reference rate, *RBI decided to bring the bank rate in alignment with the MSF rate*. Consequently**, *RBI has increased the bank rate by 350 basis points i.e. from 6.00% to 9.50%*** vide its **Circular[3] dated February 13, 2012.** Further, as specifically emphasized by the RBI, the change can be *"viewed and understood as one-time technical adjustment to align the Bank Rate with the MSF rate rather than a change in the monetary policy stance"*.

❖ EFFECT OF THE HIKE ON INTER-CORPORATE LOANS AND ADVANCES:

Section 372A of the Companies Act deals with Inter-Corporate Loans and Advances. As per the provisions laid down, a company shall not make any loan to any bodies corporate, either directly or indirectly, of an

[2] One basis point is one-hundredth of a percentage point. Therefore, 100 basis points represent 1%.
[3] The RBI Circular dated February 13, 2012 can be viewed at:
http://rbidocs.rbi.org.in/rdocs/notification/PDFs/BRS130212FL.pdf

amount exceeding 60% of its paid-up share capital and free reserves, or 100% of its free reserves, whichever is higher. Further, sub section 3 of the said section enumerates that ***"no loan to any body corporate shall be made at a rate of interest lower than the prevailing bank rate, being the standard rate made public under section 49 of the Reserve Bank of India Act, 1934"***

The 3.5% leap taken by the bank rate will definitely affect the loans given under Section 372A of the Companies Act, which pursuant to the revision by the RBI cannot be given at a rate less than the prevailing bank rate of 9.50%.

- ***Effect on the lending company:***

  The lending company will be required to make suitable amendments in the clauses pertaining to interest, in the loan agreement where loans were extended specifying the extant bank rate (for instance, interest @ 6%). Failure to revise may result in a violation of Section 372A of the Companies Act.

- ***Effect on the borrower company:***

  As the interest rate on the inter-corporate loans is linked to the bank rate (as for example, interest at the prevailing bank rate or bank rate plus a certain percentage), the hike will impose additional interest burden on the borrowing entity.

To conclude, it can be said though RBI mentions the hike as one-time technical adjustment, yet the change has got far-reaching effects since the penal interests or any other interest, e.g. the one under Section 372A of the Companies Act, linked to the bank rate will stand revised, with implications which will create a panic situation for the borrower company.