

# RBI Notifies Banks to Link Medium Enterprise Loans with External Benchmark

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**The Reserve Bank of India (RBI) has directed Banks to link floating rate loans to the Medium Enterprises with External Benchmark.**

**Loans extended from April 1, 2020, by Banks to Medium Enterprises shall be linked to External Benchmarks, says RBI.**

In October 2019 RBI rolled out a circular asking Banks to link floating rate personal and retail loans with external benchmarks. The circular also notified the linking of floating rate loans to Micro and Small Enterprises (MSEs) with external benchmarks.

As per RBI's recent notification, the introduction of external benchmark system has improved the monetary policy transmission of the sectors whose floating rates loans were linked to the external benchmarks.

This improvement in the Monetary Policy Transmission motivated RBI further to strengthen the Monetary Policy Transmission of Medium Enterprises. As per RBI's notification, the apex bank has decided to ***link all new floating rate loans to the Medium Enterprises extend by banks from April 1, 2020, with external benchmarks.***

Last year in October RBI introduced the external benchmark regime. RBI gave many options of External Benchmark Rate or the reference rate, which includes:

- Reserve Bank of India policy Repo Rate.
- Government of India 3-Months and 6-Months Treasury Bill yields published by Financial Benchmarks India Private Ltd (FBIL).
- Any other benchmark market interest rate published by FBIL.

All these rates mentioned above will remain similar for the Medium Enterprises as well.

As per Reserve Bank of India's circular banks are free to charge margin and risk premium over and above the external benchmark. Let us understand with an example. Let's say a Bank adopted the repo rate as an external benchmark. To calculate the interest rate that will be charged on loans by the Bank, firstly margin is added to the repo rate which leads to repo rate linked lending rate (RLLR) and then risk

premium is added to the RLLR. The final result after the addition of RLLR and risk premium will be the interest rate that shall be charged by the Bank.

This decision of RBI of linking of loans with external benchmark boils down to the fact that if there is any downward revision of rate from the prescribed external benchmark rates, and then Banks will necessarily have to revise rates and pass on the benefits at the similar rate.

However, if RBI increases the key policy rates, then Banks shall also hike the interest rates.

### **Take Away**

The move from RBI of linking Medium Enterprise Loans with External Benchmark aims at strengthening Monetary Policy Transmission so that Medium Enterprises can avail the benefits of reduction in key lending rate. Since February 2019, RBI has reduced the repo rate or short term lending rate by 135 basis points.