ROYAL MONETARY AUTHORITY OF BHUTAN
Minimum Lending Rate

Reference No: RMA/RSD/293

21st July 2016
Updated on 8th August 2016

Circular

In exercise of the powers conferred by Section 203 (e) and Section 210 of the Financial Services Act of Bhutan 2011, the Royal Monetary Authority of Bhutan (RMA) hereby issues the Circular on Minimum Lending Rate to all the Financial Institutions (FIs) replacing the existing Base Rate System with effect from 1st August 2016. The new interest rate policy was approved by the Board during its 112th meeting held on 20 June 2016 and subsequently endorsed by the Cabinet during its meeting held on 17th July 2016.

The RMA is pleased to issue this updated circular following the completion of bilateral consultative workshops with the banks on computation of Minimum Lending Rate from July 27-29, 2016. ***Accordingly, the RMA has finalized the Single MLR at 6.75% based on data for 30 June 2016.***

I. Rationale

A recently concluded review of the Base Rate System has revealed several rigidities in the system: (i) Computation was backward-looking and pre-emptive since the previous year's costs were extrapolated into the coming year's lending; (ii) Computation also included a double accounting of margins which resulted in high lending rates, while deposit rates remained rigid; (iii) Use of multiple Base Rates and computation of the previous year's average return on net worth (ARNW) discouraged competition and financial innovation; and, (iv) the Base Rate was used as a tool to address multiple objectives, such as promoting transparency in loan pricing and curtailing excessive credit growth.

The Minimum Lending Rate (MLR) is a forward-looking and integrated policy expected to address the rigidities of the existing Base Rate System. The main objective of the

MLR is to encourage competition and professionalism among the financial institutions to result in a balanced approach of engaging in financial intermediation.

II. Computation of Minimum Lending Rate

The MLR is a single benchmark or minimum reference rate for lending of money across all financial institutions.

The MLR uses three cost parameters that are common across all banks. **A single MLR is computed by averaging the MLR of the individual banks.**

Minimum Lending Rate = (i) Marginal Cost of Funds + (ii) Negative Carry Charges on CRR + (iii) Operating Costs

(i) **Marginal Cost of Funds** for a bank is the marginal cost of mobilizing all funds (such as deposits and borrowings) calculated as under:

For each type of fund = Interest rate x Percent Share to Total Funds

(ii) **Negative Carry Charges on CRR:** the negative carry on the mandatory CRR which arises due to return on CRR balances being nil, will be calculated as under:

Required CRR x (marginal cost) / (1- CRR)

The marginal cost of funds arrived at (i) above shall be used for arriving at negative carry on CRR.

(iii) **Operating Costs** for each bank is calculated as a function of total funds of the bank, calculated as under:

(Operating Cost / Total Funds) x 100

Since the MLR will be reviewed on a semi-annual basis, only the half-yearly operating cost will be accounted while computing the MLR.

Numerical examples for computing the above three parameters are illustrated in the Annexure attached with this circular.

III. Computation of Final Lending Rate

On the single, common MLR, each financial institution shall competitively add its expected spread – which is the Average Return on Net Worth (ARNW) – to arrive at the **median final lending rate**.

Financial institutions shall compute their product-specific final lending rates by adding the following components on to the MLR: (i) **Credit Risk Premium**; (ii) **Tenor Risk Premium**; and (iii) **Business Strategy.**

(i) The **credit risk premium** charged to the customer representing the default risk arising from loan sanctioned shall be arrived at based on a standard credit appraisal model. The financial institutions shall have developed their own models latest by December 2017.

In the interim period, to ensure uniformity and address practical problems, the computation of credit risk premium shall be product specific rather than borrower specific.

(ii) The **tenor risk premium** shall not be borrower specific or loan class specific but shall be uniform for all types of loans for a given tenor.

The financial institutions may choose to apply either fixed or residual maturities for assessing their tenor risk premium depending upon the choice over fixed or flexible interest rate system.

(iii) The **business strategy** component shall be arrived at by taking into consideration the market competitiveness and the financial institutions' business strategy. The business strategy shall be computed based on a transparent policy approved by the Board.

IV. Applicability

(i) The single MLR computed by averaging the MLR of each bank shall be used by all financial institutions (banks and non-banks) to compute their final lending rates.

(ii) The final lending rates computed from the MLR shall be applied only to new loans. The financial institutions may uniformly offer fixed or flexible interest rate choices to consumers, to be reflected in the signed loan agreements.

(iii) The application of the final lending rates based on the MLR for existing loans including those that fall due for renewal, restructuring, and rescheduling shall be at the discretion of the financial institutions.

(iv) The financial institutions cannot lend below the MLR, except for those types of loans listed under **Section V below.**

V. Exemptions

The following types of loans shall be exempted from the MLR-based computed final lending rates:

(i) Advances to depositors against their own deposits;
(ii) Loans for liquidity management of a maturity of less than 90 days;
(iii) Consortium loans approved by the Royal Government for Bhutan for investment in strategic sectors that are of national interest;
(iv) Strategic/priority sectors as defined from time-to-time by the RMA; and
(v) Staff Incentive Loans.

VI. Implementation, Review and Supervision

(i) The MLR shall be reviewed on a semi-annual basis, based on the end of June and December months' balance sheets. The reviewed MLR shall be finalized and implemented within two months i.e. by the end of August and February respectively.

(ii) The revised MLR shall be announced by the RMA.

(iii) The RMA shall monitor the strict implementation and compliance of the above provisions by the financial institutions.

(iv) In line with section 166 of the RMA Act 2010, the RMA shall conduct periodic supervision of the financial institutions' books of accounts to monitor the computation of final lending rates.

(Dasho Penjore)
Governor
Royal Monetary Authority of Bhutan

Copy to:

1. Hon'ble Prime Minister of Bhutan, for favour of kind information.
2. Hon'ble Minister, Ministry of Finance, Tashichhodzong, Thimphu for favour of kind information.
3. Secretary, Ministry of Finance, Tashichhodzong, Thimphu for favour of kind information.
4. Chief Executive Officers, all Financial Institutions (FIs), Thimphu for information and necessary action.

Annexure

Computing the MLR: A Numerical Illustration

Type of Deposits	Interest rate (Existing)	Outstanding Deposits Amounts (Nu)	Weights (%) (Share in Total Deposits)	Marginal Cost (%) (Interest Rate x Weight)
i. Recurring Deposits				0.89
91 to 364 days	5.0%	1,030,637,087	9.1	0.46
365 to 729 days	7.0%	560,976,846	5.0	0.35
730 to 1094 days	7.5%	121,234,971	1.1	0.08
ii. Fixed Individual Deposits				0.38
91 to 364 days	7.0%	264,871,038	2.3	0.16
365 to 729 days	7.5%	224,199,488	2.0	0.15
730 to 1094 days	7.5%	96,251,644	0.9	0.06
iii. Corporate Time Deposits				2.46
91 to 364 days	6.0%	1,317,186,558	11.7	0.70
365 to 729 days	7.0%	2,414,662,680	21.4	1.50
730 to 1094 days	7.5%	389,277,490	3.5	0.26
iv. Current Account	0.0%	2,074,502,301	18.4	0.00
v. Savings Account	5.0%	2,281,410,000	20.2	1.01
vi. Bonds	6.0%	500,000,000	4.4	0.27
TOTAL DEPOSITS (i+ii+iii+iv+v)		11,275,210,102		
			MARGINAL COST OF FUNDS:	5.00

Computation of Negative Carry Charges on CRR

	Percent
Marginal Cost of Funds / Deposits for Bank A (%)	5.00
CRR (%)	10
Negative Carry on CRR (%)	= 10 x (5.00) / (100-10) or 0.1 x (5.00) / (1-0.1) **= 0.55**

Computation of Operating Cost

Operating Costs	321,025,868
Total Funds	11,275,210,102
Operating Costs as a Function of Total Funds (%)	**2.85**