

Floating Rate Loans

For Prelims: Reserve Bank of India (RBI), Equated Monthly Installments (EMIs), Floating Rate

Loans

For Mains: Concept of floating rate loans, Challenges in the financial institutions

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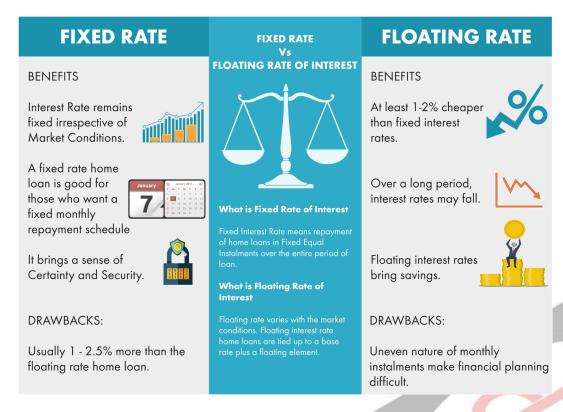
Why in News?

Recently, the <u>Reserve Bank of India (RBI)</u> will introduce a comprehensive framework to enhance transparency and establish proper rules for resetting <u>Equated Monthly Installments (EMIs)</u> for floating rate loans.

This move aims to address borrower concerns and ensure fair practices by financial institutions.

What are Floating Rate Loans?

- Floating rate loans are loans that have an interest rate that changes periodically, depending on a benchmark rate or the base rate.
 - This base rate, such as the <u>repo rate</u> rate at which RBI lends money to financial institutions is influenced by market forces.
- Floating-rate loans are also **known as variable or adjustable-rate loans,** as they can vary over the term of the loan.
- Floating rate loans are common for credit cards, mortgages, and other consumer loans.
- Floating rate loans are beneficial to borrowers when interest rates are expected to drop in the future.
 - In contrast, a fixed interest rate loan requires a borrower to pay set installments during the loan tenure. It offers a greater sense of security and stability in times of fluctuations in the economy.



What is the Need for the New Transparent Framework?

- Until recently, the RBI had been raising the repo rates in order to contain inflation. With a rise in repo rates, the floating rates too increase. This translates into higher EMIs for borrowers.
 - But it has been found that instead of asking for higher EMIs, some banks are simply increasing the tenure of the loan without informing the borrower.
 - This is making loan repayments unreasonably long and without proper consent from borrowers.
- Prevent borrowers from being harmed by changes in the internal benchmark rate and the spread during the term of the loan.
- Address issues faced by borrowers such as lack of information about foreclosure charges, switching options, and key terms and conditions.

What are the Features of the Framework Proposed by RBI?

- Lenders should communicate clearly with borrowers on resetting the tenor and/or EMI.
- RBI has asked lenders to **offer borrowers an option to switch to fixed-rate home loans** or foreclosure of loans whenever they want.
- Banks would also need to disclose various charges incidental to the exercise of these options beforehand to borrowers and properly communicate key information to borrowers.
 - This would result in borrowers taking a more informed and calculated decision while repaying their home loans.
- Lenders should not engage in unethical or coercive loan recovery practices, such as harassment, intimidation, or violation of privacy.

How will the Framework Benefit Borrowers and Lenders?

- Borrowers will have more clarity, transparency, and choice regarding their floating rate loans, and will be able to exit or switch them without any penalty or hassle.
- Borrowers will be protected from unfair or arbitrary changes in interest rates or EMIs by lenders and will be able to plan their finances better.
- Borrowers will be treated with dignity and respect by lenders, and will not face any harassment or abuse during loan recovery.
- Lenders will be able to maintain good customer relations and trust and avoid reputational risk or legal action due to improper lending conduct.

• Lenders will be able to improve their asset quality and risk management and ensure compliance with regulatory norms and expectations.

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