



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

Source: [IE](#)








Why in News?

Recently, the [Reserve Bank of India \(RBI\)](#) will introduce a comprehensive framework to enhance transparency and establish proper rules for resetting [Equated Monthly Installments \(EMIs\)](#) 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 [repo rate](#) - 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.

FIXED RATE	FIXED RATE Vs FLOATING RATE OF INTEREST	FLOATING RATE
<p>BENEFITS</p> <p>Interest Rate remains fixed irrespective of Market Conditions.</p>  <p>A fixed rate home loan is good for those who want a fixed monthly repayment schedule.</p>  <p>It brings a sense of Certainty and Security.</p>  <p>DRAWBACKS:</p> <p>Usually 1 - 2.5% more than the floating rate home loan.</p>	 <p>What is Fixed Rate of Interest</p> <p>Fixed Interest Rate means repayment of home loans in Fixed Equal Instalments over the entire period of loan.</p> <p>What is Floating Rate of Interest</p> <p>Floating rate varies with the market conditions. Floating interest rate home loans are tied up to a base rate plus a floating element.</p>	<p>BENEFITS</p> <p>At least 1-2% cheaper than fixed interest rates.</p>  <p>Over a long period, interest rates may fall.</p>  <p>Floating interest rates bring savings.</p>  <p>DRAWBACKS:</p> <p>Uneven nature of monthly instalments make financial planning difficult.</p>

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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