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Betting on banks: New base rate to help rate transmission

By **ECONOMICTIMES.COM** | Updated: Dec 19, 2015, 11.33 AM IST [Post a Comment](#)

By **D K Aggarwal**

The Reserve Bank of India (RBI) wants banks to quickly and effectively pass on the reduction in RBI's key rates from time to time to the end consumer. So, it has introduced new methods to replace the present base rate system with effect from April 1.

Under the new methodology, banks will calculate their lending rates based on the marginal cost of funds based lending rates (MCLR), making lending rates more responsive to policy rate changes.

So far since January 2015, banks have passed on just 60-70 basis points (bps), whereas RBI has slashed its key lending rate by 125 basis points.

At present, banks set their lending rates based on the average cost of funds on outstanding deposits. The base rate system was introduced in July 2010 replacing the previous benchmark prime lending rate (BPLR).

Under the new methodology, RBI has mandated that MCLR will be a tenure-linked benchmark. It has also directed banks to arrive at the MCLR of a particular maturity by adding the corresponding tenure premium to the sum of marginal cost of funds, cost of maintaining cash reserve ratio and operating costs.

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Furthermore, RBI has asked banks to review and publish their MCLR of different maturities every month on a pre-announced date. Under the new development, banks now have to calculate MCLR for different maturities like one day, one month, three months, six months and one year.

Moreover, banks are free to include more maturities for MCLR. Additionally, it has also clarified that loans that charge fixed interest rates in initial years and floating rates in the later years should be priced according to the MCLR norms.

RBI has also set how a bank should decide its spread and said that lenders should have to determine the range of spread for a given category of borrower or type of loan. It has said the policy regarding the spread should be approved by the bank's board.

With the marginal cost of funds, including tenure premium, RBI has now moved closer to the international standards of benchmarking interest rates.

Apart from facilitating new customers to reap the benefit of lower rates, the new step will also bring in transparency in the methodology followed by banks in influencing interest rates on advances.

However, existing customers of banks will also have an option to alter to the new regime at mutually acceptable terms. Though at this point of time, banks are reluctant to comment on the new methods of calculation and its impact on revenues, RBI has given them enough time to switch over to the new regime of MCLR.

With the MCLR regime in place, any fall in deposit rates will reflect quickly in lending rates and when the deposit rates rise, lending rates will also go up quickly.

(The author is Chairman and MD, SMC Investments and Advisers. Views and recommendations expressed in this section are his own and do not represent those of EconomicTimes.com.)

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