

**TOP NEWS:** Donald Trump's plan to dump TPP is against India's interests; here's why



CFA Institute

A Difference That Matters™



[Home](#) / [Economy](#) / Raghuram Rajan sets new rules for a faster, transparent rate transmission

# Raghuram Rajan sets new rules for a faster, transparent rate transmission

Even though the RBI slashed the base rate by 125 bps within a span of less than a year, the banks haven't been able to fully pass on the benefits to borrowers, thereby forcing the central bank to switch to a new mechanism of rate calculation.

By: [George Mathew](#) | Published: December 25, 2015 4:21 PM





The RBI has been urging banks to pass on the benefit arising from repo rate cut to borrowers but with little success. (PTI photo)

---

A major concern of Reserve Bank Governor [Raghuram Rajan](#) has been the slow transmission of policy rates by banks to their customers. Since the rate reduction cycle that commenced in January, less than half of the cumulative policy repo rate reduction of 125 bps has been transmitted by banks, he says. For borrowers, the median base lending rate has declined only by 60 bps though many banks slashed deposit rates by up to 125-150 points.

The [RBI](#) has been urging banks to pass on the benefit arising from repo rate cut to borrowers but with little success. The central bank then decided to change the structure of calculation of lending rate. In short, it followed the motto: change the system if the system doesn't work. The Marginal Cost of Funds based Lending Rate (MCLR) announced by the RBI last week is not only expected to improve the transmission of policy rates into the lending rates of banks, but also set to improve transparency in the methodology followed by banks for determining interest rates.

Bankers say the RBI is expected to ensure availability of bank credit at interest rates which are fair to the borrowers as well as banks. Further, RBI says marginal cost pricing of loans will help banks become more competitive and enhance their long run value and contribution to economic growth.

For monetary transmission to happen, lending rates have to be sensitive to the policy rate. Currently, banks follow different methodologies for computing their base rate, the minimum lending rate. While some use the average cost of funds method, some have adopted the marginal cost of funds while others use the blended cost of funds (liabilities) method. The RBI deduced that Base Rates based on marginal cost of funds are more sensitive to changes in the policy rates. "While these (MCLR) guidelines will benefit the new customers, existing customers will also have an option to shift to the new regime with some conditions. Sufficient time has been given to banks to switch over to the new

regime. We have moved closer to international manner of benchmark rates,” SBI chief Arundhati Bhattacharya said. 

### **How it works**

All rupee denominated loans from April 1, 2016 will be linked to MCLR which will be calculated by banks on a monthly basis. Unlike the current base rate system, MCLR will be a tenor linked internal benchmark, which addresses major inefficiencies of the current system.

Banks will review and publish their MCLR of different maturities every month on a pre-announced date. The RBI has prescribed that banks should publish the internal benchmark for maturities: Overnight, one-month, 3 -month, 6-month and one-year MCLR. Banks will publish their MCLR of different maturities every month on a pre-announced date. The MCLR will comprise of marginal cost of funds, negative carry on account of cash reserve ratio, operating costs and tenor premium. Banks will add the spread to MCLR to factor in the credit risk or market conditions while pricing any loan.

The MCLR prevailing on the day the loan is sanctioned will be applicable till the next reset date, irrespective of the changes in the benchmark during the interim period. The exact periodicity of reset will form part of the terms of loan contracts and must be of one year or lower. Banks will continue to review and publish base rate along with the MCLR. Existing loans and credit limits linked to the base rate may continue till repayment or renewal.

The RBI has accepted the major demand of banks by not linking base rate linked existing loans to new MCLR regime. “As a result, we see minimal impact on the net interest margin (NIM) of banks due to shifting to new lending rate regime. Although new MCLR will be linked to marginal cost of funding but components like tenor premium, operational expenses and credit risk premium are within banks’ control,” said a review by Reliance Securities.

“The focus on asset liability management, higher competition due to potentially higher demand for refinancing and reduced flexibility in loan pricing will put pressure on bank’s margins,” said an analyst with Prabhudas Lilladher. Banks with higher share of

fixed rate loan portfolio and/or higher proportion of loans at the longer end will stand to benefit while banks with higher share of loans at short end will likely face yield pressure. 

### **How customers benefit**

Home and personal loan customers saw the RBI slashing repo rate by 125 points in 2015, but this benefit did not reach them in full in terms of a lower equate monthly installment (EMI) on their loans. The new system will be closer to the reality on the ground and the customer gets an idea about the rate structure more periodically. While several MCLR rates would increase operational expenses for banks, borrowers can look at the option of refinancing activity more frequently as they are likely to borrow at shorter end where the MCLR rate is lower due to lower premium.

Customers will see a fall in EMI at a faster pace when the RBI cuts the repo rate as banks will have to revise MCLR of different maturities every month on a pre-announced date. The method of calculation is clearly defined and transparent and banks can't dilly-dally on revising the lending rate whenever the RBI cuts the Repo rate. It will be immediately reflected in the monthly MCLR calculation.

“We expect short tenure MCLR of banks will be 50-120 bps below their current base rate and will help them to get back the business they had lost to the money market due to the introduction of base rate regime in 2010. Under the new MCLR system, banks are allowed to charge a differential rate for short tenure loans, which will help them to compete with money market for corporate borrowings,” said an analyst.

Both the old system and MCLR will eventually merge. “The sense I am getting is it is historical and there is a future. Future has to be on marginal based and historical can continue the way it's. That's fair. At some point of time, history will get over and we will move to marginal,” said Uday Kotak, Vice Chairman and MD of [Kotak Mahindra Bank](#).

Interestingly, the RBI has raised the possibility of a benchmark gaining traction on the lines of LIBOR (London Inter Bank Offered Rate). “They (RBI) have also made one thing clear. If the banks lend at external benchmark, it does not need to follow marginal cost

of lending. RBI has actually opened up that window. Of course we will look at benchmarks like MIBOR (Mumbai Inter-Bank Offer Rate) or something like



Treasury Bills or government securities,” Kotak said.

According to bankers and analysts, there are still some grey areas. They say tenor premium has not been defined by the RBI and there’s no clarity on whether MCLR will be based on the overall cost of funds or the cost of funds for a particular maturity segment. Further, banks still enjoy discretion in spreads and operating cost. That said, the RBI’s plan of speeding up monetary transmission is expected to show the desired results and customers can enjoy repricing of loans and faster changes in rate transmission.

---

#### PROMOTED STORIES

---



**Enjoy exciting cash giveaways and rewards with this online game!**

jungleerummy



**Van Cleef & Arpels’ new Perlée collection arrives just in time for the holidays**

LifestyleAsia



**5 ways to wear a suit for any occasion**

LifestyleAsia



**These are some of the coolest places to stay in Europe**

LifestyleAsia



**Credit card: the more you spend, the more you earn. Apply now!**

ABM MyUniverse®



**The US Presidents Ranked from Richest to Poorest**

InsideGov | By Graphiq



### 25 Dogs You Cannot Go Wrong With

PetBreeds | By Graphiq



### M&F Maiden: Malin Akerman

Muscle & Fitness



### The Rock Inspires with 'Hercules' Workout Pics

Muscle & Fitness

Recommended by

**TAGS:** Raghuram Rajan RBI

Give your rating:

Average: 5stars from1ratings

Leave a comment

ME

What is your opinion?

Name

Email

Post

I Agree to T&C

[#Discover](#)



[Download Now](#)



---

## TRENDING NOW



[Transgender faces humiliation in Kolkata bank, asks for written apology](#)



[US President-elect Donald Trump reverses stance on torture tactics](#)



[Arvind Kejriwal: Badals trying scare me away from Punjab](#)



[Demonetisation: Narendra Modi government gets cracking on printing of notes; check it out](#)



[Donald Trump calls for national healing, unity on Thanksgiving](#)



[Rupee free fall continues unabated, sheds another 27 paise](#)



[At least 40 dead in China construction accident](#)

---



[Top 5 reasons why Shahrukh Khan and Alia Bhatt's Dear Zindagi is a must-watch](#)



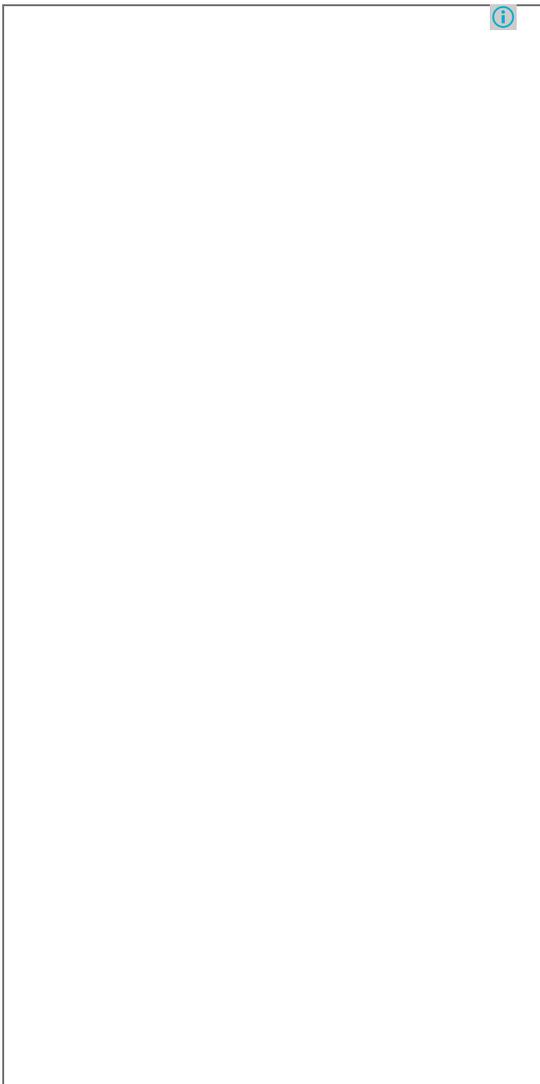
[On Donald Trump, a letter from John Cleese to the United States](#)



[Twitter suspends CEO Jack Dorsey's account; check out why](#)



[Political divide over demonetisation force GST Council meet postponement](#)



---

**EDITOR'S PICKS**

[MSDE to seek Cabinet nod to set up ITIs in 2,500 blocks](#)



[Mastercard, Visa hail government's demonetisation move](#)



[Infosys chief Narayana Murthy rues Americans failure to ink history through Hillary Clinton](#)



[Thippagondanahalli tragedy: Missing actor Raghav Uday's body found](#)



[Barack Obama campaigns for Hillary Clinton, for the last time as a President](#)



[US Presidential Elections: Voters say they might leave America if 'lunatic, racist, anti-national' Donald Trump wins](#)



[US presidential elections: Here's what will happen in Congress especially if Hillary Clinton wins](#)



[Lady Gaga calls Melania Trump's anti-bullying campaign 'hypocrisy'](#)

---

**VIDEOS**

[Netflix launches new horror series in LA](#)



[Free wifi: a wolf in sheep's clothing?](#)



Delhi woman, teenager blame each other of rape in a hotel room



2016 Range Rover Discovery Sport Startech Exterior Interior Walk around 2016 Geneva Motor Show

 **Vodafone**  
Power to you

**Get 9GB data FREE  
with 1GB on your  
new iPhone**



iPhone 7

T&C Apply. Visit: [www.vodafone.in/smartoffers](http://www.vodafone.in/smartoffers)



[Download Now](#)

[The Express Group](#) | [The Indian Express](#) | [The Financial Express](#) | [Loksatta](#) | [Jansatta](#) | [inUth](#) | [Ramnath Goenka Awards](#)  
[Privacy Policy](#) | [Advertise with Us](#) | [Contact Us](#) | [Feedback](#)

---

Copyright © 2016 The Indian Express [P] Ltd. All Rights Reserved.