

RBI just cannot get banks to lower their loan rates; why that is

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Concerned that commercial banks are not

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lowering lending rates in sync with the fall in the key policy rate, RBI had, in April 2016, introduced the concept of a marginal cost of funds rate (MCLR) which prices loans on the basis of the incremental cost of funds. Now, the central bank is suggesting banks use an external benchmark to price loans by April 2018, and all existing loans be linked to it by March, 2019. It has suggested lenders use the T-Bill, certificate of deposits (CD) or the repo. It is true there has been insufficient transmission via the base rate. This is because banks want to protect their margins and do not believe a lower rate will attract a larger volume of business that can compensate for the cut. This might seem harsh, but the fact is public sector lenders have been struggling with

loan-losses for which they need to make bigger provisions. However, it is also a fact that despite a reasonable drop in the MCLR—of around 125 basis points, compared to a fall of 200 basis points in the repo—demand for loans has not exactly surged. In a difficult environment, most lenders have understandably sought to bring down the interest rates on deposits and, thereby, lower the cost of their funds before dropping loan rates.

At the same time, the reality is that whenever banks spot a good opportunity, they are more than willing to drop rates. This explains their increasing participation in the bond and Commercial Paper (CP) markets and also the under-cutting in the loan market. It also explains why the MCLR of leading banks are almost at the same level; no bank wants to be uncompetitive. As such, while there may be some merit in transitioning to a new pricing mechanism, it will not work unless banks are willing lenders.

External benchmarks such as the T-Bill, CD and repo might prove to be more transparent. However, the money markets in India are not as large and liquid as they are overseas and, consequently, the volatility in the rates could be higher. More importantly, banks rely almost entirely on retail deposits to fund their assets with wholesale borrowings accounting for relatively small share of total liabilities. The costs of funds for banks—interest rate on deposits—is fixed and consequently re-pricing deposits takes time. On the other hand, loan rates are variable and assets are repriced faster. For banks to work with a model where the assets are priced in line with market rates but liabilities command a fixed rate will prove to be a challenge. They will be tempted to protect their margins by building in higher spreads, although they will take care to stay competitive. This will be particularly true in a scenario where interest rates are falling and lenders become vulnerable to falling net interest margins. The RBI study group has proposed that banks should accept floating rate bulk deposits, linked to one of the three external benchmarks. It is hard to say whether this will make borrowing cheaper; bulk lenders can drive a bargain. RBI has proposed in its discussion paper that the commercial spread remain fixed through the tenure of the loan and be adjusted only to reflect a credit event. It is hard to believe any banker would risk losing a good customer by increasing the spread unnecessarily. Tweaking the spread is a business decision and must be left to the discretion of the bankers. At the end of the day, competition will determine the price of loans.