

# How does an external benchmark linked lending rate help retail borrowers

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[The Reserve Bank of India](#) has decided in favour of external benchmark linked lending rates over the existing [marginal cost of funds-based lending rate \(MCLR\)](#) system. The regulator issued a circular on Wednesday mandating that banks link all new floating rate loans to an external benchmark like repo rate, 3-month or 6-month treasury bill yield, or any other benchmark published by the Financial Benchmarks India Pvt. Ltd., from 1 October 2019.

The discussion was kicked off in August 2017, when RBI constituted an Internal Study Group (ISG) to examine the efficacy of the MCLR system, which reported that the system did not allow for effective transmission of rate cuts to customers. In light of this finding, RBI decided to mandate a switch-over to an external benchmark for lending rates, as recommended by the ISG.

Even before RBI had made it mandatory, several banks, including State Bank of India, Bank of Baroda and Oriental Bank of Commerce had launched repo-linked lending rate products. This was done in an effort to ensure faster transmission of policy rate cuts to borrowers.

The repo (or repurchase) rate is the rate at which the Reserve Bank of India (RBI) lends money to other banks. Hence, cuts in the repo rate are meant to lead to cuts in home loan and other lending rates as banks get to borrow money cheaply from the RBI. By pegging the rate to an external benchmark RBI is hoping for a faster transmission of rate cuts than has happened so far under the MCLR system. RBI's statement in June noted that a 0.5% cumulative cut in February and April resulted in only 0.21% average reduction in fresh rupee loans.

The circular went on to state that while it mandated external benchmark linked lending rates to be applicable for new floating rate personal or retail loans and floating rate loans to [MSMEs](#),

banks were also free to offer such external benchmark linked loans to other types of borrowers. According to Anuj Kacker, COO & Co-Founder, MoneyTap, this is a welcome move. "Interest rates will get reduced, which should result in the cost of loans going down. People who have opted for floating interest rates will benefit from this as their EMIs will become lower," he said, adding that those who have opted for fixed interest rate loans will not see any changes.

The banks have also been asked to reset the interest rate under external benchmark at least once in three months. Under the MCLR system, even if banks were to cut rates, there was a reset clause, which meant that there could be a lag in your home loan rate being changed even if the MCLR changed, because the reset period could be as long as a year. But, in the case of external benchmark linked rate, your interest rate will be reset within three months of a rate cut.

The circular further said while the banks are free to decide the spread over the external benchmark, the credit risk premium may undergo change only when borrower's credit assessment undergoes a substantial change. But according to Gaurav Gupta, founder and CEO, MyLoanCare, there is lack of clarity about some aspects of the move, spread being one of them. "The RBI should clarify that once a spread has been fixed over an external benchmark, it should not change for the longevity of the loan. The current wording is not very clear. Under some heads the banks might have the flexibility to increase the spread, which would defeat the purpose of the move," he said.

While this change is a reason for new borrowers to rejoice, for existing borrowers, it's slightly more complicated. The circular states that "existing loans and credit limits linked to the MCLR/Base Rate/BPLR shall continue till repayment or renewal." Existing borrowers who have the option of pre-paying without incurring pre-payment charges will be eligible to shift to the benchmark-linked rate without any additional charges, except reasonable administrative and legal costs. For other borrowers, the option to move to an external benchmark will be available on the basis of their agreement with the bank.

The move is a welcome change for borrowers, and can give a much needed boost to the retail lending space, which could, in turn, boost consumption. But on the downside, the notification still lacks clarity in some aspects.

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