Cheaper repo-linked home loans? Not necessarily, so don’t rush to borrow

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While repo-linked lending rates ensure quicker transmission, they do not necessarily mean cheaper loans across all banks

With the RBI cutting its policy repo rate last week for the fifth time this year and banks linking retail loans to the external benchmark from October 1, there is optimism among borrowers that loans have become significantly cheaper. But, while the new interest rate regime adopted by banks ensures that lending rates react more quickly to the RBI’s future rate actions, it does not necessarily imply cheaper loans across banks.

Importantly, effective lending rates on home loans have at best fallen by 70-75 basis points, even after taking into account the linking of lending rates to the repo rate. This means that only about half of the RBI’s rate cut (135 basis points) so far has been passed on to borrowers. From here on, while bank lending rates will move in tandem with the RBI's action, borrowers have not received a chunk of the earlier cuts.

Here are some facts borrowers need to keep in mind before jumping onto the loan bandwagon.

Weak transmission

Till now, floating rate loans – on your home loan or vehicle loan – were linked to a bank-specific benchmark: MCLR (marginal cost of funds-based lending rate). Lending rates were arrived at by adding a spread to the MCLR. Each bank decided its benchmark based on its cost of deposits or borrowings and, hence, MCLR varied across banks.

The key concern for borrowers, as always, has been the poor transmission of policy rate actions. That is, the extent and pace of reduction in lending rates has not been in tandem with the RBI's cut in the policy repo rate.

In the current rate easing cycle, even as the RBI cut the repo rate by 110 basis points until September, the weighted average lending rates on fresh loans fell by just 29 basis points.

A key reason for the weak transmission has been that banks source only a nominal portion (1 per cent) of their deposits at RBI's repo rate. Hence, banks' cost of funds reduce or increase marginally over repo rate movement, limiting the changes in MCLR.

To address this issue, the RBI has mandated banks to link their loan rates to the external benchmark from October 1. This achieves two things. One, it removes the ambiguity and opaqueness with bank-specific benchmarks. Two, under the repo rate-linked system, RBI's rate actions will get transmitted almost immediately. Hence, every time the RBI changes its repo rate, one can be sure of changes in lending rates.

While all this is good news, borrowers should exercise caution and not be swayed by reports of cheap loans and sweet deals. Here's why.

Not much cheaper than MCLR

While lending rates under the new repo-linked structure are cheaper than that under the erstwhile MCLR regime, in most cases, there is only a slight difference between the two. For instance, for home loans in the ₹30-75 lakh bracket, SBI's lending rate in September under the earlier MCLR structure was 8.55 per cent (MCLR of 8.15 per cent plus 40 basis points mark-up) for salaried borrowers with a good credit score.

Under the new repo-linked scheme, the effective lending rate stood at 8.45 per cent (until October 4 when the RBI cut the repo rate by another 25 basis points). In the case of Bank of India, while the effective lending rate under MCLR was 8.45 per cent, that under the repo-linked loan was 8.35 per cent until the RBI's recent rate cut.

While the 25 basis points reduction in the repo rate by the RBI last week has made repo-linked home loans much cheaper, a subsequent cut in MCLR can bridge the gap once again. Hence, repo-linked loans may not be much cheaper than MCLR-linked loans.

In the case of ICICI Bank, while the effective home loan rate varied between 8.8-9.2 per cent in September under the MCLR regime (across both salaried and non-salaried), under the new repo-linked structure, the effective lending rates from October 4 range between 9.05-9.35 per cent for loans between ₹35-75 lakh.

Bottomline: The new external benchmark loan structure may not necessarily mean cheaper lending rates in all cases.

Different benchmarks

While the new structure does away with bank-specific internal benchmarks (MCLR), it does not mean that all banks will have the same benchmark. For instance, while SBI and ICICI Bank have linked their home loans to the repo rate, their benchmark rates are still different. In the case of SBI, from October 4, the benchmark, called EBR (external benchmark rate) is the repo rate plus 2.65 per cent, that is, 5.15 per cent (repo rate) plus 2.65 per cent, which is 7.8 per cent.

Over this benchmark, SBI adds a mark-up to arrive at the effective lending rate. In the case of ICICI Bank, the repo rate is the benchmark, over which the bank charges a different spread. PNB's repo-linked lending rate (RLLR) is currently at 7.8 per cent, over which a mark-up is applied.

Hence, it is important to look at the underlying benchmark of each bank.

Bottomline: While any action by the RBI in future will see lending rates move higher or lower by the same quantum in all banks, since the initial benchmark rate is different, the effective lending rate would vary across banks.

Watch out for the spread

One of the key impediments in transmission has been the ad hoc manner in which banks charge spread over the benchmark rate. Unfortunately, the new interest rate structure only partially resolves this issue.

Borrowers should remember that banks add a spread or mark-up to the benchmark rate to arrive at the effective lending rate. For instance, in the case of ICICI Bank, the spread is 3.9 per cent over the repo rate, which implies an effective lending rate of 9.05 per cent for a salaried borrower. In the case of Axis Bank, the minimum mark-up is 3.45 per cent over the repo rate, which leads to an effective lending rate of 8.6 per cent.

In some cases, banks charge an additional mark-up/ spread or risk premium before arriving at the lending rate. For instance, in the case of SBI, first there is a mark-up of 2.65 per cent over repo rate, then another 40 basis points spread for salaried borrowers with a good credit score. The effective lending rate works out to 8.2 per cent currently. In the case of Bank of India, there is a 2.85 per cent mark-up over the repo rate, then another 10 basis points risk premium. In the case of PNB, there is a 2.65 per cent mark-up over the repo rate to arrive at the benchmark lending rate, on which again there is a 55 basis points spread to arrive at the final lending rate.

As a borrower, how does one navigate through the labyrinth of spreads?

A few pointers can help. One, under the new loan structure, the RBI has mandated that while banks are free to decide the spread over the external benchmark, the credit risk premium can be changed only when the borrower's credit assessment undergoes a substantial change. Also other components of spread, including operating cost, can be altered once in three years.

Hence, note the spread charged at the time of taking the loan, and watch out for any ad hoc changes to the spread during the tenure of the loan. Two, opt for less complicated spread structures. Avoid multi-layered spreads that are difficult to decipher. Three, ensure that the risk premium charged is based on transparent credit bureau scores, rather than ad hoc internal bank policies.

Bottomline: Avoid products with opaque and multi-layered spreads/mark-ups.

Don't rush to switch

The RBI has allowed existing borrowers under MCLR to move to external benchmarked loans without levy of any charge or fee. If loans under the repo-linked structure are way cheaper than under MCLR, you can consider making the switch. But there are some important points you need to consider before making the shift.

One, while under the new repo-linked structure the RBI has mandated that loans are reset at least once in three months, this will happen only if there are any changes in the underlying repo rate. Hence lending rates from now on will fall further only if the RBI reduces repo rate further.

While the RBI’s commentary suggests that there could be one or two more rate cuts, the scope for sharp reduction is limited. This is because the RBI has already lowered repo rate by 135 basis points. Since 2000, repo rate has fallen to a lowest of 4.75 per cent in April 2009. The repo rate, currently at 5.15 per cent, implies that there is limited scope for steep rate cuts. Hence lending rates may not fall sharply.

Two, the no-charge mandate appears to apply only for making the switch within the same bank. Hence, if you are planning to move your loan to another bank, take note of the processing fee and other charges before making the move.

Finally, do a detailed cost-benefit analysis. Make the switch only if interest savings are substantial.

Bottomline: If you are at the end of your loan tenure, don’t hurry to move to the new structure. When the RBI starts hiking rates in future, it will pinch you more under the repo-linked structure.

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