Rate cut by RBI – Part II

Why in news?

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While cutting the repo rate by 25 basis points, RBI called on banks to reduce rates for existing borrowers too.

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How does the repo rate work?

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- Repo rate is the interest rate at which the RBI lends money to commercial banks.
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- It is a monetary policy instrument which can be used to control the money supply and thereby inflation.
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- By reduction the rate, borrowing becomes cheaper for the banks.
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- So the banks will end up with more money which can be lent to its customers.
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- More money with the public will result in higher economic activity thus pushing the growth of the country.
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What do banks do to subvert this?

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- Base rate is the minimum rate set by the Reserve Bank of India below which banks are not allowed to lend to its customers.
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- Banks calculate the lending rates to its customers based on the base rate.
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- The main components of base rate system are –\n
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  1. Cost of funds (interest rates offered by banks on deposits)
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  2. Operating expenses to run the bank.
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  3. Minimum Rate of return ie margin or profit
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  4. Cost of maintaining CRR
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- It does not consider ‘repo rate’ in their calculations. So the effect of Repo rate is not reflected in this.
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- Banks often does not reduce their lending rate even after the reduction of repo rate, to increase their profits.
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How was it rectified?

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- In April 2016 MCLR was introduced.
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- The components of MCLR include –\n
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  1. Operating Expenses
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  2. Cost of maintaining CRR
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  3. Marginal Cost of funds\n
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     a. After considering interest rates offered on savings / current / term deposit accounts.
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     b. Based on cost of borrowings - short term borrowing rate i.e **repo rate** & also on long-term borrowing rates.
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     c. Return on Net-worth
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4. Tenor Premium - based on the loan tenure & commitments.

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- So any change in repo rate will be reflected in lending rates too.

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What is the current problem?

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- The central bank has reduced the repo rate by 200 bps since January 2015.
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- While banks cut the marginal cost of funds based lending rate (MCLR) by up to 90 bps, the reduction in the base rate was much lower.
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- MCLR has been operational only from April 2016.
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- So a large proportion of loans are still linked to the base rate and such borrowers have not benefited to the extent of the new borrowers.
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- The difference between the base rate and MCLR, for some banks, is as high as 90-100 bps.
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- The commercial banks also have a tendency to reduce interest rates only for prospective customers in order to push new business.
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- They reduce rates for segments where competition was high as in the case of home loans and personal loans.
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- So the RBI pushed the lenders to pass on lower loan costs to borrowers who had not received the full benefit of the reductions in the policy rate.
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Source: The Hindu

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