RBI's Proposal on Loan Pricing - External Benchmark

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What is the issue?

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The Reserve Bank of India (RBI) has proposed linking the interest rates charged by banks on loans to the external benchmarks.

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What is the current practice?

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- Currently, interest rates on loans are linked to internal benchmarks.
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- All loans such as for car and home disbursed from April 1, 2016 are linked to marginal cost of funds-based lending rate (MCLR).
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- The MCLR-based regime had replaced the earlier base rate regime.
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- The shift was to provide transparency in the transmission of monetary policy decisions.
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- MCLR is an internal benchmark rate that depends on various factors such as fixed deposit rates, source of funds and savings rate.
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- The price of loan comprises the MCLR and the *spread* or the bank's profit margin.
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What is the concern with MCLR-based system?

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- The biggest problem with the current system is the lack of required

transmission of policy rates. Click here to know more.
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- The internal benchmark is not influenced solely by the policy rate cut but depends on a variety of factors.
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- So, policy rate cuts often do not reach the borrowers i.e. when the RBI cuts repo rate there is no guarantee a borrower will get the benefit of it.
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- Also, the MCLR system is opaque since it is an internal benchmark that depends on the way a bank does its business.
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How will the new system work?

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- The new system will come into effect from April 1, 2019.
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- Banks will then have to link their lending rates charged on different categories of loans with an external benchmark instead of MCLR.
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- The RBI has given the following options to banks:
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i. RBI repo rate
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ii. the 91-day *T-bill* yield
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iii. the 182-day T-bill yield
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iv. any other benchmark market interest rate produced by the Financial Benchmarks India Pvt. Ltd
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- One of these benchmarks will be used to decide the lending rate in addition to the spread.
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- Banks will be free to decide their spread value but it will have to be fixed for the tenure of the loan.
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- However, it can change if the credit score of the borrower changes.
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- The interest rates under the new system will change every month.
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How will it benefit borrowers?

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- It will help better transmission of policy rate cuts i.e. an RBI rate cut will immediately reach the borrower.
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- It will make the system more transparent since every borrower will know the fixed interest rate and the spread value decided by the bank.
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- It will help borrowers compare loans in a better way from different banks.
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- Under the new system, a bank is required to adopt a uniform external benchmark within a loan category.
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- This will ensure transparency, standardisation and ease of understanding for the borrowers.
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- This would mean that same bank cannot adopt multiple benchmarks within a loan category.
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Source: Economic Times

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Quick Facts

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Interest rate spread

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- Spread refers to the difference in borrowing rates and lending rates of financial institutions.
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- In other words, it is the interest yield on earning assets such as a loan minus interest rates paid on borrowed funds.
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T-Bill Rate

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- Treasury Bills are government bonds or debt securities with maturity of less than a year.
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- T-Bill Rates are determined by the central bank and used as a primary instrument for regulating money supply and raising funds.
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