IAS PARLIAMENT
Information is Empowering
A Shankar IAS Academy Initiative

# Transmitting the Rate Cuts

## What is the issue?

The existing home loan customers are getting differential treatment from banks and Housing Finance Companies (HFCs) in transferring the cuts in lending rates.

## What is PLR, MCLR, Repo rate?

- **Prime Lending Rate:** PLR was used as benchmark rate by banks for lending till June 2010.
- Under it, bank loans were priced on the actual cost of funds.
- However, the PLR system was opaque because bulk of wholesale credit (loans to corporate customers) was contracted at sub-PL rates.
- Under this system, banks were subsidising corporate loans by charging high interest rates from retail and small and medium enterprise customers.
- **Marginal Cost of Lending Rate**: It came into effect in April 2016 and it is a benchmark lending rate for floating-rate loans.
- This is the minimum interest rate at which commercial banks can lend.
- This rate is based on four components—the marginal cost of funds, negative carry on account of cash reserve ratio, operating costs and tenor premium.
- It is linked to the actual deposit rates i.e. when deposit rates rise, it indicates the banks are likely to hike MCLR and lending rates are set to go up.
- **Repo Rate:** It is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds.
- It is used by monetary authorities to control inflation.
- In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank.
- This ultimately reduces the money supply in the economy and thus helps

in arresting inflation.
- The central bank takes the contrary position in the event of a fall in inflationary pressures.
- When the RBI slashes its repo rate, it expects the banks to lower their interest rates charged on loans.

### How does this rate cut system works?

- The cut in rates for existing customers depends on the reduction in MCLR by banks and in PLR by HFCs in response to a repo cut by RBI.
- HFCs base their lending rates on PLR and offer a discount on it to customers which is fixed for the term of the loan.
- A cut in PLR is reflected in the effective rate for the customer within three months.
- In the case of banks, lending rates are based on either MCLR or on the repo rate.
- When RBI cuts the repo rate, the customer (on the MCLR base) will see a fall in her effective rate only if the bank lowers its MCLR.
- For new customers, banks could reduce their spread over MCLR to offer an attractive rate.
- In 2019, RBI introduced the external benchmarking system to replace the MCLR for home loans and other loans.
- This new lending rate system is only applicable for loans with floating interest rates.
- Banks now offer external benchmark-linked loans that are connected to repo rate, Government of India treasury bills, etc..

**Source: The Indian Express**