

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. \n
- By reduction the rate, borrowing becomes cheaper for the banks. \n
- So the banks will end up with more money which can be lent to its customers. \n
- More money with the public will result in higher economic activity thus pushing the growth of the country. \n

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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. \n
- Banks calculate the lending rates to its customers based on the base rate. \n
- The main components of base rate system are -\n

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- 2. Operating expenses to run the bank.
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- 3. Minimum Rate of return ie margin or profit n
- 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. \n
- 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. $\normalized{\normalized}$
- The components of MCLR include -\n

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1. Operating Expenses

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- 2. Cost of maintaining CRR n
- 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. $\ensuremath{\sc vn}$
- 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. \n
- MCLR has been operational only from April 2016. $\normalized{\carbon}$
- 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. \n
- 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. \n
- They reduce rates for segments where competition was high as in the case of home loans and personal loans.
- 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. \n

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Source: The Hindu

