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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