RBI Circular on Lending Rate

Why in news?

In a recent circular to banks, the RBI has directed lenders to link lending rate to external benchmark.

What is the rationale?

- The benefits of changes made by the RBI to the policy repo rate (rate at which RBI lends to commercial banks) is often not transmitted to the borrowers by the banks.
- In 2015, then RBI Governor Raghuram Rajan decided that the system used by banks to price their loans needed to be changed.
- So, he introduced the Marginal Cost of Funds based Lending Rate (MCLR) regime.
- In October 2017, an internal study group of the RBI recommended the adoption of external benchmarks to ensure effective policy transmission.
- This came after observing that the MCLR too had failed to deliver.
- Notably, RBI made a total of 75 basis points (bps) reduction in the repo rate between February and June 2019.
- Against this, the weighted average lending rate on fresh rupee loans at banks eased only by 29 bps.
- The current RBI move comes as an effort to address this problem of inadequate interest rate transmission.

What is the order?

- Lenders will have to link all new floating rate loans given in the personal, retail and MSME categories to external benchmarks, including the repo rate, with effect from October 1 2019.
- The banks are free to choose one of the several benchmarks:

i. RBI repo rate
ii. the 91-day T-bill yield
iii. the 182-day T-bill yield
iv. any other benchmark market interest rate produced by the Financial Benchmarks India Pvt. Ltd

- However, the RBI has made it clear that lenders would need to adopt a uniform benchmark within a particular loan category.
- Banks have also been given the leeway to determine their spread over the benchmark rate.
- This is however subject to the condition that changes to the credit risk premium can only be made when the borrower's credit assessment undergoes a substantial change.

What lies ahead?

- While the real economy needs some support, there has to be more transmission of rates happening at the first place.
- The latest move will surely lower the interest cost on new floating rate loans availed by borrowers to buy cars or homes.
- However, it may force banks to start cutting the interest rate they pay to deposit holders or risk seeing their margins shrink.
- The RBI's aim is to boost credit for the dull personal consumption and encourage borrowing by stressed MSMEs.
- But the real success of the measure will ultimately be determined by a regaining of confidence by consumers to spend and a conviction by industry to invest.

Source: The Hindu

Quick Facts

Interest rate spread

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

T-Bill Rate

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