Lending Rate Setting Mechanisms and their Efficacy

Consistent with the objective of providing credit to the productive sectors of the economy, the lending rates as well as the allocation of bank credit, was, by and large, regulated by the Reserve Bank till the late 1980s. After the initiation of financial sector reforms in the early 1990s, various steps were initiated to deregulate the lending rates of commercial banks.

The Indian banking sector has tried a number of rate-setting methods over the last few years and has moved from a Benchmark Prime Lending Rate (BPLR) system to a base rate (or minimum lending rate) system and now the Marginal Cost of funds-based Lending Rate (MCLR). However, they all had multiple issues like lack of transparency, ineffective policy transmission, cross subsidization. Let us examine the recent rate setting systems and their implementation in more detail.

BPLR is the rate at which commercial banks charge their customers who are most credit worthy and such a rate could be fixed with the approval of the bank boards. The central bank stipulated that the it should be influenced by the Repo rate and Cash Reserve Ratio (CRR) apart from individual bank's policy. However, BPLR system failed due to lack of transparency and allowed banks to lend below BPLR leading to some bad accounts. Sub-BPLR lending on a large scale has created a perception that large borrowers are being cross subsidised by retail and small borrowers. The lending rates of different banks in a deregulated competitive environment by nature are expected to be different as the cost of funds, cost of operations and margins for capital charge and profits for each bank are different. However, the experience of the BPLR system shows that BPLR of different bank groups have tended to vary significantly. Considering the above shortfalls, the base rate was introduced. In 2009, the central bank set up a working group under RBI executive director Deepak Mohanty to review the benchmark prime lending rate (BPLR). The group then recommended what is called a base rate, which is a common rate based on the banks' cost of funds. The base rate system has replaced the BPLR from July 1, 2010.

Base rate is the minimum interest rate of a bank, below which it cannot lend, except for DRI allowances, loans to bank's own employees and loans to bank's depositors against their own deposits. Individual banks were to fix their base rate and declare, thus making it a more transparent system. Loan pricing was done by adding base rate and a suitable spread depending on the credit risk premium. Banks had to revise their base rate at least once every quarter and could review the base rates more than once a quarter ensuring that banks pass on their lower cost of funds to their customers. A host of factors, like the cost of deposits, administrative costs, a bank's profitability in the previous fiscal year and a few other parameters, with stipulated weights, are considered while calculating a lender's base rate. The cost of deposits has the highest weight in calculating the base rate. Banks, however, had the leeway to consider the cost of deposits of any tenure while calculating their base rate. Base rate too failed to satisfy the RBI as policy transmission continued to be ineffective given that banks had to take a direct hit on the profitability to ensure immediate transmission and that for capital starved banks did not seem to be a promising idea. Thus, in April 2016, RBI introduced MCLR-based rate.

Every bank is required to calculate its marginal cost of funds across different tenors. To this, the banks add other components including operating cost and a tenor premium. Lending rates are reset only at intervals corresponding to the tenure of the MCLR. For monetary transmission to occur, lending rates must be sensitive to the policy rate. MCLR system facilitates this as it is mandatory for banks to consider the repo rate while calculating their MCLR. With MCLR, banks are obliged to adjust interest rate monthly. This means that frequent revisions will encourage consideration of the repo rate changes.

While the current system of MCLR seems more responsive than base rate, RBI seems to be disappointed as it noted that legacy issues, varying reset periods (for lending rates) and banks tinkering with the mark-up (spread) on MCLR to tweak the final lending rate have been deterring a full pass through of lower rates under the MCLR framework. Some of the issues mentioned have impeded the new rate system from making a real impact on the final lending rate. Since this system is now being reviewed by RBI and the observations have been made, the hope is that some of these issues would soon be addressed while still leaving the direction to market forces without RBI micro managing the rates.