MCLR Marginal Cost of Funds Based Lending Rate

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Introduction

RBI recently made its move from the historic Benchmark Prime Lending Rate (BPLR) to Marginal Cost of Funds Based Lending Rate (MCLR) in April 2016 as the current rate setting method for lending money by commercial banks

Need for MCLR

- RBI changes the repo rates and other rates periodically but the banks are slow in changing their interest rates according to RBI rates

- Most commercial banks do not change their lending rates to customers
- Ultimately, bank customers does not receive the benefits aimed by RBI
- Till now, RBI was verbally instructing the commercial banks to change their lending rates with every Repo rate change
- The real benefit of repo rate change will be realised only when the customer gets benefited
- With the New MCLR, there will be quick change in the lending rate and the commercial banks will have to oblige with RBI at a fast pace as repo rate is included in MCLR calculation

How MCLR is calculated?

- RBI has instructed all the commercial banks to calculate their marginal cost
- Novel feature of MCLR is the inclusion of repo rate along with marginal cost
- Commercial banks now must include the marginal cost components along with the repo rate to arrive at the MCLR lending rate

What are the Marginal cost components?

- Marginal cost weightage in MCLR – 92 %, return on net worth – 8%
- RBI has included the following main components in marginal cost
- Return on net worth (capital adequacy norms)
- Repo rate (short term borrowing rate) and long term borrowing rate
- Interest rate given by banks to various deposits including
- Savings deposit
- Term deposit
- Current deposit
- Foreign currency deposit

What are other components of MCLR?

- CRR negative carry charged on customers
- RBI does not pay any interest to banks for CRR maintained by them and hence banks charge interest to customers for this idle money in RBI
- Tenor premium of charging higher interest rates on long-term loans
- Exclusion of factor minimum rate of return under MCLR

- Overall, MCLR is mainly determined by the marginal cost and the deposit rate

Benefits of MCLR

- MCLR revised on monthly basis benefiting bank customers especially borrowers
- Banks to compete with commercial paper market
- Reduces borrowing cost for companies
- Indian banking industry moves towards international standards

Pitfalls

- MCLR rule exempted for loans given to retired employees, existing employees, government schemes etc
- Banks will be reluctant to change to MCLR rule due to cut in interest rates as currently, it is up to the customer to exercise their loans under MCLR as an option

Conclusion

- Bank customers will quickly get the benefit of the repo rate changes from their respective banks
- Banks also get benefited to compete with commercial paper market
- Companies and borrowers will get benefited with the low-interest rates for short term loans and reflection on repo on lending rates
- MCLR has to be implemented by RBI with a strong monitoring system to check whether banks change their lending rates according to the repo rate cuts
- The ultimate success of MCLR lies in the end user getting benefited
- Lending rates will see quick change in MCLR
- The entire economy of India will get a boost with increase in rate transparency as a result of MCLR - A change in repo by RBI reflects on the loans borrowed by individuals from banks
- Overall, this MCLR regime is one of the innovative measures of RBI to improve Indian banking system to global standards