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WHY A RATE CUT WON’T HELP LOWER LENDING RATES

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Delay in norms:As final norms have not been issued, the new external benchmark scheme is not yet in place.V.V. Krishnan

With the first bimonthly review of the Reserve Bank of India’s monetary policy of this fiscal scheduled to be announced on April 4, there is an expectation of another rate cut as inflation continues to remain soft.

Though retail inflation — the central bank’s main yardstick for policy making — rose to a four-month high of 2.57% in February, it is still below the RBI’s medium-term target of 4%.

In the previous policy in February — which was the first one under Governor Shaktikanta Das — the central bank had reduced the repo rate by 25 basis points (bps) to 6.25%. [100 basis points = 1 percentage point]

Despite the rate cut, the response from banks, in cutting lending rates, has only been partial. Only a few banks reduced their marginal cost of funds based lending rate (MCLR) — the benchmark lending rate to which all the loans are linked — by 10-15 bps.

Bankers justify not passing on rate changes to end customers on two grounds: one, their cost of deposits has not fallen with a cut in the repo rate; two, monetary transmission comes with a lag. So, even if the RBI cuts lending rates again on Thursday, it is unlikely that banks will pass on the entire benefit to the customers.

But banks have been prompt, and even ahead of the curve, when rates were rising. Many lenders, including State Bank of India and ICICI Bank, announced 20 bps MCLR hikes from March 1, 2018, while the RBI started the repo rate increase cycle only in June 2018.

Monetary transmission has been an issue for the central bank for more than a decade and all the Governors tried to address it in the last 10 years. First, Duvvuri Subbarao replaced the then benchmark prime lending rate regime with the base rate in July 2010. His successor Raghuram Rajan introduced the MCLR regime, which replaced the base rate from April 2016.

Both the base rate and the MCLR were a function of cost of funds of the banks.

With both the regimes largely failing to address the issue of monetary transmission, Dr. Rajan’s successor Urjit Patel proposed a new regime in which the floating loan rates for small borrowers would be linked to an external benchmark. Four options were given to banks to choose the external benchmark, one of them being the repo rate. In his last monetary policy held on December 5, Dr. Patel mandated that this new system of external benchmark-linked lending rates will come into effect from April 1, 2019. The final guidelines were scheduled to be issued by the end of December 2018.

The final guidelines are yet to be issued. Hence the new scheme was not made operational from the beginning of this month. Banks have opposed this system tooth and nail. They argue that the costs are not linked to external benchmark and lending rates should be a function of cost. But at the same time, SBI decided to link the savings account rate (for deposits over Rs. 1 lakh) to the

repo rate from May 1.

RBI is yet to clarify why there is a delay in implementing the scheme even after it was announced.

In the February policy, when asked about shifting the lending rate to an external benchmark, Mr. Das said: “We have received comments from the public and the banks; they are currently under examination.” The Governor may choose to clarify the RBI’s position on the issue in the monetary policy review on Thursday.

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