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INTERESTING, BUT RISKY: ON RBI'S FLOATING RATE LOANS DIKTAT

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

The Reserve Bank of India (RBI) has finally decided that it needs to address the problem of inadequate interest rate transmission head on. In a circular to banks on Wednesday, it directed lenders to link all new floating rate loans given to borrowers in the personal, retail and micro, small and medium enterprise (MSME) categories to external benchmarks, including the repo rate, with effect from October 1. While giving banks the relative freedom to choose the specific external benchmark, including yields on the 3-month and 6-month Treasury Bills published by the Financial Benchmarks India Pvt. Ltd., the central bank made it clear that lenders would need to adopt a uniform benchmark within a loan category. Banks have also, crucially, been given the leeway to determine their spread over the benchmark rate with a caveat that changes to the credit risk premium can only be made when the borrower's credit assessment undergoes a substantial change. That the inadequate transmission of policy rate moves has been an abiding conundrum for the RBI is well known. In 2015, then Governor Raghuram Rajan decided that the system used by banks to price their loans needed to be changed and so 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, after observing that the MCLR too had failed to deliver.

Policymakers, in fact, have been so vexed with poor transmission — against a total of 75 basis points (bps) reduction in the RBI's repo rate between February and June, the weighted average lending rate on fresh rupee loans at banks eased only by 29 bps — that Monetary Policy Committee member Chetan Ghate in August cited the issue as reason to oppose the proposed 35-bps cut and instead voted for a 25-bps reduction. "By a large cut (35 bps) I feel we will be burning through monetary policy space without much to show for it. While the real economy needs some support, we should wait for more transmission to happen," he said at the MPC's rate setting meeting, the minutes show. Though the latest move will surely lower the interest cost on new floating rate loans availed by borrowers to buy cars or homes, it may force banks to start cutting the interest rate they pay deposit holders or risk seeing their margins shrink. And while the RBI wants to try and nudge an uptick in credit for becalmed personal consumption and borrowing by beleaguered MSMEs, the success of the measure will ultimately be determined by a regaining of confidence by consumers to spend and a conviction by industry to invest.

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