Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: about MCLR and its significance; reasons for private banks not passing on the benefits of interest rate cuts to its customers compared to other banks

News: Private banks were the **slowest to pass** on the benefits of falling interest rates to their customers in 2019 compared to their state-run and foreign rivals, Reserve Bank of India (RBI) data showed.

Background

The **process of setting interest rates** by banks is at the **core of transmission and the central bank** has for several years been trying to make it more transparent. This has led to the **change from benchmark prime lending rate (BPLR) to base rate to MCLR** and finally to external benchmark-based lending rates.

**What does the RBI data show?**

- The median one-year marginal cost of funds-based lending rate (MCLR) for **private banks** fell a meagre 12 **basis points (bps)** to 9.18% between January and December 2019, compared to **RBI’s cumulative 135 bps cut in its key policy rate** to 5.15%. **Most bank loans are typically priced over the one-year MCLR, making it the most tracked rate.**

- In the same period, **state-run banks** have lowered their one-year median MCLR by 45 bps and **foreign banks** have cut their lending rates by 75 bps.

- **Foreign banks have the lowest median one-year MCLR** rate at 7.9% as of December. Their public counterparts are at 8.3%. For all **scheduled commercial banks** taken together, the one-year median rate stands at 8.3%.
Why are private banks showing so much reluctance?

- The reason private banks are less eager to cut interest rates lies in their cost of funds.

- **They pay the highest interest to their depositors.** Private lenders are followed by public sector and foreign banks, respectively. While private banks paid depositors 6.91% interest in November 2019 (latest data), public sector banks paid 6.65% and foreign banks 5.38%, according to RBI data on weighted average deposit rates.

- For public sector banks, credit growth is slow and, therefore, the need to aggressively mobilize deposits by offering a higher interest rate to deposits is little. Accordingly, the deposit rates for private sector banks remain higher.

- **Foreign banks, however, pay depositors less than what other categories of banks do** and, therefore, their lending rates are among the cheapest. One factor behind it is foreign banks’ limited retail franchises and the presence of large deposits from multinational corporations, which keep their money in the same bank across the world. Hence, in the absence of retail depositors, the need to offer higher deposit rates to attract retail deposits is lower than other banks. These MNCs also maintain large current account deposits instead of term deposits, leading to lower cost of deposits.

**About MCLR**

- The Marginal Cost of Funds based Lending Rate (MCLR) system was introduced by the Reserve Bank to provide loans on minimal rates as well as market rate fluctuation benefit to customers.

- This system has modified the existing base rate system of providing home loans. In this system, banks have to set various benchmark rates for specific time periods starting from an overnight to one month, quarterly, semi-annually and annually.
MCLR replaced the earlier base rate system to determine the lending rates for commercial banks. RBI implemented it on 1 April 2016 to determine rates of interests for loans.

**Its objectives:**

- To improve the transmission of policy rates into the lending rates of banks.
- To bring transparency in the methodology followed by banks for determining interest rates on advances.
- To ensure availability of bank credit at interest rates which are fair to borrowers as well as banks.
- To enable banks to become more competitive and enhance their long run value and contribution to economic growth.