B. A. (Hon). Economics

VI Semester

Paper Name : Money and Financial Markets

*Dear Students, We have been discussed Topic-1 in the previous lecture Notes. And also as I already covered (**topics-3 : Interest Rates: Determination, Sources of interest rates differentials, Theories of term structure of interest rates: interest rates in India,** Topic 3 ,chapter-1 Baye & Jansen reading) in the class room before mid break . Now in this week I would like to discuss part of Topic 3, Chapter-2 : RBI Report , October 4, 2017 according to University of Delhi Syllabus.*

Topic-3

RBI Report,October 4,2017 'Report of the Internal Study Group to Review The Working of the Marginal Cost of Funds Based Lending Rate System', Reserve Bank of India, September, 2017,

Introduction

As we have seen RBI report 2017 highlighted that an internal Study Group was constituted by the Reserve Bank of India to study the various aspects of the MCLR system from the perspective of improving the monetary transmission and exploring linking of the bank lending rates directly to market determined benchmarks. The constitution of the Study Group(July 24 2017) was announced in the Statement on Developmental and Regulatory Policies of the Reserve Bank of India on August 2, 2017. The Study Group submitted its report on September 25, 2017.

The key findings emerging from the analysis undertaken by the Study Group and the recommendations made are set out below

Monetary Transmission – the Base Rate and the MCLR Systems

A review of banks' deposit and lending rates undertaken by the Study Group indicates that the transmission from the changes in the policy repo rate has been slow and incomplete under both the base rate and the marginal cost of funds based lending rate (MCLR) systems. The monetary transmission has improved since November 2016 under the pressure of large surplus liquidity in the system post demonetisation. While the transmission to interest rates on fresh loans was significant, it was muted to outstanding loans (base rate and MCLR)

Furthermore, the transmission to lending rates was asymmetric over monetary policy cycles – higher during the tightening phase and lower during the easing phase – irrespective of the interest rate system. For instance, the pass-through to outstanding loans from the repo rate was around 60 per cent during the tightening phase (July 2010 to March 2012), while it was less than 40 per cent during the subsequent easing phase (April 2012 to June 2013).

Analysis conducted by the Study Group suggests that banks deviated in an ad hoc manner from the specified methodologies for calculating the base rate and the MCLR to either inflate the base rate or prevent the base rate from falling in line with the cost of funds. These ad hoc adjustments included, inter alia,

(i) inappropriate calculation of the cost of iv funds;
(ii) no change in the base rate even as the cost of deposits declined significantly;
(iii)sharp increase in the return on net worth out of tune with past track record or future prospects to offset the impact of reduction in the cost of deposits on the lending rate; and
(iv) inclusion of new components in the base rate formula to adjust the rate to a desired level. The slow transmission to the base rate loan portfolio was further accentuated by the long (annual) reset periods.

Overall, monetary transmission has been impeded by four main factors:

(i) maturity mismatch and interest rate risk in the fixed rate deposits but floating rate loan profile of banks;

(ii) rigidity in saving deposit interest rates;

(iii) competition from other financial saving instruments; and

(iv)deterioration in the health of the banking sector.

A major factor that impeded transmission was the maturity profile of bank deposits. Deposits with maturity of one year and above constituted 53 per cent of banks' total deposits at endMarch 2016, most of which were at fixed rates of interest. Another source of weak transmission was rigidity in interest rates on banks' saving deposits, which remained notoriously stubborn even as the policy repo rate and interest rates on term deposits moved in either direction

Spreads charged over the Base Rate and the MCLR

1. Median spreads charged over the MCLR by all bank groups remained broadly stable in the case of fresh rupee loans from April 2016 to December 2016. However, median spreads charged rose sharply in January 2017. Median spreads of public and private sector banks declined by June 2017.

2. However, while the median spread of private sector banks declined to the pre-January 2017 level, the median spread of public sector banks remained significantly above the pre-January 2017 level.

3. Spreads charged by private sector banks on fresh rupee loans were consistently the largest, followed by public sector banks and foreign banks. Spreads charged varied significantly across banks and also temporally. Spreads of foreign banks were relatively more volatile than those of public and private sector banks.

4. The transmission from the reduction in the MCLR to lending rates occurred with a lag. In the case of private sector banks, it took almost six months for the transmission from the lower MCLR to actual lending rates. However, in the case of public sector banks, the transmission was not complete even after six months.

5. The transmission to interest rates on outstanding rupee loans was significantly lower than on fresh rupee loans. 4The median spread in the case of outstanding rupee loans remained significantly higher than that of fresh rupee loans, reflecting the dominance of base rate loan portfolio in outstanding loans and lagged interest rate reset (normally one year) for the existing borrowers under the MCLR system. Spreads on outstanding loans were also more volatile than those on fresh loans.

6. Being an internal benchmark, the MCLR is expected to vary across banks. The spread over the MCLR could also vary from bank to bank due to idiosyncratic factors. However, variations in the spreads across banks appear too large to be explained based on bank level business strategy and borrower-level credit risk. In particular, spreads charged by some banks seem excessively and consistently large. The analysis suggests that the spreads were mostly changed arbitrarily by banks for similar quality borrowers. While the spread over the MCLR was expected to play only a small role in determining the lending rates by banks, it turned out to be the key element in deciding the overall lending rates. This has made the entire process of setting lending interest rates by banks opaque and impeded the monetary transmission.

7. That many banks tended to charge the spreads over the MCLR arbitrarily is evident from a special study of select banks conducted by the Study Group.

8. The key findings of the study are:

(i) large reduction in MCLR was partly offset by some banks by a simultaneous increase in the spread in the form of business strategy premium ostensibly to reduce the pass-through to lending rates;

(ii) there was no documentation of the rationale for fixing business strategy premium for various sectors;

(iii) many banks did not have a board approved policy for working out the components of spread charged to a customer;

(iv) some banks did not have any methodology for computing the spread, which was merely treated as a residual arrived at by deducting the MCLR from the actual prevailing lending rate; and

the credit risk element was not applied based on the credit rating of the borrower concerned, but on the historically observed probability of default (PD) and loss given default (LGD) of the credit portfolio/sector concerned.

Recommendations

The recommendations made by the Study Group are detailed below.

★ The lower transmission from the policy rate to the base rate loan portfolio was mainly due to the reason that banks followed different methods to calculate the base rate. Banks, therefore, could be advised to re-calculate the base rate immediately by removing/readjusting arbitrary and entirely discretionary components added to the formula. It needs to be ensured that the calculation of the base rate is not compromised in any way. The methodology adopted by banks should be subject to a regular supervisory review.

★ The Study Group recommends that it should be made mandatory for banks to display prominently in each branch the base rate/MCLR (tenor-wise) and the weighted average lending rates on loans across sectors separately for loans linked to the base rate and the MCLR.

★ The Study Group recognised that internal benchmarks such as the base rate/MCLR have not delivered effective transmission of monetary policy. Arbitrariness in calculating the base rate/MCLR and spreads charged over them has undermined the integrity of the interest rate setting process. The base rate and MCLR regimes are also not in sync with global practices on pricing of bank loans. Given that there has not been much forward movement on the external benchmark even after seventeen years from the time when it was first allowed in the country, the development of an external benchmark would need guidance from the Reserve Bank.

★ The Study Group recommends that all floating rate loans extended beginning April 1, 2018 could be referenced to one of the three external benchmarks selected by the Reserve Bank after receiving and evaluating the feedback from stakeholders.

- ★ The Study Group is of the view that the decision on the spread over the external benchmark should be left to the commercial judgment of banks. However, the spread fixed at the time of sanction of loans to all borrowers, including corporates, should remain fixed all through the term of the loan, unless there is a clear credit event necessitating a change in the spread.

- ★ Banks may be encouraged to accept deposits, especially bulk deposits at floating rates linked directly to one of the three external benchmarks selected by the Reserve Bank after receiving the feedback from stakeholders as recommended by the Study Group.

- ★ The Study Group recommends that the corporates and banks be encouraged to actively manage interest rate risks once the external benchmark is introduced. It should also help deepen the IRS market, going forward.

- ★ Finally, but equally importantly, the reset clause, which is typically one year, impedes monetary transmission as the pass-through of monetary policy changes to existing floating rate loans is delayed. The Study Group, therefore, recommends that the periodicity of resetting the interest rates by banks on all floating rate loans, retail as well as corporate, be reduced from once in a year to once in a quarter.

Chapter I

In the context of India the above recommendation the RBI working groups has identified important the points given below.

The efficacy of monetary policy depends on the magnitude and the speed with which policy rate changes are transmitted to the ultimate objectives of monetary policy, viz., inflation and growth. With the deepening of financial systems and growing sophistication of financial markets, most monetary authorities use interest rate as the key instrument to achieve the ultimate objectives of monetary policy. Adjustments in the policy interest rate, for instance, directly impact short-term money market rates which then transmit the monetary policy impulses across financial markets and maturity spectrum, including banks' deposit and lending rates. These, in turn, influence consump-

tion, saving and investment decisions of firms and households, which ultimately influence aggregate demand, and hence, output and inflation.

In a bank dominated system like India, the transmission to banks' lending rates is the key to the successful implementation of monetary policy. However, the issue of transmission from the policy rate to banks' lending rates has all along been a matter of concern for the Reserve Bank. The transmission to banks' lending rates has been impeded by a variety of factors, the major one being the opacity in the process by which the banks set their lending interest rates. To address this concern, the Reserve Bank has refined the interest rate setting methodology of banks from time to time.

In 1994, when the lending interest rates were deregulated, the Reserve Bank prescribed that banks should disclose their prime lending rates (PLRs), which will be the interest rate charged for the most creditworthy borrowers. Keeping in view the request from banks that the PLR should be converted into a reference or benchmark rate for banks, the Reserve Bank advised banks in April 2003 to announce a Benchmark PLR (BPLR) with the approval of their boards. The dominance of sub-BPLR lending, however, defeated the very purpose for which the BPLR system was introduced.

The Reserve Bank instituted a new lending rate system for banks – the marginal cost of funds based lending rate (MCLR) system – effective April 1, 2016 with a view to improving transmission. The BPLR, the base rate and the MCLR were internal benchmarks set by each bank for pricing of credit. However, unlike the BPLR and the base rate, the formula for computing the MCLR was prescribed by the Reserve Bank. Since 2000, banks are also free to price credit linked to external benchmarks. However, the share of rupee loans linked to external benchmarks has been miniscule.

The experience with the MCLR system has not been satisfactory, even though it has been an improvement over the base rate system. The transmission has remained uneven in terms of its pace and magnitude: (i) across the sectors of the economy; (ii) between deposit and lending rates; and (iii) between fresh rupee loans and outstanding rupee loans. The base rates of different banks, in particular, have remained rigid since introduction of the MCLR. While the extent of change in base rate may not necessarily mirror the changes in the MCLR, the rigidity of the base rate is a matter of concern for efficient transmission of monetary policy to the real economy. Also, a large portfolio of

banks' loans – about one-fourth – continues at the base rate and does not show the expected sensitivity to changes in the policy rate of the Reserve Bank.

The spread, as measured by the difference between the lending rate and the 1-year MCLR, which was expected to be by and large stable, has shown large variations from month to month, from bank to bank and from sector to sector. While some variability in the spread over the MCLR was expected, large variations in the spreads are difficult to explain.

Chapter II

Monetary Transmission: The Base Rate and the MCLR Systems

In India, banks are the main conduits through which monetary impulses are transmitted to the real economy. Hence, it has been the endeavour of the Reserve Bank to strengthen the monetary transmission by focussing on the design of the lending interest rates of the banking system. It was in keeping with this that the Reserve Bank introduced the base rate system in July 2010, which was replaced by the marginal cost of funds based lending rate (MCLR) system in April 2016. This chapter undertakes a detailed review of the working of the base rate and the MCLR systems with a view to (i) assessing how monetary transmission has worked under these two regimes; and (ii) understanding the various factors that impede the monetary transmission.

Banks' Lending Rate Systems since the Early 1990s: An Overview

Prime Lending Rate (PLR) System II.2 After the introduction of the financial sector reforms in the early 1990s, the Reserve Bank initiated various measures to progressively deregulate the interest rates – both deposit and lending rates. In a major initiative in October 1994, the Reserve Bank deregulated lending rates for credit limits over Rs.2 lakh. Banks were also required to declare their prime lending rates (PLR), i.e., the interest rate charged for the most creditworthy borrowers. The PLR was to be computed taking into account factors such as cost of funds and transaction costs, and was expected to act as a floor for lending above Rs.2 lakh. The experience with the working of the PLR system, however, was not satisfactory mainly for two reasons: (i) both the PLR and the spread

charged over the PLR varied widely across banks; and (ii) the PLRs of banks were rigid and inflexible in relation to the overall direction of interest rates in the economy.

Benchmark Prime Lending Rate (BPLR) System

In order to improve transparency and ensure appropriate pricing of loans, the Reserve Bank advised banks in April 2003 to announce Benchmark PLRs (BPLRs). Banks were required to compute BPLRs taking into account the cost of funds, operational costs, minimum margin to cover regulatory requirements (provisioning and capital charge), and profit margin.

The Base Rate System

The drawbacks of the BPLR system called for a further refinement of the lending rate system and the base rate system was introduced in July 2010. Under this framework, each bank was required to announce its base rate, taking into account, inter alia, the costs of borrowed funds (Table II.1). The base rate was to be the minimum rate for all loans, except for some specified categories1 . The actual lending rate charged to the borrowers was to be the base rate plus borrower-specific charges. The base rate system, with a link to the banks' cost of funds, was expected to facilitate better pricing of loans, enhance transparency in lending rates and improve the assessment of the transmission of monetary policy. In practice, flexibility accorded to banks in the determination of cost of funds – average, marginal or blended cost – caused opacity in the determination of lending rates by banks and clouded an accurate assessment of the speed and strength of the transmission. Moreover, the discrimination in the pricing of credit between the new and old customers continued, as banks often adjusted the spread over the base rate to benefit the new borrowers.

Marginal Cost of Funds based Lending Rate (MCLR) System

The weaknesses and rigidities observed with the transmission under the base rate system were intended to be addressed through marginal cost of funds based lending rate (MCLR) system for new loans, effective April 1, 2016. The base rate system, however, was expected to be in operation concomitantly for the loans already contracted, pending their maturity or a shift to the MCLR system at mutually agreeable terms between the bank and the borrower.

The MCLR consists of four components: (a) marginal cost of funds [marginal cost of borrowings (comprising deposits and other borrowings) and return on net worth]; (b) negative carry on account of cash reserve ratio (CRR); (c) operating costs; and (d) term premium (Table II.1). Under the MCLR system, banks are required to determine their benchmark lending rates linked to their marginal cost of funds [unlike the base rate system where banks had the discretion to choose between the average cost or the marginal cost (or blended cost) of funds].

References:

1. *RBI Report, October 4, 2017 , 'Report of the Internal Study Group to ReviewThe Working of the Marginal Cost of Funds Based Lending Rate System', Reserve Bank of India, September, 2017; Chapter 1, (p.1-2) and Chapter 2,* (p.5-7).

2. https://rbidocs.rbi.org.in/rdocs//PublicationReport/Pdfs/MCLRCF-F20B31A4A24D0487D8659079CF392B.PDF

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