MCLR, External benchmarking

June 25, 2020
Base Rate:

- Base Rate was introduced in July 2010 replacing the Benchmark Prime Lending Rate (BPLR) system. Base Rate is the minimum rate below which Scheduled Commercial Banks cannot lend. RBI publishes guidelines for calculation of Base Rate and every bank calculates its own base rate.
- Base rate calculation methodology was based on the following four factors:
- (Average) Cost of deposits/funds (interest rate that bank offers to its depositors)
- Cost of maintaining CRR and SLR (if the banks are required to keep higher reserves like CRR and SLR, then they will be able to lend less money & will have to charge higher interest rate)
- Operational Costs of Banks
- Return/profit on Net worth (investment)

MCLR (–> Internal Benchmark)

From 1st April 2016, RBI has introduced a new methodology for calculation of the Base Rates based on marginal cost of funds rather than average cost of funds. This new methodology is called Marginal Cost of Funds based Lending Rate (MCLR) or Base Rate based on marginal cost of funds.

- MCLR calculation methodology is based on the following four factors:-
  - Marginal cost of deposits/funds
  - Cost of maintaining CRR and SLR
  - Operational Costs of Banks
  - Tenor Premium (based on the time period for which loan is given)
- The basic difference between the previous Base Rate and the new MCLR based rate is the change of calculation of

cost of deposits from ***average to marginal***. The banks shall review and publish their MCLR every month.

- As per the new methodology of MCLR, the banks must link their lending rates with the marginal/additional cost of deposits i.e. the rate at which they are receiving the new deposits
- So in this situation whenever RBI reduces the repo rate, banks reduce their deposit rate and since the lending rate is linked to the new deposit rate, they reduce the lending rate also.
- Hence, because of linking the lending rate with marginal cost of deposits, there will be fast transmission of repo rate into lending rate (better monetary policy transmission). It will also help improve the transparency in the methodology followed by banks for determining the lending rates.
- Every bank calculates its own MCLR rate based on the cost of deposits, operational costs, reserve requirements, and tenor premium. ***So MCLR is an internal benchmark.***
- But the transmission of policy rates(repo), to the lending rates of the bank has not been satisfactory because if the reasons like
    - –> reduced repo–> reduced deposit rates–> reduced deposit rates may not be attractive to the customers/depositors. Hence, banks may not reduce the deposit rates–> MCLR linked to deposit rates may not reduce the lending rates
    - Government offering higher interest on small savings schemes
- Hence RBI has made it mandatory for banks to link all new floating rate personal or retail loans, and floating rate loans to MSMEs to an external benchmark from October 1, 2019.
- Banks can choose one of the ***four external benchmarks***– repo, 3-month treasury bill, 6-month treasury bill yield

or any other interest rate published by Financial Benchmarks India Private limited.