Living in the MCLR regime - What CFOs should be aware of

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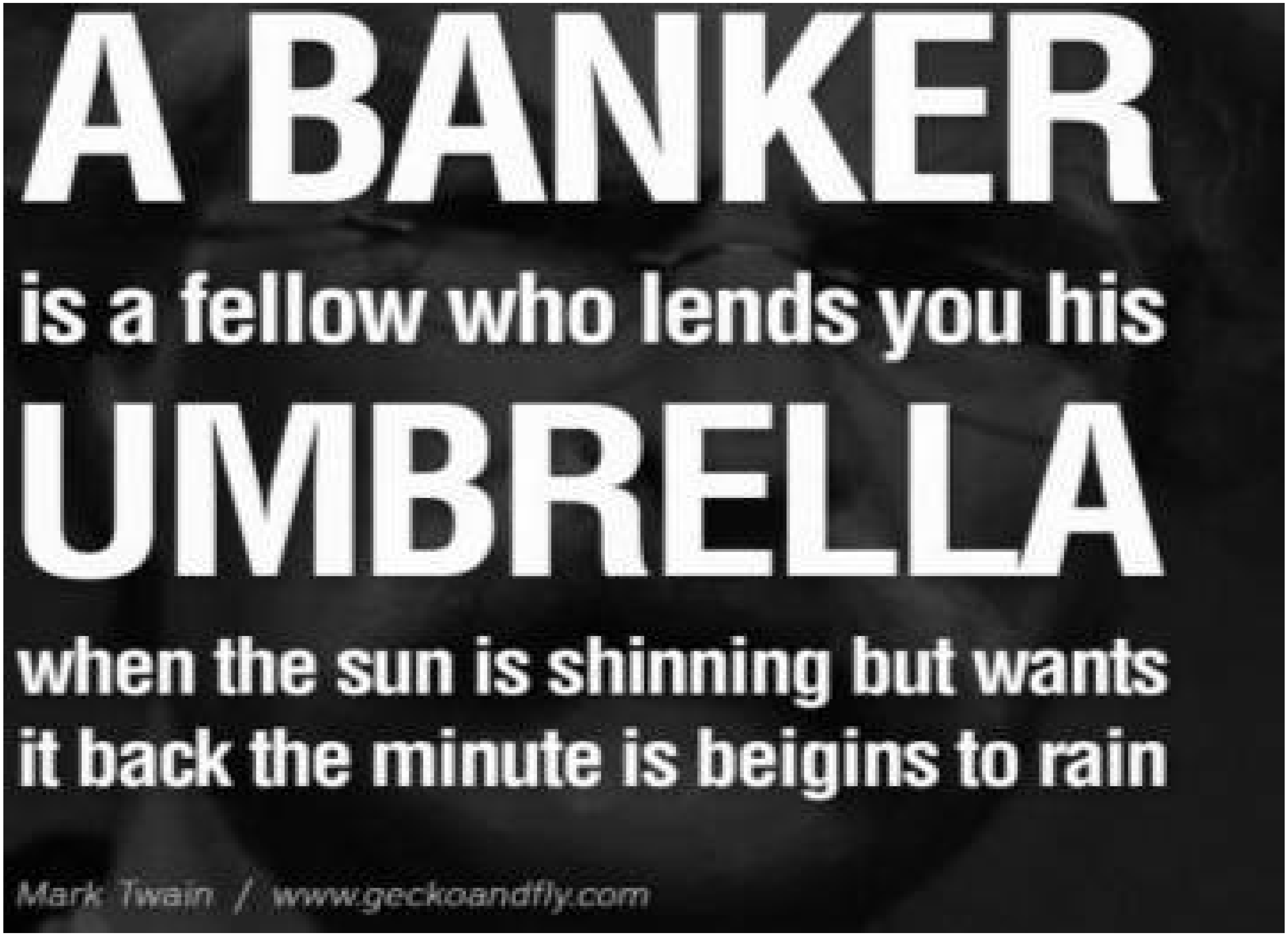
RBI Stance on Lending rates (1960-2016)

October, 1960	Minimum Interest rate on Advances
March, 1968	Maximum Lending rate
January, 1970	Minimum Lending rate
March, 1976	Maximum Lending rate
October, 1994	Free Lending rate above Rs 2 Lakhs
2003	BPLR - for bringing transparency in lending rates (Banks could lend below BPLR)
July, 2010	Base rate
April,2016	MCLR


A BANKER
is a fellow who lends you his
UMBRELLA
when the sun is shinning but wants
it back the minute is beigins to rain
Mark Twain / www.geckoandfly.com

Why MCLR ?

- For ensuring quicker and better transmission of monetary policy with special reference to interest rate curs to ultimate borrowers.
- Repo rate cuts not being passed on by banks to borrowers.
- Time lag and transmission loss.
- Justification – Impact of repo rate on banks cost of fund negligible.
- Marginal Cost of Funds based Lending Rate (MCLR)
- MCLR would serve as the new tenor link benchmark lending rate

MCLR : Methodology as per RBI Circular

Marginal Cost of Funds

- Marginal Cost of Funds = **92%** of Marginal Cost of Borrowings + **8%** * Return on Networth
- Marginal Cost of Borrowings = Rates offered on deposits on the date of review/rates at which funds raised * Balance outstanding up to seven days prior
- Return on Networth is Cost of Capital arrived using any pricing model like CAPM

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Negative CRR Carry

- Required CRR * (Marginal Cost of Funds arrived above)/(1-CRR)

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Operating Costs

- All operating costs associated with providing the loan product including cost of raising funds
- Exclude costs of providing those services which are separately recovered by way of service charges

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Tenor Premium

- Uniform for all types of loans for a given residual tenor
- Overnight MCLR, 1 Month MCLR, 3 Month MCLR, 6 month MCLR and 1 Year MCLR to be published

Particulars	**Cost %**	**Weight %**
Marginal cost of borrowings	6.50%	92%
Return on Networth	20.00%	8%
Weighted Marginal cost of borrowings	5.98%	
Weighted Return on Networth	1.60%	
Total Cost	7.58%	
Add Carrying Cost of CRR	0.27%	
Add Operating Costs	2.15%	
Total Cost	**10.00%**	
Overnight MCLR	**9.00%**	
One Month MCLR	**9.10%**	
Three Month MCLR	**9.35%**	
Six Months MCLR	**9.65%**	
One Year MCLR	**10.00%**	

Base rate Vs MCLR

• Average Cost of Funds	• Marginal Cost of Funds
• Minimum Rate of Return	• Tenor Premium
• Operating Expenses	• Operating Expenses
• Cost of CRR	• Cost of CRR

Impact of Moving towards Marginal Cost

Tenure of Deposits	Amount of deposits (Rs Cr)	Carrying Cost	Current Rate of Interest
30 days	3	6.00	5.50
30 to 180 days	5	7.00	6.00
180 days to 1 year	4	8.00	7.00
1 to 2 year	12	9.25	8.50
Above 2 year	3	9.00	8.00
Wt. Avg Carrying Cost		8.26	7.43

Will banks be lending at MCLR ?

- Concept of Spread.
- The reference benchmark rate used for pricing the loans should form part of the terms of the loan contract.

Spread : RBI Guidelines

Business Strategy

- Business Strategy
- Market Competition
- Embedded Options in Loan Product
- Market Liquidity of the loan etc.

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Credit Risk Premium

- Credit Risk Rating/Scoring Model
- Expected Losses
- Customer Relationship
- Collaterals etc.

The Spread charged to an existing borrower should not be increased except on account of deterioration in the credit risk profile of the customer and should be supported by full-fledged risk profile review of the customer.

Exceptions - Mandatory

- Loans covered by schemes specially formulated by Government of India
- Working Capital Term Loan (WCTL), Funded Interest Term Loan (FITL), etc. granted as part of the rectification/restructuring package.
- Loans granted under various refinance schemes formulated by Government of India or any Government Undertakings

Exceptions - Optional

- Advances to banks' depositors against their own deposits.
- Advances to banks' own employees including retired employees.
- Advances granted to the Chief Executive Officer / Whole Time Directors.
- Loans linked to a market determined external benchmark (say LIBOR).
- Fixed rate loans granted by banks.

Review of MCLR

- On a monthly basis.

- Flexibility till March,2017 to do on a quarterly basis.

Reset of Interest Rates

- Reset – a new concept
- Reset dates may be specified for floating rate loans.
- Reset dates linked either to the date of sanction of the loan/credit limits or to the date of review of MCLR.
- The Marginal Cost of Funds based Lending Rate (MCLR) prevailing on the day first disbursal will be applicable till the next reset date, irrespective of the changes in the benchmark during the interim.
- The periodicity of reset shall be one year or lower. The exact periodicity of reset shall form part of the terms of the loan contract.

Loans under Base Rate Regime

- Existing loans and credit limits linked to the Base Rate may continue till repayment or renewal, as the case may be.
- Bank will continue to review and publish Base Rate as hitherto.
- Existing borrowers will also have the option to move to the Marginal Cost of Funds based Lending Rate (MCLR) linked loan at mutually acceptable terms. However, this should not be treated as a foreclosure of existing facility.

Tenors and Linked Products

Benchmark*	Linked Products
Overnight MCLR	Withdrawals against Uncleared Effects and Temporary Overdrafts in Current Accounts
One Month MCLR	Cheques Purchased (Domestic & Foreign)
Three Month MCLR	Pre Shipment & Post Shipment Credit, LC Bills Discounting
Six Months MCLR	Pre Shipment & Post Shipment Credit, LC Bills Discounting
One Year MCLR	All other loans (Cash Credits, Overdrafts, Term Loans)

* Actual Interest Rates will be the relevant Benchmark + Spread

How MCLR will affect borrowers ?

General

Ensure faster transmission of interest rates due to adoption of marginal cost of Funds and the mandate that banks should declare MCLR on a monthly.

But the provision for reset period contravenes with the RBI's objective of quick transmission of monetary policy. However the RBI has capped reset period at one year.

Borrowers stand to benefit in a falling interest rate scenario and lose in a raising interest rate scenario

Individuals

The frequent change in interest rate and the tenure of the loans will make managing long duration loans like home loan a volatile tasks.

To avoid lot of complexities most of the banks have specified a standard reset period varying from 6 months to one year for retail products. Eg Kotak Mahindra – 6 Mts, SBI, ICICI – 1 Yr
It may be noted that MCLR is applicable only for banks and not for NBFCs and housing finance companies.

MCLR being applicable only on floating rate loans, there is a possibility that banks soon could shift to long term fixed rate loans. Fixed rate loans of above three years are exempted from MCLR system

Corporates

Only new loans and loans renewed with effect from 01st April,2016 would be covered under MCLR. Existing customer has an option to switch to MCLR system by specific request .
SME and corporate customers have the option to negotiate across the multiple sets of resets.
Banks shall have the option to offer loans with reset dates linked either to the date of first disbursement of the loan/credit limits or to the date of review of MCLR.

The Marginal Cost of Funds based Lending Rate (MCLR) prevailing on the date of first disbursement, whether partial or full, shall be applicable till the next reset date, irrespective of the changes in the benchmark during the interim. Future reset dates shall be determined accordingly.

The tenor premium will be the appropriate premium for the residual period up to the next reset date.

The components of the spread i.e. business strategy and Credit risk premium shall have either a positive value or be zero. In other words, the spread components cannot be negative.

The interest charged on fixed rate loans as well as the fixed portion of hybrid loans will be the interest rate mentioned in the sanction letter.

Decision to switch should be based on the total cost including MCLR, spread and conversion cost. Once you switch to MCLR regime you will not be able to go back to base rate regime.

MCLR Revised rates						
Bank		Marginal Cost based Lending rates				
	Old Base	Overnight	1-month	3-month	6-month	1 year
SBI	9.30	8.95	9.05	9.10	9.15	9.20
		8.85	8.95	9.00	9.05	9.10
Axis	9.45	8.95	9.05	9.25	9.30	9.35
		8.90	8.95	9.15	9.25	9.30
HDFC	9.30	8.95	9.05	9.10	9.15	9.20
		8.90	8.95	9.05	9.10	9.15
ICICI	9.35	9.00	9.00	9.10	9.15	9.20
		8.95	8.95	9.05	9.10	9.15

Example

3 Month Reset Period	MCLR Rate
1st April, 2016	**9.50%**
1st June, 2016	9.40%
1st Oct, 2016	9.25%
1st Jan, 2017	**9.10%**
1st April, 2017	9.25%
1st June, 2017	9.50%
1st Oct, 2017	9.75%
1st Jan, 2018	**9.80%**

Conclusion

As far as banks are concerned, their margins might take a hit in the range of Rs 15,000 to Rs 22,000 crore assuming a 75 basis point decline (source – ICRA).

According to a Centrum Broking Ltd report, past studies, including references to global banks, suggest limited rate transmission to end user.

Thank You