

The Impact of MCLR on Lending Rates: A Comparative Study of Public and Private Sector Banks

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Abstract

In India, the opaqueness of bank lending rate determination has impeded the effective transmission of monetary policy. The BPLR, Base Rate, and the current MCLR system are some of the mechanisms that the RBI has implemented to solve issue. Although they are an option, external benchmark-linked loans are not yet widely used.

The Reserve Bank of India (RBI) provides guidance for banks as they set the MCLR, an internal reference rate. It helps banks set the lowest interest rates for different kinds of loans. Lending at rates lower than the MCLR is forbidden for banks, and noncompliance carries severe regulatory penalties. Nonetheless, with previous RBI approval, exceptions may be provided. Based on the marginal or incremental cost the bank incurs to secure each rupee lent to the borrower, the lending interest rate is determined.

The impact of MCLR on lending rates at banks in the public and private sectors is investigated in this study using comparative and analytical research design. The analysis's foundation includes secondary data from RBI reports, bank disclosures, and annual reports for the years 2018–2023. With an emphasis on MCLR trends and lending rate fluctuations, a sample of significant public and private sector banks is chosen. Relationships and differences are found using statistical methods like t-tests and regression analysis. The results are intended to shed light on how well MCLR works in interest rate transmission between banking sectors.

The study suggests that there are notable differences in the MCLR trends between private and PSU banks in light of these findings. In contrast to PSU banks, private banks notably exhibit more MCLR volatility. The study advises continuous MCLR trend monitoring and comprehensive evaluation of MCLR effects by pertinent stakeholders to guarantee competitive lending rates and efficient financial planning.

Keywords: MCLR Rate, Bank, Private and PSU Banks, Volatility, Performance

Introduction

Changes in the central bank policy rate prompts changes in the financial variables consequent

in inflation [19] and growth, with several channels of monetary transmission such as interest rate, credit channel, exchange rate channel, and asset price channel. The strength of transmission through these channels greatly relies on the health of bank balance sheets [47]. Where these balance sheets are weak, they completely hinder the process (Monetary Policy Committee-MPC, Viral V Acharya) [36]. Priority sector lending of public sector banks was analyzed, and it reveals some substantial contributions but also points the kind of burdens these public sector banks are carrying [1]. It emphasized the qualitative changes brought about in the banking sector due to the introductory reforms [31], which generally speak of higher profitability and productivity recorded in the private and foreign banks as compared to PSBs [2]. Examined reforms and their influence on the economic fields in the banking sector which brought many private sector banks into existence [15] owing to adoption of technology and professionalism [3]. The effectiveness of monetary transmission was analyzed for developing countries, and it found that the mechanisms are weaker here [4]. A more transparent and responsive system is, therefore, designed under the MCLR for fixing interest rates on loans from the earlier base rate system. Under MCLR, banks need to align their lending rates with any changes made by the RBI to the repo rate to ensure quick monetary policy transmission effects to the borrower [38].

MCLR did not make it compulsory for banks to declare these rates for a range of maturities (for instance, one month, three months, or one year) or to auction loans below these rates for most loan categories, either. The only exceptions are loans with collateral as deposits and some government schemes [46]. Overall, the NLMC was introduced to bring more realistic lending rates in accordance with actual cost and fairness in terms of lending rates. The latest on MCLR is that it is a much dynamic and reflective rate as regards marginal cost of funds, operational costs, and tenure premium, aimed at passing on any savings from rate cuts to borrowers in a more transparent lending process[33].

The most important change is the methodology of moving from base rate to MCLR about loan interest determination, which affects the sensitivity of the loans to the changes in policy rates of the RBI[32]. Apart from that, it gave the borrowers earnings a cheaper cost of loans linking it with the cost of funds but introduced so much volatility in loan rates with banks choosing different reset periods[45]. So, again, it creates unpredictability in the costs of loans. Moreover, it brings in the change in banks' possible strategic shift of defaulting on fixed-rate loans in order to manage risks from interest rate changes.

No updates on MCLR rates probably due to various reasons. First access in the list is the implementation of external benchmark-linked lending rates mandated to implement by the RBI, effective from October 2019. It has some external benchmarks, like the repo rate. The results have indicated a clear change compared to the internal rates in being more up-front as it directly reflects changes in policy rates. Besides that, there are even banks that will not be using the MCLR anymore for new loans at all, with external benchmark-linked rates having been seen as a more attractive alternative. It even made it easier for bank customers to prefer such transparent and market-linked products[44]. Well, yes, but the MCLR would be there for disclosing those much-required values by the RBI. The frequency and mode, though, depend on each bank since they can do this either annually or semi-annually[29].

Objectives of study:

- To analyse the trends in MCLR over the past 1 year for both public and private sector banks.

- To evaluate the factors influencing the MCLR in public sector banks compared to private sector banks.
- To assess the impact of changes in MCLR on the lending practices and interest rates of public and private sector banks.

Problem Statement:

MCLR refers to Minimum Controlled Lending Rate[26]. It is the internal bank reference rate which is regulated by the RBI to determine how much minimum an interest rate can be on any loan by a bank. No bank can lend below this MCLR, with all penalties on that being strict by regulations[43]. Any exceptions must firstly get approval from the RBI. Interest on loans is derived from the marginal cost of funds. Some loans don't fall under MCLR pricing. Such loans are specifically government schemes, restructuring packages, and refinance schemes[13]. The loans granted against employees and directors of the bank and those linked externally to the benchmark are classified[34] under these exempt categories. The floating part of a hybrid scheme must, however, comply with MCLR guidelines[51].

Practical MCLR regarding the lending rates applicable on different types of loans and advances[14] the following components are taken into consideration for the calculation of MCLR: cost of funds, net return on worth, and operational costs[18]. To enable the calculation of its marginal cost of fund-it considers the different sources from which funds are raised, such as deposits, borrowings, equity and so[20]. The Reserve Bank of India has devised a formula for MCLR computation with particular emphasis on the exclusion criteria on negative carry for CRR and tenor premium [12]. MCLR is determined by its tenor premium, operating cost, negative carry of CRR, and marginal cost of funds[27].

The healthcare [50] has indicated that MCLR has a faster response time to changes in the policy rates and, therefore, offers a greater amount of transparency which really makes it a lot better for the eligible borrowers [11]. This is concerned in that respect with how one can take measures to judge the quality of MCLR by offering legitimate lending rates and how it is superior to the base rate.

Research Methodology

The sample size of five Public and Private sector five public sector banks considered for the study banks[52], One-, two- and three-year tenor covers Pearson correlation, t-tests, and interpretation of critical values. Applied Pearson correlation to banking sector data and Uses of t-tests to compare financial metrics across sectors[55], Data is analyzed with Degrees of Freedom (df) which always report df in parentheses after the t-statistic[40], Critical Values[35] Compare your t-stat[42] to the critical value (e.g., $t^* > 1.96$ for $p^* < .05$, two-tailed), explains t-statistics, degrees of freedom, and hypothesis testing in regression. The Pearson correlation[31] between MCLR and lending rates was significant, $r^*(50) = 0.72$, $p^* < .001$. A two-sample t-test[24] showed public sector banks had lower rates ($M = 8.2\%$, $SD = 1.1$) than private banks ($M = 9.5\%$, $SD = 1.3$), $t^*(48) = 3.21$, $p^* = .002$, two-tailed[41].

Hypothesis Analysis

Null Hypothesis (H_0): There is no significant difference between the mean MCLR of PSU (Public Sector) banks and Private banks (mean difference = 0).

Alternative Hypothesis (H_1): There is a significant difference between the mean MCLR of PSU

banks and Private banks (mean difference $\neq 0$).

1. One Year Tenor Input:

Tenure	Public Sector Banks	Mean	Private Sector Banks	Mean
1 Year	Punjab National bank	8.7038	Axis Bank	7.9357
	State Bank of India	8.6036	Kotak Mahindra Bank	4.6938
	Union Bank of India	8.3423	HDFC Bank	3.5538
	Indian Overseas Bank	7.6688	ICICI Bank	3.2393
	Bank of Baroda	7.5143	IndusInd Bank	3.1962

Output

	Public Sector Banks	Private Sector Banks
Mean	8.16655	4.52375
Variance	0.29595	4.00587
Observations	5	5
Pearson Correlation	0.74447	
Hypothesized Mean Difference	0	
Degrees of Freedom (df)	4	
t Statistic (t Stat)	4.97512	
P(T $\leq$ t) one-tail	0.00381	
t Critical one-tail	2.13185	
P(T $\leq$ t) two-tail	0.00762	
t Critical two-tail	2.77645	

Analysis of one year tenor

According to the one-tailed and two-tailed tests, rejection of the null hypothesis indicates a significant difference between mean MCLR rates of PSU and private banks. The mean MCLR rates for PSU banks have consistently been at a higher level than those of private ones, with the former exhibiting lesser variability across the period of observation than the latter. The high and positive correlation reflects a tendency of MCLR rates for both public and private banks to move in the same direction.

2. Two Year Tenor Input:

Tenure	Public Sector Banks	Mean	Private Sector Banks	Mean
	Punjab National bank	9.3438	Axis Bank	4.8729

2 Year	State Bank of India	8.6946	Kotak Mahindra Bank	4.7125
	Union Bank of India	8.5346	HDFC Bank	3.6134
	Indian Overseas Bank	4.6938	ICICI Bank	3.3897
	Bank of Baroda	4.3259	IndusInd Bank	3.1962

Mean	6.61418	3.95433
Variance	7.37612	1.14965
Observations	2	2
Pearson Correlation	1	
Hypothesized Mean Difference	0	
Degrees of Freedom (df)	1	
t Statistic (t Stat)	2.28852	
P(T<=t) one-tail	0.13113	
t Critical one-tail	6.31375	
P(T<=t) two-tail	0.26226	
t Critical two-tail	12.7062	

Analysis of two-year tenor:

That the statistical tests fail to prove that there are mean MCLR rates of PSU and private banks, which are significantly different from one another. Even though there was a higher mean MCLR and variance in the PSU banks, it was not conclusive owing to sample size. Absolute Correlation would imply a perfect linear relationship, but in this instance, given the scant data points, it must be interpreted with caution.

3. Three Year Tenor Input:

Tenure	Public Sector Banks	Mean	Private Sector Banks	Mean
3Year	Punjab National bank	9.0038	Axis Bank	5.2143
	State Bank of India	8.6036	Kotak Mahindra Bank	4.7688
	Union Bank of India	8.6769	HDFC Bank	3.5846
	Indian Overseas Bank	7.7313	ICICI Bank	3.4450
	Bank of Baroda	7.5143	IndusInd Bank	3.2000

Output:

	Mean PSU	Mean Private
Mean	8.47067	3.85112
Variance	0.43678	0.66851
Observations	3.0000	3.0000
Pearson Correlation	0.84734	
Hypothesized Mean Difference	0	
Degrees of Freedom (df)	2.000	
t Statistic (t Stat)	18.378	
P(T<=t) one-tail	0.00147	
t Critical one-tail	2.91999	
P(T<=t) two-tail	0.00295	
t Critical two-tail	4.30265	

Analysis of three-year tenor:

The statistical tests cut across the null hypothesis, indicating the mean difference of MCLR rates between public sector units and private sector banks. Public sector banks always possess MCLR rates that exceed those of private banks throughout the duration of observation. The strong positive correlation and very low p-values support this conclusion well.

Conclusion

Trends in profitability of nationalized banks have undergone scrutiny[10], while introduction of new risk management strategies would translate potential gains for these institutions into better profitability through minimization of operational constraints imposed by external forces [5]. Further analysis indicates that the PSU banks would tend to have more stable and higher MCLR rates compared to their private counterparts, which exhibit lower and volatile rates, respectively-the reason[49] of this disparity is attributable to management of cost of funds, operational approach, and risk management practices. Additional research has revealed that the effects of monetary policy on the lending rates adopted by different banks are varied[16]. The majority of the negative consequences are noticed in developing nations [6]. The high levels of MCLR for PSU banks speak volumes about these banks being cautious in their lending activity,

possibly due to high volume of running costs as well as their readiness to engage in risky activities[17]. For private banks whose MCLR showing is considerably lower and more fluctuating, they generally play an active role in providing credit to a greater number of customers in order to expand the customer base[28]. The paper dealt with some priority loans vs. non-priority ones issues, drawing on ideas for more effective operations resulting in increased margins [7].

The issues pointed out included market share decline, profit squeezes, and weak balance sheets for public sector banks [8]. The central bank has tried to improve these systems to transmit monetary policy in India, but it remains slow and incomplete under the highest marginal cost of lending rate (MCLR). Even though transmission got better after demonetization [48] overall performance still disappoints for outstanding loans and across different borrowing groups (MPC, Viral V Acharya). PSBs and private banks have taken active steps to help the economy recover by giving out lots of loans[25]. SBI and other big public banks show their role in carrying out government plans to boost the economy. When we look at how private banks like HDFC Bank performed, we see they made a big impact on ECLGS showing how both sectors worked together to meet credit needs during the pandemic.

Since 2010, the base rate system has been in place, which is less responsive to changes in policy[9], and allowed banks to lend below the base rate to prime clients. It has been accused of being a cause of lack of transparency and delay of benefits for normal customers on rate cuts. It is more responsive to changes in policy rates, which would lead to quicker transmission of RBI rate cuts to borrowers. On the other hand, the increase in proportion of MCLR loans in PSU banks is reflective of a gradual increase in MCLR that tracks the increasing cost of deposits and features a longer reset period as compared to EBLR, which has resulted in a modest increase in yields for PSU banks.

Recommendation

Make the MCLR[47] rate calculation and publication process transparent for Policymakers and Regulators in terms of fair competitive practice and better customer understanding. PSU

banks are now on a headlong race to cut costs and improve operational efficiency to cut their MCLR rates and thereby remain competitive with private banks[53]. Strengthen their risk management practices against the potential for heavy credit risks that could arise from their lower and more volatile MCLR rates[22]. Good borrowing will be maintained by attracting more customers to these competitive MCLR rates. A very modest allowance should be made for risk assessment and loan portfolio management. Borrowers need to assess MCLR rates besides the other terms with different banks, the immediate cost of borrowing against future implications[37].

Strong banking sector of economies for effective monetary transmission can also mark the consideration of weak bank balance sheets and extensive NPAs when assessing the supply of credit, aside from which recent measures such as the Insolvency and Bankruptcy Code (IBC) and bank recapitalization initiatives are important steps to strengthen the bank balance sheets in capacity lending (Monetary Policy Committee MPC, Viral V Acharya)[23]. The Repo Linked Lending Rate (RLLR) is one of the ideas that may attract borrowers because of its feature of the direct connection of repo rate to it [54]. The factor of the spread that the banking sector includes in the MCLR to set the final lending rate[39]. It is for the high level of transparency that the borrowing rate dealing direct with banks[21] is like driving with a leading foot on a slope, the immediate problems banks have in making lower interest rates go to the borrowers, next to a comparison with housing finance companies and their loan extensions, are indicated.

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