Marginal Cost of Funds Based Lending Rate (MCLR) – An Evaluation

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Abstract

RBI was facing a good deal of criticism because commercial bank's lending rates were not decreasing as fast as some groups expected it to come down. With a view to overcoming such criticism, RBI wanted the efficiency of monetary policy transmissionto improve andprescribed a formula whereby commercial banks could work out a Marginal Cost of Funds based Lending Rate(MCLR).

We undertake a critical evaluation of the two equations used by RBI for this purpose and find that there is some lack of overall compatibility in the entire process. We re-formulate these equations to accommodate the requisite internal consistency and re-work the Marginal Cost of Funds based Lending Rate. The current scenario for NPAs and possible irrecoverable loan assets of commercial banks is also discussed and its possible impact on MCLR is dwelt on.

Keywords*: Liberalisation; Tandon Committee; Marginal Cost of Funds; Marginal Cost of Borrowings; Return on Net Worth; Marginal Cost of Funds based Lending Rate; Negative Cost of Carry; Operating Cost; Tenor Premium; CRR; SLR; NPA; Irrecoverable Loan Asset; Interest Spread; Global Financial Crisis*

1.   Introduction

Over the years, RBI had steadily dismantled various regulatory requirements being mandatorily followed by the commercial banks. The margin on working capital loans was relaxed, thereby withdrawing the guideline regarding the popular lending norm formulated by the Tandon Committee. Interest rates on term deposits as well as loans and advances were liberalised quite some time back. The last regulated interest rate, the one applicable on Savings Bank deposits, was also finally relaxed. Moreover, CAS was replaced by CMA and Consortium Financing was made optional.

In the wake of such a persistent advancement along the path of financial liberalization, it was somewhat surprising to watch RBI stipulate a detailed methodology for working out a Marginal Cost of Funds based Lending Rate (MCLR), to be implemented with effect from April 2016, by the commercial banks operating in India. India appears to havea strong lobby who preach that lowering of interest rates is the only way to overcome all kinds of growth related problems. The central bank was under intense pressure to lead the way to a lower interest rate regime and brought down the benchmark (SLAF) rates from time to time. However, initially this did not translate into immediate lowering of interest rates by a similar magnitude for loans extended by commercial banks. This was inevitable in a way because of the relatively low contribution that the funds borrowed by a commercial bank at such benchmark rates can have in its total pool of funds. However, there was great necessity for ensuring a quick transmission of the policy changes brought about by the central bank to the operating level, and RBI stated that in order to improve the efficiency of monetary policy transmission, the Reserve Bank will encourage banks to move in a time-bound manner to marginal cost of funds based determination of their Base Rate. Accordingly, in December 2015, RBI came up with their circular number DBR.No.Dir.BC.67/13.03.00/2015-16 dated December 17, 2015, detailing the methodology for computing MCLR[1]as well as their Press Release[2].

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Methodology for Computation of MCLR: According to RBI, with effect from April 1, 2016, all rupee loans sanctioned and credit limits renewed would have to be priced with reference to the Marginal Cost of Funds based Lending Rate (MCLR), which would be the internal benchmark for such purposes. The MCLR would comprise:

a. Marginal Cost of Funds.
b. Negative Carry on account of CRR.
c. Operating Costs.
d. Tenor Premium.

(a) Marginal Cost of Funds: The Marginal Cost of Funds for any commercial bank would naturally incorporate contributions from Marginal Cost of borrowings and Return on Net Worth. RBI pointed out that, as per extant capital adequacy norms, the minimum Tier 1 equity capital required to be maintained as a fraction of the Risk Weighted Assets (RWA) is 8%. Accordingly, the weightage of Net Worth in the Marginal Cost of Funds would be 8%. The weightage allotted to Marginal Cost of borrowings in the Marginal Cost of Funds would consequently be 92%. Here, the cost of equity capital is the minimum desired rate of return on equity computed as a mark-up over the risk free rate (CAPM).

Thus, Marginal Cost of Funds = 92% x Marginal Cost of borrowings + 8% x Return on Net Worth

(b) Negative Carry on CRR: Negative Carry on account of the mandatory CRR arises from the fact that a commercial bank earns no return on the CRR balance. Such Negative Carry can be calculated as under:

Negative Carry on CRR = Required CRR x (Marginal Cost)/(1- CRR)

Marginal Cost of Funds worked out at (a) above will be used for computing the Negative Carry on CRR.

(c) Operating Costs: This is to include basically all costs other than interest cost-such as infrastructural cost, manpower cost and cost of issuance of securities etc. However, such costs of providing services as are separately recoverable by way of service charges are to be kept out of this component.

(d) Tenor Premium: This is on account of loan commitments with longer tenor. As per RBI, the tenor premium cannot be borrower specific or loan class specific. In other words, tenor premium will be identical for all types of loans with a given tenor. This premium thus clearly cannot incorporate any kind of risk premium.

Evaluation of MCLR Methodology: (1) Considering that CRR is currently 4%, Negative Carry on account of CRR, as per RBI's formula, is Marginal Cost of Funds*4/96. We can thus see from (a) and (b) above, that the sum total of Marginal Cost of Funds and Negative Cost of Carry for CRR turn out to be Marginal Cost of Funds x [1+(4/96)] = Marginal Cost of Funds x 100/96.

This implies that out of a total asset base of 100 units, loans and advances account for 96 units while the balance 4 is accounted for by CRR. But, since CRR is non-interest bearing, the total interest burden towards fund of 100 units would need to be borne by the loans and advances of 96 units alone. In other words, in order to work out the effective cost of funding the loans and advances, the Marginal Cost of Fund has to be calibrated by a factor of 100/96 to account for the fact that every asset block of 100 units has a non-interest bearing component of 4 units.

(2) Also, based on the capital adequacy requirement, RBI has set the equation for Marginal Cost of Funds as:

Marginal Cost of Funds = 92% x Marginal Cost of borrowings + 8% x Return on Net Worth = 92/100* Marginal Cost of borrowings+8/100 Return on Net Worth

(3) If we combine these 2 equations together, the underlying position appears to be as follows:

Net Worth	8	CRR	4
Borrowed Fund	92	Loan Assets	96
Total	100	Total	100

Here, we observe that:
   (i)   Net Worth is NOT 8% of Loan Assets, as required by RBI.
   (ii) CRR is NOT 4% of Borrowed Fund, as required by RBI.
   (iii) SLR is NOT shown separately as an asset class, although a large SLR (21.5%) is a special feature of Indian banking. SLR, it would appear, might have been clubbed with Loan Assets. However, this is questionable inasmuch as SLR is a Risk Free asset (free from Default Risk and having quite small a risk weight on account of Market Risk), whereas Loan Assets are fraught with considerable counterparty risk.

As a matter of fact, NPAs of PSBs have now turned out to be a subject of major concern for the Indian economy and several banks have been placed under watch by RBI, who has initiated prompt corrective action (PCA) – placing restrictions on their banking activities.

In other words, the two equations used by RBI for computation of MCLR are not completely mutually compatible. Let us now try to resolve the above issues and work out below a fully compatible solution, which also incorporates SLR as a separate asset class. For this purpose, we start with the following picture:

Net Worth	8	CRR	5 (@4% of 123)
SLR	26 (21.5% 0f 123)		
Borrowed Fund	123	Loan Assets	100
Total	131	Total	131

The Borrowed Fundis higher at 123 units inasmuch as this amount, after pre-emption son account of CRR (5) and SLR (26), make exactly 92 units available for funding Loan Assets worth 100 units. So, this underlying picture is self-consistent and can be used for computing MCLR in a compatible fashion.

As per this picture, maintaining full compatibility, MCLR would work out as:
Marginal Cost of Funds (MCF, say) = 123/131xMarginal Cost of borrowings + 8/131xReturn on Net Worth and
MCLR = [131xMCF – (5xreturnon CRR + 26xreturn on SLR)]/100 = (131MCF – 26R_F)/100, where R_F = Risk Free Rate of Return = Return on Treasury (SLR) securities

The numbers featuring in this equation, viz. 131 and 26, will of course change with change of CRR and/or SLR Ratio(s).

Impact of NPAs and Irrecoverable Loan Assets: Indian banks have of late been dogged by burgeoning NPAs. According to a report by CARE Ratings, as of June 2017,the aggregate NPA for 38 banks amounted

to almost Rs 8.3 trillion. As many as 18 banks had their gross NPA ratios in double digits (excess of 10) and the highest NPA ratio, for IDBI Bank Ltd, was 24.11%[3].

In order to deal with such high incidence of NPAs, the union government has introduced, inter alia, what is known as the Insolvency and Bankruptcy Code, 2016[4]. Subsequently, via an ordinance, the union government empowered RBI to direct banks to initiate insolvency and bankruptcy moves against identified NPA holders or to go for resolution of stressed assets[5].

Under the aforesaid scheme, RBI identified, for early resolution, the first bunch of 12 NPAsin the steel sector (contributing 20-30% of total NPAs). 5 out of these 12 identified by RBI, viz. Monnet Ispat, Essar Steel, Bhushan Steel, Electrosteel and Bhushan Power and Steel, account for a combined loan amount of more than Rs 1 trillion. It is estimated that the lending banks may have to take a haircut as high as 56% (against their current provision of about 30%) to bail out such debt ridden steel firms[6].In other words, very substantial parts of such NPAs are irrecoverable. Irrecoverability of a loan means even its principal component cannot be recovered. This is much worse than CRR, where no interest is payable on the outstanding balance but the principal amount is fully recoverable (zero risk weight).

If 10% is the gross NPA ratio, out of a loan asset of 100 units, NPA would amount to 10 units. With a haircut of 50%, the quantum of irrecoverable loans would come to 5 units. This will have considerable impact on the profitability and interest spread for a commercial bank[7,8,9,10].

Since the impact of NPAs and irrecoverable loan assets has been kept out of the purview of MCLR, this impact can only be accommodated in the interest spread. However, burgeoning NPAs and incidence of ever increasing haircuts are apt to lead to sky rocketing of interest spreads. What would then happen to the ceiling spread set by the central bank of India, which earned a lot of kudos for RBI during the days of the infamous Global Financial Crisis? Or, has the ceiling for interest spread been completely done away with!

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