MCLR & Home Loan

For new borrowers, home loan rates will be automatically reset either yearly or every six months

State Bank of India (SBI), India's largest lender, was the first to announce the new marginal cost-based lending rate (MCLR), on 1 April 2016. This is the new benchmark lending rate and it replaces the base rate for new borrowers.

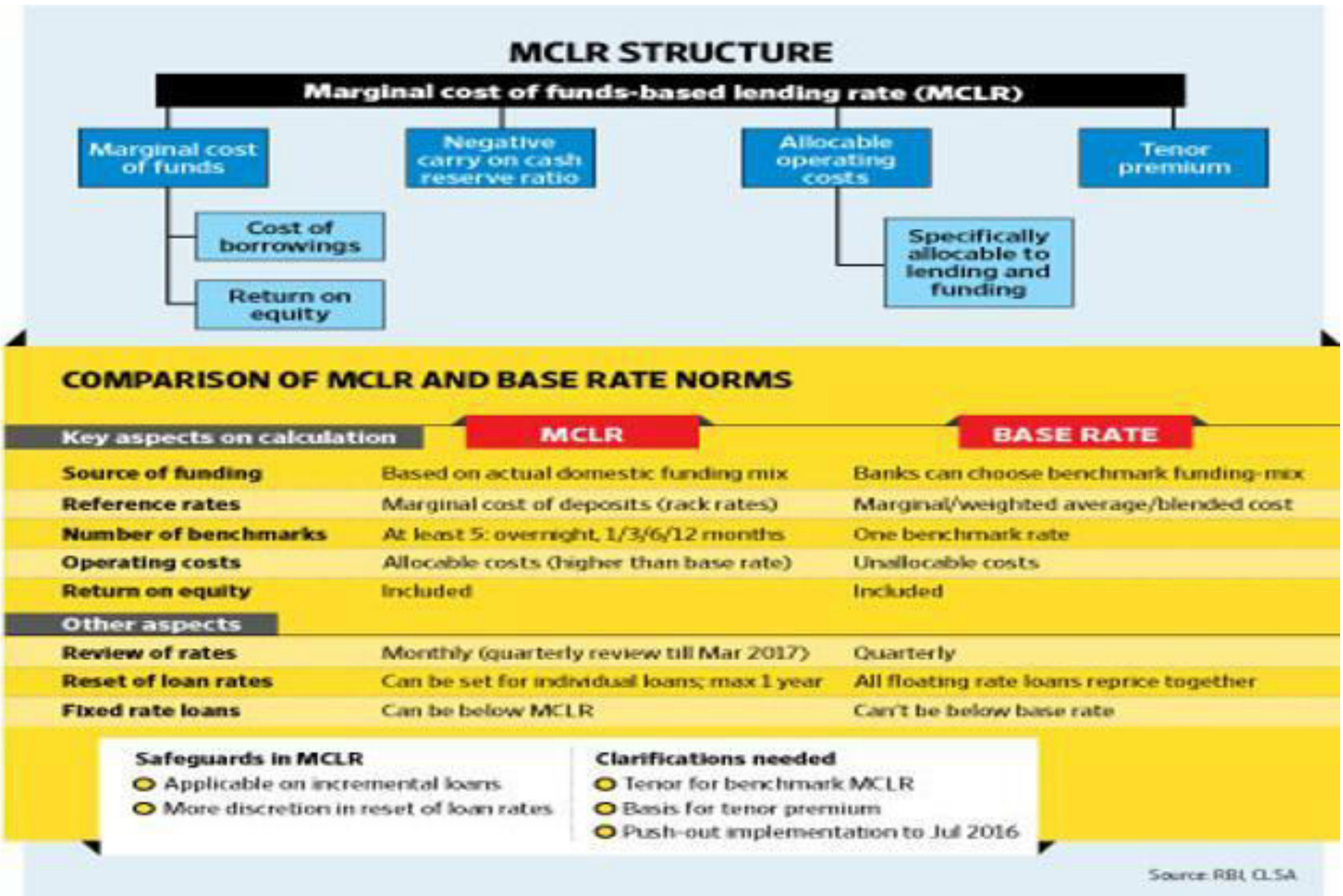
What is MCLR?
MCLR is the new benchmark-lending rate at which banks will now lend to new borrowers. Till 31 March 2016, banks used the base rate as the benchmark rate to lend.

MCLR is built on four components—marginal cost of funds, negative carry on account of cash reserve ratio (CRR), operating costs and tenor premium.
Marginal cost of funds is the marginal cost of borrowing and return on net worth for banks. The operating cost includes cost of providing the loan product including cost of raising funds. Tenor premium arises from loan commitments with longer tenors. According to brokerage and investment group CLSA, the source of funding for a bank is based on actual domestic funding mix. MCLR is closely linked to the actual deposit rates.

"If one-year term deposit is at 7.50%. Then one-year MCLR will be 7.50% plus CRR, operation cost and tenor premium," said Ashutosh Khajuria, executive director, Federal Bank Ltd.

The Reserve Bank of India (RBI) has asked banks to set at least five MCLR rates— overnight, one month, three month, six month and one year. Besides these, banks are free to set rates for longer durations as well. The rates have to be reviewed on a monthly basis, but banks that don't have the capacity to do monthly reviews on can do so quarterly till March 2017.

MCLR-linked loans will be reset for a maximum of one year. So, you will have a new interest rate on your home loan at a pre-decided time and for a maximum period of one year.



Banks are also allowed to determine a spread that is higher than MCLR. Depending on your credit profile, banks will decide this. The spread will be decided based on credit risk and tenor.

Not all loans will come under this rate. For instance, loans covered by government schemes where banks have to charge interest rates as per the scheme are exempted from being linked to MCLR as the benchmark for determining interest rate.

What you should know

Home loan rates will now depend on the bank's choice of reset period—six-month or one-year MCLR rate and spread rather than one common base rate and spread. While MCLR is intended to ensure effective policy transmission, past studies, including references to global banks, suggest limited rate transmission to end-user. Existing borrowers should wait for the new system of calculation to settle before deciding to switch loans.