Your Money: Why impact of repo rate cut is not immediate

While loans get re-priced immediately and new and renewed deposits go at the new rate, the impact on average cost of deposits come with a lag.

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One of the ways of measuring the efficacy of the repo rate cut of Reserve Bank of India (RBI) is to ascertain how the system has reacted to the change. Whenever the rate is lowered, it is expected that the banks would lower the lending rate which will help borrowers and enhance further lending and hence assist growth.

This is the chain that has been analysed often. There is an argument that the transmission is not as swift as it should be. However, the lending rate which is defined by the MCLR or base rate or more recently the accepted benchmark, is also linked to the deposit rate which has to be altered first as it goes into the cost of funds. As loans get re-priced immediately while only new and renewed deposits go at the new rate, the impact on average cost of deposits would come with a lag. There is a reason for the transmission to be slow which can take a period of over six months provided banks lower the deposit rates—which may not happen across the board depending on the funds situation of various banks.

The repo rate was lowered in the April 2019 policy to 6%. From then on there were three cuts till March 2020 when the lockdown was announced. This was of the order of 85 bps in tranches—one 35 bps and two of 25 bps each to 5.15%. On announcement of the lockdown, RBI lowered the repo rate on March 27 by 75 bps bringing the total reduction in FY20 to 160 bps with the year ending with a repo rate of 4.4%, though the last cut would have an impact in FY21 rather than FY20. Two months later on May 22, RBI further lowered the rate by 40 bps bringing down the repo rate to 4%. Again, the impact would be felt from June onwards.

Response of rate cut on deposits

The RBI presents data on the weighted average monthly term deposit rate on outstanding deposits which gives an idea of how banks re-priced their deposits following the repo cuts. In the first stage of FY20 when the repo rate was lowered by 85 bps the weighted average term deposit rate for all banks came down by around 50 bps with foreign banks and private banks being more aggressive in lowering these rates. These rates are computed on outstanding deposits for the month. The response rate has been around 60%.

Subsequent reduction in repo rate by 75 bps led to a decline of 26 bps for the system in May (response rate of around 35%) bringing a total of 77 bps decline in deposit rates against 160 bps cut in repo rate during this 14-month period. There has hence been a transmission rate of just about 50% in average deposit rates. In fact, post May 22, the average deposit rate on one-year deposits of the banking system based on five large banks came down from a mid-value of 5.7% to 5.375%, a reduction of 32.5 bps. With the repo rate being lowered by 40 bps, the response was close to 80% reduction in the one-year deposit rate.

Transmission on lending side

bps fall for all banks. Foreign banks had a response rate of over 100%, while private banks did not witness a significant change in WALR. The response of PSBs was around 60%. Hence 160 bps cut for 14 months had WALR coming down by 122 bps which is quite significant with the response of WALR on fresh loans being above 75%.

Edited excerpts from Care Ratings report