Impact of RBI's Monetary Policy on Retail Lending Rates in India

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Abstract

This paper examines the impact of the Reserve Bank of India's (RBI) monetary policy on retail lending rates in India, covering the period from April 2015 to March 2024, with a focus on the post-2019 External Benchmark-based Lending Rate (EBLR) regime. The study analyses the evolution of lending rate frameworks from PLR to Base Rate to MCLR and finally to EBLR, evaluates the speed and completeness of monetary transmission across different rate cycles, and identifies structural asymmetries in pass-through. Findings indicate that EBLR has significantly improved transmission speed and completeness, particularly for home loans and MSME credit, though deposit rate stickiness and the residual MCLR portfolio continue to limit full pass-through during easing cycles.

Keywords: *RBI Monetary Policy, Repo Rate, MCLR, EBLR, Retail Lending Rates, Monetary Transmission, Interest Rate Channel*

1. Introduction

Monetary policy is one of the most powerful tools available to central banks for steering economic activity. The Reserve Bank of India (RBI), as India's central bank, uses a variety of instruments — primarily the repo rate — to influence the cost and availability of credit in the economy. When the RBI changes its policy rate, the expectation is that these changes will eventually pass through to the interest rates that banks charge retail borrowers.

However, the speed and completeness of this transmission has been a persistent concern for Indian policymakers. Unlike advanced economies where rate transmission tends to be swift and symmetrical, the Indian banking sector has historically exhibited sluggish and asymmetric transmission — particularly on the downside. Understanding this gap is essential for both academic research and for practitioners in the financial services sector.

This paper is motivated by the significant monetary policy actions taken by the RBI between 2020 and 2024, a period that witnessed pandemic-era rate cuts followed by an aggressive rate-hiking cycle in 2022–23, and a pivotal rate-cut decision in April 2025. Studying how these changes have flowed through to retail borrowing costs offers rich insights into the functioning of India's credit markets.

1.1 Objectives of the Study

- To analyze the relationship between RBI's repo rate and retail lending rates in India.
- To evaluate the effectiveness of the MCLR and EBLR frameworks in improving monetary transmission.
- To identify asymmetries in rate transmission — comparing rate hike vs rate cut cycles.
- To assess the sectoral impact on home loans, personal loans, auto loans, and MSME credit.
- To suggest policy measures for strengthening the monetary transmission mechanism in India.

1.2 Scope and Limitations

The study covers the period from April 2015 (introduction of MCLR) to March 2024, with a special focus on the post-2019 EBLR period. Data is sourced from the RBI's Annual Reports, Monthly Bulletins, and SEBI disclosures. Limitations include the unavailability of granular bank-level lending data and the exclusion of non-banking financial companies (NBFCs) due to data constraints.

2. Literature Review

The monetary policy transmission mechanism has been studied extensively in both developed and emerging market contexts. The interest rate channel — through which policy rate changes affect deposit and lending rates, which in turn influence investment, consumption, and aggregate demand — is considered the most direct transmission channel.

In the Indian context, early studies by Mohan (2008) and Singh (2011) documented the sluggish pass-through from the RBI's policy rate to bank lending rates under the Prime Lending Rate (PLR) system. The introduction of the Base Rate system in 2010 was intended to improve transparency, but Bhaumik et al. (2011) found that the Base Rate itself was subject to significant bank discretion, limiting effective transmission.

The landmark shift came with the introduction of MCLR in April 2016, which required banks to link their lending rates to their marginal cost of funds. Pattanaik et al. (2017) found that MCLR improved transmission somewhat, but that banks' behaviour of maintaining wide spreads over MCLR limited the benefits to borrowers. The RBI's Internal Study Group (2017) subsequently recommended shifting to an external benchmark entirely.

Following the introduction of External Benchmark-based Lending Rates (EBLR) in October 2019, where banks were mandated to link floating-rate retail and MSME loans to an external benchmark (typically the repo rate), empirical evidence began to show faster and more complete transmission. RBI studies (2021, 2022) confirmed significant improvement in the magnitude and speed of pass-through under EBLR compared to MCLR.

Internationally, the concept of 'interest rate stickiness' — where retail rates respond sluggishly to policy changes — has been documented by Hannan and Berger (1991) and Borio and Fritz (1995). The Indian experience mirrors many of these dynamics, with additional complications arising from high government borrowing, predominance of public sector banks, and structural rigidities in the deposit market.

3. RBI's Monetary Policy Framework

3.1 Key Policy Instruments

The RBI employs several instruments to conduct monetary policy. The repo rate — the rate at which the RBI lends overnight funds to commercial banks — is the primary signalling tool. Complementary tools include the reverse repo rate (rate at which RBI absorbs excess liquidity), the Cash Reserve Ratio (CRR), the Statutory Liquidity Ratio (SLR), and Open Market Operations (OMOs).

Since 2016, the RBI has operated under a flexible inflation targeting (FIT) framework, with a mandated inflation target of 4% (with a band of ±2%). The Monetary Policy Committee (MPC) — a six-member body comprising RBI officials and external economists — meets bi-monthly to review and set the policy rate.

3.2 Repo Rate Movements: 2015–2024

Period	Policy Action	Repo Rate	Key Context
Jan 2015 – Mar 2016	Gradual easing	8.00% □ 6.75%	Post-inflation targeting framework
Apr 2016 – Jul 2017	Further cuts	6.75% □ 6.00%	MCLR introduced; demonetisation
Aug 2017 – May 2019	Hike then cut	6.00% □ 6.50% □ 5.75%	Global trade tensions, oil prices
Mar 2020 – Apr 2022	Pandemic cuts	5.75% □ 4.00%	COVID-19 economic support
May 2022 – Feb 2023	Aggressive hikes	4.00% □ 6.50%	Inflation surge, global tightening
Apr 2023 – Feb 2025	Hold / Pause	6.50%	Inflation management, growth watch
Apr 2025	Rate cut	6.50% □ 6.25%	Growth support, inflation eased

Table 1: RBI Repo Rate Movements, 2015–2025

4. Evolution of Retail Lending Rate Frameworks

4.1 Prime Lending Rate (PLR) — Pre-2010

Under the PLR system, banks had significant discretion in pricing loans. Sub-PLR lending was rampant, making the benchmark rate meaningless for most large borrowers. This opacity made it virtually impossible for retail borrowers to understand how their loan rates were determined.

4.2 Base Rate System (2010–2016)

The Base Rate was introduced in July 2010 as the minimum lending rate below which banks could not lend. It was calculated based on a bank's cost of funds, operating expenses, and a minimum return on capital. While more transparent than PLR, banks retained the freedom to compute the Base Rate using different methodologies, limiting comparability and transmission.

4.3 Marginal Cost of Funds-based Lending Rate (MCLR) — 2016–2019

Introduced in April 2016, MCLR required banks to set lending rates based on the marginal (incremental) cost of funds, operating expenses, and a tenor premium. MCLR offered better pass-through than the Base Rate since it was more sensitive to current market rates. However, banks could reset rates only at specific intervals (e.g., monthly, quarterly), creating lags in transmission.

4.4 External Benchmark-based Lending Rate (EBLR) — 2019 Onwards

From October 2019, the RBI mandated that all new floating-rate retail loans (home, auto, personal) and MSME loans be linked to an external benchmark. Most banks chose the RBI repo rate as their benchmark. Under EBLR, any change in the repo rate must be fully and immediately passed on to borrowers. This represented a structural improvement in monetary transmission.

Framework	Period	Basis	Speed	Key Issue
PLR	Pre-2010	Bank discretion	Very Slow	No transparency
Base Rate	2010–2016	Average cost of funds	Slow	Bank-specific computation
MCLR	2016–2019	Marginal cost of funds	Moderate	Reset lags, wide spreads
EBLR	2019–Present	Repo rate (external)	Fast	Spread rigidity

Table 2: Comparative Overview of Lending Rate Frameworks

5. Monetary Policy Transmission: Data and Analysis

5.1 Pass-Through Under EBLR vs MCLR

Data from RBI's Monetary Policy Reports reveals a marked improvement in transmission under EBLR. During the COVID-era rate cut cycle (March–May 2020), the repo rate was reduced by 115 basis points (bps). Under MCLR, the weighted average lending rate on outstanding loans fell by only about 43 bps over the same period. Under EBLR, fresh loan rates fell by nearly the full 115 bps, demonstrating near-complete pass-through.

Similarly, during the 2022–23 hiking cycle when the repo rate was raised by 250 bps, EBLR-linked home loan rates increased by 240–250 bps within a few months — confirming rapid transmission in the upward direction as well.

5.2 Sectoral Analysis of Lending Rates

Loan Segment	Apr 2020 (Low)	Feb 2023 (Peak)	Mar 2024	Spread over Repo
Home Loans	6.70%–7.15%	8.50%–9.50%	8.35%–9.10%	+185–260 bps
Auto Loans	7.50%–8.50%	9.00%–10.50%	8.85%–10.25%	+235–375 bps
Personal Loans	10.50%–12.00%	11.50%–14.00%	11.50%–14.50%	+425–725 bps
MSME Loans	7.50%–9.00%	9.50%–12.00%	9.25%–11.50%	+275–500 bps

Table 3: Sectoral Retail Lending Rates, 2020–2024

Source: RBI Monetary Policy Reports, Bank websites (HDFC Bank, SBI, ICICI Bank), 2020–2024.

5.3 Asymmetry in Transmission

A critical observation from the data is the asymmetry in how banks transmit policy rate changes. During rate hike cycles, banks are quick to raise their EBLR-linked rates within the mandatory monthly reset window. However, during rate cut cycles, the headline rates on outstanding loans (still linked to MCLR for older loans) have been slower to adjust, as the transition from MCLR to EBLR portfolios is gradual.

As of March 2024, approximately 55% of outstanding floating-rate loans were linked to EBLR, while the remaining 45% were still on MCLR or Base Rate. This dual-track system creates a two-speed transmission

mechanism — a gap that will narrow as existing MCLR-linked loans mature or are refinanced.

5.4 Deposit Rate Stickiness

An important structural constraint on lending rate transmission is deposit rate stickiness. Since term deposits in India are contracted for fixed tenors (1 year to 5 years), banks cannot immediately reduce their deposit costs even when policy rates fall. This limits the downward flexibility of MCLR and keeps spreads elevated during cutting cycles. Banks argue — with some justification — that they cannot reduce lending rates without first reducing their cost of funds.

6. Key Findings

- The EBLR regime has significantly improved the speed and completeness of monetary policy transmission compared to MCLR and Base Rate systems.
- Near-complete pass-through was observed in the 2022–23 hiking cycle for EBLR-linked loan segments, particularly home loans.
- Asymmetry persists — banks transmit rate hikes faster and more fully than rate cuts, a pattern consistent with international evidence on interest rate stickiness.
- Personal loan rates show the widest spreads over the repo rate, reflecting unsecured credit risk premiums and strong demand among retail borrowers.
- The coexistence of MCLR (older loans) and EBLR (new loans) portfolios creates a dual-speed transmission system, diluting the aggregate impact of policy rate changes.
- Deposit rate rigidity — especially for term deposits — acts as a structural floor on lending rate reductions, limiting pass-through during easing cycles.
- Public sector banks (PSBs) tend to transmit rate cuts more readily than private sector banks, possibly due to social lending mandates and lower profitability thresholds.

7. Policy Recommendations

7.1 Accelerate Migration to EBLR

The RBI should consider setting a sunset date for MCLR-linked loans, encouraging or mandating conversion of existing floating-rate loans to EBLR. This would eliminate the two-speed transmission problem and ensure that all borrowers benefit equally from policy rate changes.

7.2 Flexible Deposit Pricing

Encouraging banks to offer floating-rate term deposits linked to external benchmarks could reduce deposit rate stickiness. This would create a more symmetric cost structure, enabling faster and more complete lending rate transmission on both sides of the rate cycle.

7.3 Transparency in Spread Setting

While EBLR mandates immediate transmission of benchmark changes, banks retain discretion over the spread they charge over the benchmark. The RBI should require greater disclosure and justification of spread components to prevent banks from raising spreads to offset benchmark rate cuts.

7.4 Strengthening Competition in Credit Markets

Greater competition — through fintech lenders, account aggregators, and open credit enablement networks (OCEN) — can reduce the market power of incumbent banks and exert downward pressure on lending spreads. Regulatory support for these ecosystems is crucial.

8. Conclusion

The relationship between RBI's monetary policy and retail lending rates in India has undergone a significant structural transformation over the past decade. The shift from the opaque PLR system to the market-linked EBLR regime represents a major step forward in monetary policy effectiveness. Today, changes in the repo rate flow through to home loan EMIs and MSME credit costs within weeks, rather than months or years.

However, important challenges remain. Asymmetric transmission, deposit rate stickiness, and the residual MCLR portfolio continue to blunt the full impact of monetary policy. As India aims to sustain its growth trajectory while managing inflation, the efficiency of the monetary transmission mechanism will be a critical determinant of macroeconomic stability.

The RBI's April 2025 rate cut — the first in five years — will serve as an important live test of how well the current transmission infrastructure functions in a new easing cycle. For MBA students and practitioners, this dynamic landscape offers a rich arena for continued study, analysis, and policy engagement.

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