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Switching Over from Base Rate to MCLR Regime Can Bring Down the EMI of Home Loan

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Let's understand the facts on how a bank fixes its interest rates. At the time of borrowing a home loan in 2015 (let's assume), the banks were using the base rate mechanism to determine the interest rates. Base rate is the minimal rate fixed by all banks, below which the bank cannot charge its customers.

Base rate can be different for different banks. Why is that so? The answer lies in how a bank manages its profit and loss (P/L). So, its profitability based on predetermined factors plays a crucial role in determining its base rate. Typically, a bank reviews its base rate every quarter.

And just to bring in more clarity, base rate was introduced in 2010. Prior to the base rate, the interest rates were fixed based on prime lending rate (PLR). In the PLR regime, banks had the option to give a rate lower that PLR regime; banks had the option to give a rate lower that PLR, based on their due diligence of the borrower and wherever the banks believed that it was a low-risk loan. Base rate, hence, was introduced as it aimed to offer more transparency and helped the consumers in comparing the base rates between all banks – all banks were required to disclose their base rates.

However, there was a practical flaw. Whenever the Reserve Bank of India (RBI) reduced the benchmark rates (such as repo rates), the banks were not very responsive in passing the benefit to the consumers. And wherever they did pass it, either it was not the complete pass-back or there was much time delay, thereby defeating the essence of what the RBI expected of banks.
Thus, to further streamline and improve the process, the base rate regime was moved to MCLR from Aril 2016. This process is expected to speed up the process of resetting the interest rates on a more actual and real time basis.

MCLR also comes with an interest reset option, which means that the interest rate has to be reset at least once a year. So the interest rate, once on MCLR, becomes fixed till the next reset date. This reset varies from one bank to another, and some banks even offer a 6 months reset clause. This means the rate of interest (ROI) can be fixed for the said period. Hence this can be a good option when the interest rates have gone down.

The banks are now giving an option to convert the loans from base rate to MCLR on mutually acceptable terms. While this is not a new loan, and is a mere transfer from one regime to another, banks do charge for this shift.

Typically, the rate of conversion is 0.50% of the present outstanding and if they add the service tax and the actual costs to the borrower, the cost does come to about 0.58%.

And this is the rate that your bank is also charging you to convert to an MCLR, along with an interest reset clause of 1 year.
Let's now check the numbers to determine whether you should be going for the switch.

Let's assume that housing loan of Rs20.00 lakh was taken @9.90% ROI for 20 year tenure in July 2015 with an EMI of Rs19,168.After paying the regular EMI, the current outstanding is Rs16.55 lakh, at 9.30% (reduced Base Rate) ROI for an 18.5 year tenor (reduced 1.5 years of the total tenure), the EMI is Rs15,645.

And if we convert to MCLR with everything else remaining same – outstanding loan of Rs16.55 lakh and tenor of 18.5 years, but with an ROI of 8.60% the EMI becomesRs14, 917.This shows a clear saving of Rs728 per month. This means, assuming no further changes in interest rates, the cost of converting to a lower rate (Rs9600 approx 0.58% of 16.55 lakh) gets adjusted in the next 13 months. In a different way, this change of interest by 0.70% (9.30-8.60) can reduce the tenure /EMI period by 2 years.

Thus switching over from base rate to MCLR regime is more real time, as well as better regulated. And also in the current times, there are expectations that the interest rates will be coming down. So, it is better option given by the banks to convert existing housing loan from base rate to MCLR.