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# Why Are Indian Banks Unable To Pass On The Interest Rate Cuts? An Enquiry

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**Abstract**

It has been observed that there is asymmetry in the approach of Indian banks when it comes to reacting to interest rate signals given by the Central Bank. While they are quick to react to interest rate increases, they drag their feet when it comes to reacting to interest rate cuts. More often banks pass only a small part of the interest rate cuts. This paper attempts to understand the reasons behind such an asymmetric behaviour. The paper identifies two reasons in the case of Indian commercial banks which are leading to such behaviour. The first reason identified is the oligarchic structure of the Indian banking system where there is a dominance of the public sector banks. The second reason identified in this paper is the pro cyclical behaviour of the Indian public sector banks which has given them an asset-liability profile where their flexibility to react to interest rate signals got severely compromised.


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*Keyword:*Interest rate transmission; procyclical ; banking structure:monetary policy

## 1. Introduction

As the financial markets India are underdeveloped, the bank loans are an important source of funding in India. Due to this fact, the bank lending channel's primacy affects the monetary policy substantially since the transmission of monetary policy stance happens through the bank lending channel.

In the policy statement released in September, 2015 RBI had said that, "the focus of monetary action for the near term will shift to working with the Government to ensure that impediments to banks passing on the bulk of the cumulative 125 basis points cut in the policy rate are removed."[1] The Urijit Patel committee report of the

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RBI in 2014 has discussed the likely impediments to the monetary transmission mechanism in its chapter IV. One of the impediments that the report talks about is the presence of financial and credit market frictions. The report has also provided evidence of the asymmetric effect of policy rates on deposit and lending rates in India. (Table IV of the chapter).[2]

In the Monetary Policy statement by RBI in September 2015, it says that, “Markets have transmitted the Reserve Bank’s past policy actions via commercial paper and corporate bonds, but banks have done so only to a limited extent. The median base lending rates of banks have fallen by only about 30 basis points despite extremely easy liquidity conditions. This is a fraction of the 75 basis points of the policy rate reduction during January-June, even after a passage of eight months since the first rate action by the Reserve Bank. Bank deposit rates have, however, been reduced significantly, suggesting that further transmission is possible.”[1]

In 2016, RBI brought in the MCLR rates which mandated the banks to decide on their lending rates based on marginal cost and therefore pass on the cuts to the customers. The question still stands as to why Banks feel constrained in doing the same. We attempt in this paper to seek an answer to this question.

## 2. Review of Literature

This is not a phenomenon which is limited to India alone. Banks typically do not pass on the full rate cut. In the recent times, this was observed in Canada as well as Australia where banks did not pass on the rate cut in to the economy. Two main reasons as has been seen across is impact on profitability and whether banks have an oligopolistic structure. In the case of Australia for example, four banks corner 92% of the market share while in India, the public sector banks retain more than 75% of the deposits as well as advances. This automatically gives them the power to influence decisions regarding passing on the rate cut. Also, their profitability to a large extent depends on the cost of funding. In a country like Australia, a large part of the funds of the banks come from overseas and as such, a domestic central bank cut hardly impacts the cost of funding for the Australian banks. Thus, it becomes extremely difficult for them to pass on these cuts.

A study done on US commercial banks from the 70s to the 90s throw some interesting results regarding the transmission of the monetary policy. The researchers found that the impact of monetary policy on lending is stronger for banks with less liquid balance sheets, i.e., banks which had lower security to asset ratio. Also this pattern was largely observed in the case of smaller banks. (Kashyap & Stein, 2000).[3] In an idea that was developed in the 1990s, it was proposed that the lending behaviour of banks will change if it has to choose between insured and uninsured sources of funds. The researcher (Stein, 1998) propositions two pathways of monetary policy which is based on the inability of banks to move without friction from insured to uninsured sources of funds. In the first pathway, when the central bank reduces reserves in the system, it forces the banks to move away from insured deposit finance to uninsured non deposit financing. This in turn raises the relative