

Impact on Loans Due to Interest Rate Hikes

A rise in interest rates can significantly impact loans for both borrowers and lenders. The exact effects depend on the type of loan, the terms of the loan agreement, and the broader economic context. Some of the key impacts due to the rise in interest rates are:

- **Increased Monthly Payments:** When interest rates rise, the monthly payments on floating-rate loans will typically increase. This can put added financial strain on borrowers, especially if they have a tight cash flow.
- **Higher Total Interest Costs:** A higher interest rate means that borrowers will pay more in interest over the life of the loan. This is particularly significant for long-term loans like mortgages and home loans, where the total interest paid will substantially increase.
- **Reduced Affordability:** Rising interest rates can make it more challenging for people to qualify for new loans, as higher rates increase the debt-to-income ratio and may require a larger down payment for mortgages.
- **Economic Implications:** Broader economic factors, such as consumer spending and business investments, can be influenced by interest rate changes. Rising rates can slow economic growth, affecting job markets and other financial factors.
- **Inflation Control:** Central banks often raise interest rates to control inflation. While this is beneficial for maintaining economic stability, it can also affect borrowing and spending patterns.

Below, we will understand the impact of interest rate hikes specific to home loans and a similar kind of impact is found across various loans such as Vehicle, Mortgage, Personal etc. based on their rate of interest and tenure.

Effect of changes in home loan interest rate

Home loan interest rates are a factor that we as an individual cannot control. As you are aware, the RBI, in its bi-monthly policy initiative, decides to change the interest rate up or down, which affects the home loan interest rate charged by the lender on our home loan as well. When interest rates go down, we save money because we pay a lower amount of interest while repaying the loan. However,

when interest rates go up, we end up paying more on the interest part. Lenders usually allow us to maintain our EMI and reduce or increase our tenure based on our needs.

In other words, if the interest rate drops, we don't need to do anything because we will benefit from the lower rate. However, when the interest rate on our home loan increases, most people end up making the wrong decision. In this case, the cost increases for us because we will have to pay more interest than we would have if the interest remained the same.

How MCLR Affects Home Loan Interest Rates?

The marginal Cost of Funds Based Lending Rate (MCLR) is a system that Indian banks use to determine the interest rate they will charge on loans, including home loans. It was introduced by the Reserve Bank of India (RBI) to make interest rates on loans more transparent and responsive to changes in the RBI's policy rates. Here's how MCLR affects home loans:

- **Transparent and Fair Interest Rates:** MCLR is designed to bring transparency to lending rates. Under this system, banks have to review and publish their MCLR rates regularly, typically every month. This makes it easier for borrowers to understand the interest rate calculation and how it may change over time.
- **Interest Rate Transmission:** MCLR is directly linked to the policy rates set by the RBI, such as the repo rate. When the RBI changes these rates, banks adjust their MCLR rates accordingly. This means that changes in the RBI's monetary policy can have a direct impact on the interest rates for new & existing loans, including home loans.
- **Reset Periods:** Home loans linked to MCLR typically have a reset period, which can be monthly, quarterly, or annually. During the reset period, the interest rate on the loan remains constant. If the MCLR changes, the interest rate on the loan will be revised only at the end of the reset period. This can lead to some lag in the transmission of rate changes to borrowers.
- **Spread or Margin:** In addition to the MCLR rate, banks typically add a spread or margin to calculate the final home loan interest rate. This margin covers the bank's operating costs, credit risk, and profit margin. The spread remains fixed for the entire loan tenure.
- **Existing Home Loan Borrowers:** For existing home loan borrowers who took loans before the MCLR system was implemented, the interest rates might be linked to the Base Rate or Benchmark Prime Lending Rate (BPLR). They have the option to switch to the MCLR system if they wish to benefit from the more responsive and transparent interest rate regime.

- **Prepayment and Foreclosure:** Banks might charge a penalty or prepayment fee when you prepay or foreclose your MCLR-linked home loan. It's essential to understand the terms and conditions of your loan agreement in this regard.

The MCLR system has led to increased competition among banks to attract borrowers by offering lower interest rates and better terms. Borrowers can compare MCLR-linked home loan rates from different banks and choose the one that suits them best. In summary, MCLR affects home loans by providing a more transparent and responsive interest rate system. Borrowers need to stay informed about changes in MCLR rates and their reset periods, as this will impact the interest rates on their home loans. It also allows borrowers to make informed decisions about choosing a lender and loan product that best fits their financial needs.

What would be the real effect of an increase in interest rates on our home loan?

Let's assume that you are a salaried individual who opted for a home loan with the following terms:

Loan amount: Rs. 50 lakhs

Tenure: 20 years (240 months)

Home loan interest rate: 9% (floating)

EMI: Rs. 44968/-

Let's assume that the loan has been repaid for 10 years and there are still another 10 years to repay it. After 10 years, your loan details are as follows:

Outstanding balance: Rs. 35,51,294 /-

Revised home loan interest rate: 9.25%

Tenure: 10 years (120 months)

EMI: Rs. 45468/-

Thus, we see that the EMI has increased from 44,968 to 45,468 which is an increase of Rs 500. Now this increase over 120 months would be Rs 60,000 /-, which is the effect of an increase of 0.25% in interest rate. Usually, the lender (banks) would just increase the tenure by an additional month and retain the EMI the same as before.

Using the prepayment option

A home loan in India includes the option of prepaying either partially or fully after a while. A prepayment penalty is usually imposed by the lender for exercising this option. It is plausible that when the interest rate goes up and you have surplus funds, you tend to use the prepayment option since you do not want to pay too much interest. A cost-benefit analysis is the best way for you to decide whether to prepay or not. Based on the parameters of the earlier example, the analysis would be as follows:

Let's assume you have surplus funds of Rs. 5,51,294 /- and you want to prepay this amount without a prepayment penalty. When you prepay, your new outstanding would be Rs. 30,00,000 (35,51,294 – 5,51,294). The EMI would be Rs. 38,410.

Thus, we save Rs 7058 (45,468 – 38,410) on EMI which is Rs. 8,46,960 over 10 years or 120 months.

Although these savings seem great on the surface, it's important to do a cost-benefit analysis before prepaying.

Not using the part-prepayment option

If we decide not to prepay but instead invest the surplus funds in a Mutual Fund at an assumed rate of 10% for 10 years, the future value of the invested amount (Rs. 5,51,294) would be Rs 14,29,915/-.

In conclusion, to navigate the impact of rising interest rates on loans, borrowers should consider their financial situation, create a budget that accounts for higher monthly payments, and explore options like refinancing fixed-rate loans before rates rise significantly. Additionally, it's essential to stay informed about changes in interest rates and economic conditions, as they can have a significant impact on your financial well-being.

Research Desk

Dilzer Consultants Pvt Ltd
