POLICY RESPONSE

May 2011

Response to RBI's discussion paper on Deregulation of Savings Bank Deposit Rate[1]

1. Should savings deposit interest rate be deregulated at this point of time?

We think that the Indian economy is ripe for deregulation of savings rate. The recent monetary policy released by the RBI highlights that the Indian economy may experience a slow growth over this year, given an inflation focused tightening of the monetary policy. Given the tight liquidity position in the market, and the inflationary pressures, this market is suitable for deregulation from the depositors' perspective. With repo rate at 7.25%, there is a 3.25% spread between the repo rate and the savings bank deposit rate, and this will ensure that the risk of deposit rates falling below the current levels is minimised. Also, the current liquidity situation will require banks to actively compete with each other for retaining their deposits and attracting more deposits. And with new bank licenses to be issued shortly, the competition will ensure that the clients get overall better deals from banks. This has been the observation from international experience as well. Since banks will be pressured from liability as well as asset sides, they will have to improve their efficiency to stay competitive.

Overall, since a significant portion of household savings are still held in the form of cash, attractive interest rates on savings bank deposits will bring into the banking system a part of the 9.5 lakh crore that households keep with themselves as cash. The international experience shows that the financial savings increases when the deposit rates are deregulated, and people convert cash (which is a deposit with RBI) into interest-paying deposits with banks. At the present rates, the economics of transacting on such bank accounts do not work, and people are better off holding cash.

Some other concerns around the timing are discussed under subsequent questions.

2. Should savings deposit interest rate be deregulated completely or in a phased manner, subject to a minimum floor for some time?

We have addressed this issue under questions 1 and 3. Under the present liquidity and inflation conditions, it is highly unlikely that the savings deposit rates will fall below the present levels, except if banks price the rates differently for certain remote geographies and small value clients, because of real business viability issues. Though we think there is a strong case for complete deregulation, if it is not feasible for RBI to go for this due to concerns for such geographies and clients, it could consider either going for a phased implementation wherein the first stage involves removing the ceiling while maintaining the base, and the second stage involves complete deregulation; or it could initially impose a standard savings deposit rate for all clients and geographies, and deregulate completely at a later stage. Both options are sub-optimal, but the

[1] http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2344

latter is even less desirable because it will impede product innovation, which is one of the key advantages of deregulating the savings deposit rate.

3. How can the concerns with regard to savers (senior citizens, pensioners, small savers, particularly in rural and semi-urban areas) be addressed in case savings deposit interest rate is deregulated?

As the discussion paper mentions, since very rarely are savings deposit interest rates likely to decline below the present level, this is not a major concern. Still, it is possible that banks may use the deregulation to stop serving certain small value clients in remote areas, because till now they have been subsidising these clients, perhaps under pressure from RBI. There is no easy way of addressing the issue of viability of offering savings facilities to low value clients. If there is a subsidy in offering low value accounts, then as the number of these low value accounts increases, the extent of subsidy required to offer them would increase significantly. So banks will need to charge some fees from clients, and now RBI has allowed banks to do so for No Frills Accounts. This is essentially a business model issue, which banks will need to address through innovations. Recent advances in outreach technology and the use of agent-based models have helped banks develop delivery channels that are increasingly making sense for low value accounts.

Even if banks are not able to develop viable business models to service small value accounts, subsidising these accounts through the banking system may not be the best way to help the low income customers. There are other, more effective ways of helping the weaker sections than distorting the interest rates just for this purpose. Even if the rates are likely to go below their present levels for such accounts, given the Government of India's overall move away from indirect subsidies and towards direct cash transfers, it would be inconsistent to make a case for continuing this subsidy through the banking system.

For the pensioners, we must ask: Is a savings bank account a good instrument to be used for annuitisation of retirement savings? There are better annuity solutions available in the market, and better solutions will emerge as the retirement financing market develops in India's financial system. RBI's proposal of issuing inflation indexed bonds is relevant here, because such bonds may be better instruments for such investors.

Still, if it is not feasible for the RBI to go for an immediate deregulation, it could consider phased deregulation, though we don't think this is required. Under phased deregulation, RBI could consider implementing in two phases: first removing the ceiling on rate, while maintaining the base rate; and, subsequently removing the base rate, once the issues around costs of service delivery for small value accounts especially in rural areas are understood. Keeping the base rate constant will also help reduce the possibility of collusion among banks to reduce the rates in tandem, which is admittedly a low probability event, given the increasing level of competition among banks. The other option for ensuring that low value accounts do not get lower rates is to mandate the banks to pay a standard rate on all savings accounts, and then subsequently deregulating completely. But it must be noted that this will impede innovation, because the banks will not be able to adapt localised business models, which is one of the key advantages of deregulation.

4. How serious are concerns relating to a possible intense competition amongst banks and asset-liability mismatches if savings deposit interest rate is deregulated?

It is important to note that interest rate is just one of the many features of a savings bank account, and, where they have choice, the customers take a decision based on the overall experience of dealing with the bank. This may very well be the reason why the shift in deposits was not significant when the term deposit rates were deregulated. If deregulation of interest rate for term deposits, which constituted more than 60 per cent of deposits, did not have any destabilising impact, deregulation of interest rate for savings deposits, which constitute about 22 per cent of total deposits, may not have a significant adverse impact on the system.

The asset-liability mismatch issue is relevant only in the short term, and might actually create more competition among banks, which will need to compete to maintain their deposit base. In the short run, some banks, to attract deposits, may go for pricing that may turn out to be unsustainable in the long run. This would be less problematic if it only affects the respective bank, but since such behaviour by a bank may affect other banks, especially because of the ALM problems it might create for them, this may have negative externalities beyond the respective bank. Though the discussion paper describes the positive experience of deregulating term deposit rates, and how that did not lead to unhealthy competition, the competitive landscape has changed a lot in India since then, and things may turn out differently this time. This concern can be at least partially tackled if RBI considers deregulating the rate with a lag of a few months, announcing in advance but implementing 2-3 months later, so that banks get the time to plan carefully and adjust for the change. Giving more time could help reduce the probability of a hasty competitive reaction by banks competing for deposits. Also, requiring banks to communicate to RBI their cost structures and rationale in a transparent manner could also create a deterrent against over-compensating the deposits.

A concern raised in the discussion paper is that banks may introduce some complex products, which may not be so easily understood by savers, and these strategies may result in increase in the mis-selling of savings bank products. Our view is that not deregulating the deposit rate is not the answer to this problem. This issue needs to be tackled by stronger customer protection laws, holding the providers accountable for the quality of communication to the clients.

RBI should also consider issuing guidelines on best practices in ALM in wake of savings bank deposit rate deregulation, based on international experiences. Such guidelines could help the banks in dealing with the challenges that some of them may face.

5. Should higher interest rate be paid on savings deposits without a cheque book facility?

We don't see any reason for the RBI to take a view on this. The product features should be left to the banks to decide. As international experience suggests, over a period of time, competition should ensure that a range of options at various prices emerge that the clients can choose from.