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Theme 240

DEREGULATION OF SB INTEREST

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SIB STUDENTS' ECONOMIC FORUM

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THEME 240 : DEREGULATION OF SB INTEREST

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". This month, we discuss on "Deregulation of Savings Bank Deposit Interest Rates" announced by Reserve Bank of India on 25 October 2011, while releasing the Second Quarter Review of Monetary Policy for 2011-12.

What do you know of a Savings Bank Deposit?

Generally the public make their investment decisions based on four major preferences. They are

1. Liquidity
2. Safety
3. Returns
4. Convenience.

Bank deposits are widely considered as highly liquid, safe, providing reasonable returns and with high degree of convenience. Savings deposit is a hybrid product which combines the features of both a current account and a term deposit. It is a popular deposit scheme which provides the convenience of easy withdrawals, usage of ATM Cards, facility of cheques and access to numerous high tech services through the Payment and Settlement Systems. The household community considers the SB account as an avenue to park their short term funds, which provides them returns on the daily balances. There is minimum balance stipulation but there is no ceiling on the maximum amount that can be drawn per transaction.

What are the major announcements made by RBI through its Second Quarter Review of Monetary Policy for 2011-12?

RBI has deregulated the savings bank interest rate along with increase in the short term indicative policy rate (repo rate) by 25 basis points, with immediate effect. This is the 13th hike in policy rate in the last 18 months ie; since March 2010.The repo rate has been increased from 8.25 % to 8.50% and reverse repo rate stands recalibrated to 7.50% with a future outlook that inflation is likely to come down in December 2011 and as such any further hike may not be warranted. Repo rate is the rate at which banks borrow funds from the Central Bank. Hence the lending rates offered by banks may go up further. Dr. D.

Subbarao, Governor, RBI is optimistic that the rise in price will reverse and continue down a steady path to 7% by March 2012. He believes that it would moderate further in the first half of 2012-13.

What were the earlier steps of deregulation?

Deregulation means removing official controls and granting full freedom to banks for determining interest rates on their own. The process of deregulation was set in motion from April 1985. The first step was in allowing banks to fix deposit rates for maturities between 15 days up to 1 year within a ceiling of 8%. But the move led to unhealthy competition with almost all banks offering rates @8% for maturities from 15 days up to 1 year, without any concern on profitability. There was a considerable shift in CASA deposits to 15 day deposits. The price war among banks forced the regulator to withdraw the freedom in May 1985. Again in April 1992, RBI introduced a single ceiling rate of 13% for maturities above 46 days. In November 1994, the ceiling rate was brought down to 10% and again raised to 12% in April 1995. In October 1995 banks were given freedom to fix the rates on deposits above 2 years. In July 1996, the facility was extended to deposits of above 1 year. The deposits below 1 year were linked to Bank Rate by fixing the rates at 200 basis points lower. The complete deregulation of term deposits was announced by RBI in October 1997 by delinking the term deposit interest rates from Bank Rate. As such banks were given freedom to set interest rates on domestic deposits of all maturities with approval of the individual Boards on the recommendation of Asset Liability Management Committee (ALCO). Later, in April 1998, the restriction in fixing different rates depending on size of the deposits was withdrawn in respect of deposits of Rs.15 lakhs and above. As of now banks are enjoying full freedom to fix the domestic term deposit rates and penal rates for premature withdrawal. RBI has neither put a floor on savings rate nor restricted the number of times banks may change the rate. With the recent announcement, all deposit rates except the NRI segment stand deregulated.

What are the major objectives of deregulation?

The major objectives are

1. To strengthen the monetary policy measures by the regulator.
2. To strengthen healthy competition in the banking sector.
3. To improve the efficiency in resource mobilisation
4. To improve the efficiency in resource allocation.
5. To facilitate better management of assets and liabilities.
6. To improve the asset quality.
7. To benefit the masses through competitive pricing of savings accounts.

The Savings Bank deposit is the most popular product in Indian Banks. As a major content in CASA segment, the product is largely held by Indian households across the country. In order to popularise the product further, banks are applying interest on daily balances in the SB accounts from this financial year onwards. As per a recent estimate, the Savings deposits form almost 13% of financial savings of all strata of bank customers and constitute about 22% of total deposits of all the scheduled commercial banks in India. The developed economies in Canada, USA, UK and Singapore have already given the right to their commercial banks to fix interest rates on savings accounts. Deregulation has helped these countries to enhance the efficiency standards. In China, a ceiling rate is specified in these types of accounts.

What do you understand from the above announcement?

RBI considers that the price rise remaining at 9.00 % continues to be its major macro-economic concern. Inflation is measured on a broad base taking into account the three major groups viz ; primary articles, fuel and power and manufacturing products. It is necessary, for transmission of monetary policy to be effective, that all rates move in tandem with the policy rates. RBI has also revised the projected growth rate for 2011-12 from 8.00 % to 7.60%, pointing out to the slackening of investment demand and slowdown in project execution. With deregulation of savings bank deposit interest rates, banks are given freedom to determine the rates on their own. But RBI has directed that each bank has to offer a uniform rate on savings bank deposits up to Rs.1.00 lakh, irrespective of the balances held in these accounts within the above limit. Banks are given freedom to offer differential rates on savings deposits above Rs. 1.00 lakh according to their choice.

Briefly comment on the deregulation move of RBI?

RBI earlier passed a draft order regarding deregulating the savings bank rates, keeping the process of deregulation going and making its intention clear. The interest rate on savings bank deposits remained unchanged at 3.50% since March 1, 2003. The rate was increased to 4.00% from May 3, 2011. It is of course true that the rate is low compared to the prevailing high inflation. With the present move, any change in policy rates, hence forth, would reflect on savings bank rates also. RBI has made it clear that in a matured economy, even the savings bank rates should be in tune with the market rates.

How do banks react to the move by RBI?

The profit of banks depends on the “spread”- the surplus available in the yield on advances over the cost of deposits. The CASA term introduced by banks stands for deposits in **Current Account and Savings Accounts.** The CASA segment has a big role to play in determining the cost of deposits and thereby the spread and the profit. As per an estimate, the CASA deposits of public sector banks vary from 30%-50% of the total deposits. The deregulation move may further worsen the strain on margins for banks. Banks want RBI to deregulate all services so that they can charge for some services which are free now.

How do the depositors view the decision?

Depositors can expect better interest rates than the existing rates. The recent move will certainly increase competition among banks and benefit the depositors. The depositors are guaranteed more value for their SB accounts, but the service charges may go up to cover the loss due to hike in savings rates. The hike in SB rates may have good impact on rural and semi-urban depositors .The increased interest rate may bring relief against the huge price rise to the masses.

How do Banks perceive the move?

The financial reforms initiated in the early 90s have led to market efficiency, sound financial systems and entry of new banks in the private sector. During the last 18 months, the Indian Banks are under severe constraints due to frequent hike in policy rates. The margins are narrowing and the high lending rates pose the threat of a further build up in Non Performing Assets (NPAs). Deregulation of SB rates may increase the cost of deposits with further strain on the bottom lines. The new contenders awaiting entry into the banking sector view the SB segment as one of the most potent tools to attract the depositors. One of the new generation banks has already announced a hike in SB deposit rates by 200 basis points. State Bank of India expects its average funding cost for savings bank accounts to rise by 100-125 basis points.

What are the benefits of deregulation?

The Savings Bank Deposit is highly popular for its convenience in undertaking transactions through the various Payment and Settlement Systems and has become more attractive due to the recent upward revision in interest rate. As directed by RBI, the interest calculations have been modified to daily basis from monthly basis recently. The present move may further enhance the attraction towards this product, taking into account the high liquidity, high returns and the inherent convenience of this segment. With deregulation of SB rates, the regulatory frame work seems more effective. Any change in policy rates announced by RBI may have a direct impact on the SB rates like other term deposit rates. The major benefit for the depositors will be the option to choose from a wide range of products, the flexibility in operation and the high liquidity offered by banks in terms of notice period, number of withdrawals and so on.

What are the major concerns on Competition and Asset Liability Management (ALM)?

RBI has advised that each bank will have to offer a uniform interest rate on SB deposits upto Rs.1.00 lakh, irrespective of the amount in the account within this limit. For SB deposits over Rs.1.00 lakh , a bank may provide differential rate of interest, if it so chooses. However there should not be any discrimination from customer to customer on interest rates for similar deposits. There is a general apprehension that deregulation of SB interest rate, may lead to unhealthy competition among banks. The CASA content of public sector banks is estimated to be in the range of 30 to 50%, whereas some banks in the private sector and in the new generation category maintain the same in lesser proportion. As a result, banks with lower CASA content may devise strategies to improve their SB content by offering higher rates. However, if deregulation of term deposit interest rate, in the past, is any indication, the possibility of unhealthy competition, arising out of deregulation of SB interest rate, is low.

Banks may also feel the pressure in the area of Asset Liability Management. There is a strong feeling that deregulation may defeat the sanctity of the ALM process and create mismatches making it difficult for banks to mitigate the resultant risks. As of now, 90% of the SB deposits are treated as core deposits while making decisions on exposure to long term and infra structure segments. The issue is whether the core component of savings deposits would undergo a substantial shift if the SB rates are deregulated. A deeper analysis of the ALM data suggests that the fear of asset liability mismatch arising out of deregulation of SB interest is misplaced. Let us hope that deregulation may pave the way to healthy competition in resource mobilisation and improved efficiency in resource allocation.

DEREGULATION OF SAVINGS BANK DEPOSIT RATES:

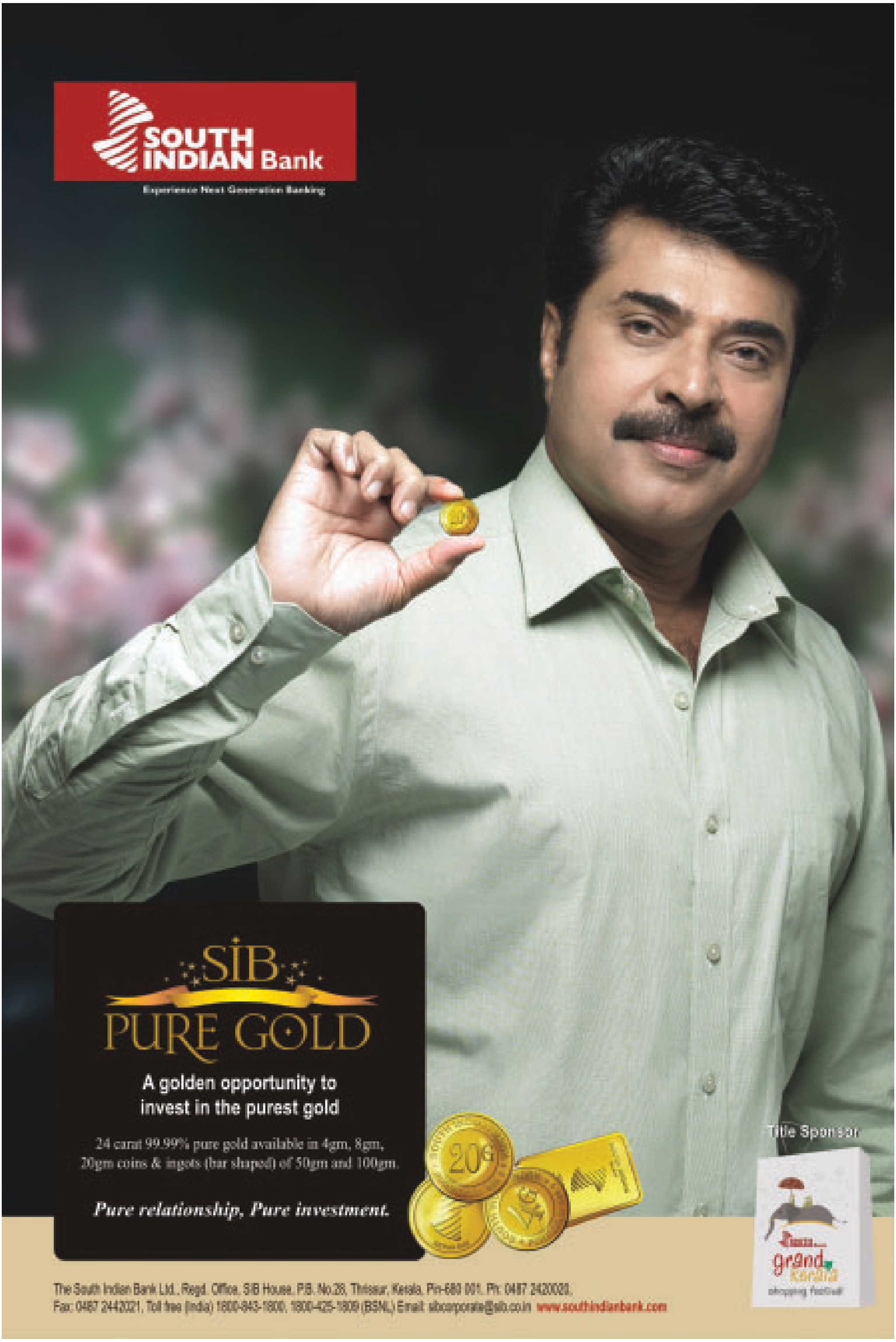
PROS:

1. IMPROVED TRANSMISSION OF MONETARY POLICY.
2. ATTRACTIVENESS OF SAVINGS BANK DEPOSITS.
3. EMPHASIS ON IMPROVED CUSTOMER SERVICE.
4. INTRODUCTION OF NEW PRODUCTS.
5. EFFICIENCY IN RESOURCE MOBILISATION.
6. EFFICIENCY IN RESOURCE ALLOCATION.
7. IMPROVEMENT IN ASSET QUALITY.

CONS:

1. UNHEALTHY COMPETITION.
2. NARROWING MARGINS.
3. ASSET LIABILITY MISMATCH.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in



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