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EXTERNAL BENCHMARKING OF LENDING RATES: TIME FOR BENCHMARKING BULK DEPOSIT RATES?

Issue No. 33, FY20
Date: 20 August 2019

RBI has deregulated the interest rate structure and has moved from Prime Lending Rate (PLR) to Base rate to MCLR for better transmission. Recently, RBI has been pushing the banks to benchmark the loans to an external benchmark. However, for external benchmarking, it is not possible for banks to only link the asset side of the balance sheet to an external benchmark creating significant ALM mismatches (close to 35% of bank liabilities are Savings Bank Deposits). Further, the banks are also not able to link external benchmark to the entire liabilities (especially time deposits), as the floating term deposits are not accepted by the Indian depositors and have already been unsuccessfully experimented by some peer banks in India.

The key to effective transmission thus we believe is adjusting either Savings Bank Deposits or Time Deposits. SB deposits typically serve the transaction needs of the depositor. The option is always available with the customer to transfer the surplus SB balance to time deposits. **However, the problem is it cannot be done in isolation by any one bank and has to be enforced by the regulator.**

The best option we believe could be that regulator enforces all incremental bulk deposits henceforth to be repo linked /flexible. In India, single rupee deposits of Rs 2 crore and above are considered as bulk deposits and banks have discretion to offer differential rate of interest on bulk deposits. The share of bulk deposits in banks' total deposits could be around 30% after the definitional change. **Needless to say, most of the bulk deposits are from institutions. It is thus logical that large institutions could afford to take interest rate risk as this would spare the retail depositors from taking the same.** We can at least initiate a discussion on this.

Even as transmission remains a challenge, we believe banks can reduce deposit rates and align real deposit rates that are as high as 4.45%. Our estimates suggest that bank deposit rates remain the largest constraining factor in rate transmission. For example, a 100 basis point cut in deposit rates could result in 45-50 basis point reduction in lending rates. Interestingly, small savings rates is not a constraining factor as incremental small saving collections are merely 11% of incremental deposits! However, in a developing country like India, cutting deposit rates always remains a challenge given that a large populace of senior citizens depend on interest income from deposits as a source of livelihood!

Finally, some food for thought. Interest rates offered on deposits in India are also demography agnostic! Time to change such a regulation?

TRANSMISSION OF POLICY RATE

- Timely transmission of the monetary policy rate in its entirety is imperative to ensure that the beneficiaries are receiving/bearing the effect of the changes of the bi-monthly monetary policy. Until now, the transmission has been slow though this is the fourth rate cut in a row - the policy rate is down from 6.25% in February 2019 to 5.40% now. During the same period, banks have on an average transmitted around 40 bps through their MCLRs with public sector banks transmitting more than the private sector banks.
- For better transmission, RBI has been pushing the banks to do external benchmarking of their lending rate either to repo, T-bills or 10-yr G-secs. Due to the volatility of the T-bills, it is always better to link lending rates with the policy repo rate. Recently, RBI Governor indicated that RBI expects banks to move faster on transmitting repo rate cuts to lending rates by linking the latter to an external benchmark, including the repo rate.
- In order to address the concern of rigidities in the Balance Sheet structure and address the issue of quick transmission of changes in RBI's policy rates, effective from 1st May 2019, SBI took the lead in linking its pricing of Savings Bank Deposits with balances above Rs 1 lakh and Short Term Loans (Cash Credit accounts and Overdrafts with limits above Rs 1 lakh) to the Repo Rate of RBI as an External Benchmark.
- Due to this move, SBI floor rate (Repo Linked Lending Rate-RLLR) for the short term loans has declined from 8.50% (at the time of announcement of linking) to 7.65% (a whopping reduction of 85 bps) effective from 1st September 2019.

1Y MCLR of Select Banks (%)

Banks	Aug'18	Jan'19	Latest (Aug'19)	Change (Jan-Aug)(BPS)	Change in BPS (Aug'18-Aug'19)
Public Sector Banks					
Bank of Baroda	8.50	8.65	8.45	-20	-5
Canara Bank	8.60	8.70	8.50	-20	-10
Punjab National Bank	8.45	8.50	8.30	-20	-15
Union Bank of India	8.55	8.70	8.50	-20	-5
Andhra Bank	8.55	8.75	8.45	-30	-10
Allahabad Bank	8.45	8.75	8.40	-35	-5
Bank of India	8.75	8.70	8.35	-35	-40
State Bank of India	8.25	8.55	8.25	-30	0
Private Sector Banks					
HDFC Bank	8.40	8.75	8.60	-15	20
ICICI Bank	8.40	8.80	8.65	-15	25
Kotak Mahindra	8.95	9.00	8.85	-15	-10
Yes Bank	9.55	9.85	9.70	-15	15
Axis Bank	8.60	8.85	8.65	-20	5
IDBI Bank	8.75	8.95	8.50	-45	-25
Memo:					
RBI Repo	6.50%	6.25% (Mar'19)	5.40% (Current)	**85 bps Reduction**	
SBI RLLR	-	**8.50% (at the time of linking)**	**7.65% (as of 1st Sep'19)**		

Source: SBI Research

Bank Group Wise Median MCLR (1 Year)

in %	Jan-19	Jul-19	Change (in
Public Sector Banks	8.75	8.60	-15
Private Sector Banks	9.30	9.45	15
Foreign Banks	8.65	8.64	-0.9
Scheduled Commercial Banks	**8.80**	**8.60**	**-20**
Memo:			
Repo Rate	6.50	5.40	-110
10-Year G-sec Yield (Avg)	7.37	6.52	-85

Source: RBI; SBI Reseach

MAKING MEANINGFUL TRANSMISSION BY MANDATING BULK DEPOSITS TO BE FLOATING

- One of the reasons why transmission is not happening is that any bank which would take the lead, of deposits being market determined, would probably lose meaningful quantum of business as bulk customers would have better bargaining power or would easily switch bank. However, retail customers can't really negotiate terms - and so it is easy to implement and let them forego. Hence, banks cannot separately link retail savings only to be linked to repo on liability side of balance sheet of bank.
- **Possibly, the only solution that regulator enforced that all incremental bulk deposits have to be repo linked.** In India, single rupee deposits of Rs 2 crore and above (since Feb'19, earlier it was Rs 1 crore and above) are considered as bulk deposits and banks have discretion to offer differential rate of interest on bulk deposits as per their requirements and asset-liability management projections. The share of bulk deposits (Rs 1 crore and above) in banks' total deposits was in the range of 32%-38% in the period between Mar'16 to Mar'18. This was more than 40% in some fiscals also but with the revision of definition we believe that this share is currently not more than 30% of total deposits. Needless to say that most of the bulk deposits are from institutions.
- This could protect interest of retail savers and also help system achieve quicker transmission. We believe banks would be comfortable if bulk deposits are floating rate and be more willing to pass on as well by having repo linked loans (as their spreads get locked with more stability in NIMs). **Since no bank can do it alone and sail through, it needs to be an RBI decision for implementation to happen**.
- A rough estimate indicates that a 100 bps decline in deposits rates translates into around 45-50 bps decline in lending rates.

SMALL SAVING RATES ARE NOT THE EVIL OF TRANSMISSION

- The market consensus is that the rate of interest on small-saving schemes must be in sync with the policy rate to enable the banks to lower the rate on their deposit schemes, which will facilitate bank transmission of lending rates. Recently, Government has cut the small saving rates to align it with market determined rates, which is effective from 01 Jul'19.
- However, considering the following data for the year FY19, incremental bank deposits expanded by Rs 11.5 lakh crores, while incremental small saving collections were at Rs 1.25 lakh crores, that is a mere 11% of overall incremental bank share. Thus, the more important factor is bank deposit rates that tend to impede transmission.
- In order to raise the resources, banks also must look to introduce more value-added products and services rather than raise the deposit rates. It will enable banks to mobilise deposits even at lower rates and pave the way for transmitting the effects of the monetary policy rate.

ASCB Share of Bulk Deposits (Rs 1 crore and above) in Total Deposits (%)

Mar-end	INDIVIDUALS		OTHERS		TOTAL	
	# of Accounts	Amount	# of Accounts	Amount	# of Accounts	Amount
Mar-13	0.1	9.8	1.1	75.9	0.2	45.6
Mar-14	0.1	18.5	1.2	52.8	0.2	34.0
Mar-15	0.1	12.9	1.2	76.8	0.1	43.0
Mar-16	0.0	11.5	1.1	72.3	0.1	38.1
Mar-17	0.0	7.5	1.2	67.8	0.1	33.4
Mar-18	0.0	6.0	1.3	68.9	0.2	32.5

Source: RBI; SBI Research

1Y Real Term Deposit Rate (%)

Private Sector Banks	IndusInd Bank	4.45
	IDBI Bank	3.95
	Axis Bank	3.95
	HDFC Bank	3.85
	ICICI Bank	3.75
Public Sector Banks	OBC	3.70
	Corporation Bank	3.65
	SBI	3.65
	PNB	3.60
	Union Bank	3.60
	Canara Bank	3.55
	Central Bank	3.45
	IOB	3.45
	United Bank	3.35
	BOI	3.35
	BOB	3.30

Source: SBI Research

Small Savings Rate

Instrument	Apr-Jun 2019	Jul-Sep 2019	Compounding Frequency
Saving Deposits	4.0	4.0	Annually
1 Yr Time Deposits	7.0	6.9	Quaterly
2 Yr Time Deposits			
3 Yr Time Deposits			
5 Yr Time Deposits	7.8	7.7	
5 Yr Recurring Deposits	7.3	7.2	
5 Yr Sr. Citizen Savings Scheme	8.7	8.6	Quaterly & Paid
5 Yr National Savings Certificate	8.0	7.9	Annually
Public Provident Fund Scheme	8.0	7.9	
Sukanya Samridhi Scheme	8.5	8.4	
Kisan Vikas Patra	7.7 (will mature in 112 months)	7.6 (will mature in 113 months)	

Source: SBI Research

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