ECOWRAP

भारतीय स्टेट बैंक
STATE BANK OF INDIA

'Be the Bank of Choice for a Transforming India'

MARCH 13, 2019
ISSUE NO:96, FY19

COMETH THE HOUR, COMETH THE LEADER!

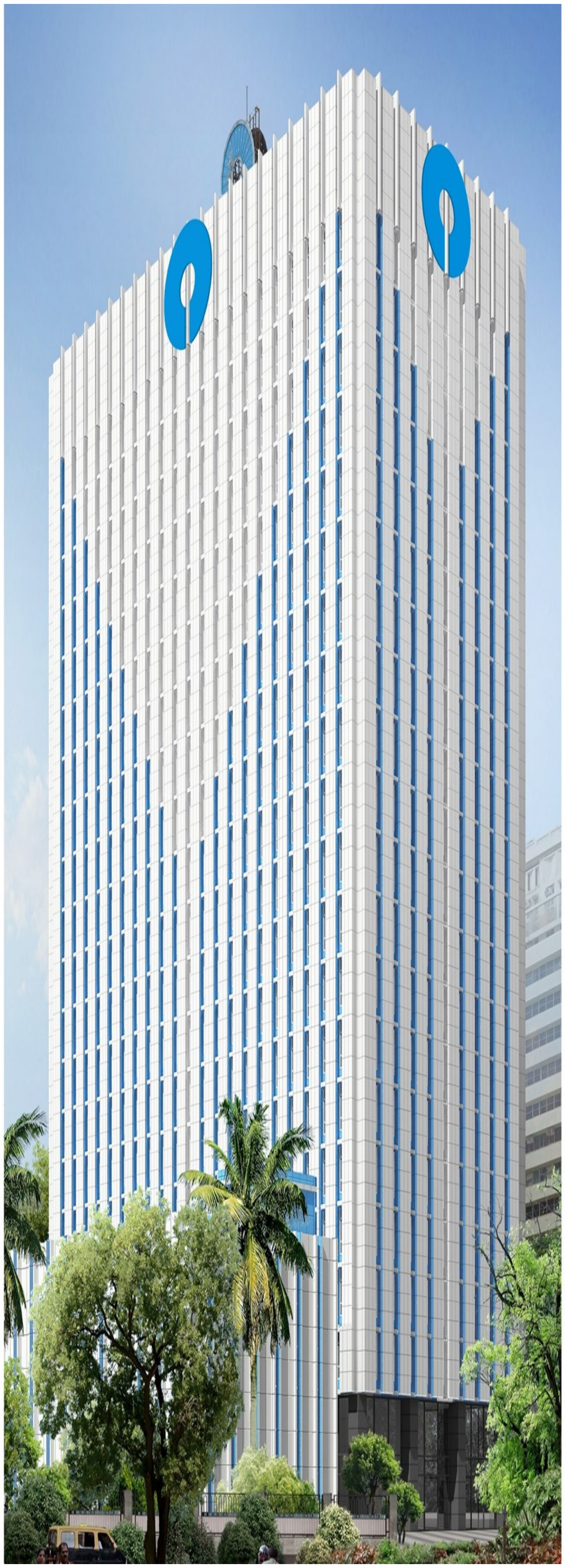
On March 8, SBI decided to link Savings Bank (SB) Deposits and Short Term Loans (over Rs 1 lakh) to the Repo Rate of RBI in order to address the concern of rigidities in the balance sheet structure and address the issue of quick transmission of changes in RBI's policy rates.

The rationale for setting the limit as Rs 1 lakh is primarily to protect the small time depositors from the vagaries of market fluctuations. It may also be noted that RBI allows a differential interest rate structure for saving bank deposits only beyond Rs 1 lakh and the deposit insurance cover is also applicable until Rs 1 lakh. Additionally, aligning the repo rate with the saving bank rate over the Rs 1 lakh threshold could be a win- win situation for the bank, the customer as well as the regulator. The option is always available with the customer to transfer the surplus SB balance to time deposits, which will help the banks to plan the ALM accordingly.

We believe that linking the SB rate with repo rate and not a market rate like T-bill is the best option. First, SB deposits typically serve the transaction needs of the depositor and thus could be less prone to movements. Second, in India, interest on deposits are an important source of income for many, particularly the rural and middle class segments. For example, term deposits with ASCBs have an average balance of Rs 2.75 lakhs equivalent to a monthly interest income of Rs 1610 (@7% p.a.) as against a monthly income of Rs 9416 (per capita income of Indians are Rs 1.13 lakh). The interest income, therefore, forms around 17% of the income, a too big an amount to be left to the whims of market determined rates. It may be noted that SB interest is around 2% of our PFCE, and hence less prone to market volatilities.

The linking of lending rates to external benchmark also needs to factor the RBI announced guidelines on carving out a loan component from working capital needs. The key intent of this was to instill a sense of discipline among large corporates by encouraging them to tap alternative funding routes. It is thus no wonder that corporate bond issuances have swelled and during the 9MFY2019 period, Rs 4.70 lakh crore has already been mobilised. Thus, this SBI step could potentially usher in a better all round price discovery and complement the rate transmission for larger borrowers that is already in process.

Further, this step could also result in a push to derivative market in India. Of late, the growth in the Indian IRS market has been expedited with the various market development initiatives by the regulator. Just to put in a different way - currently, all kinds of risk, be it FX, credit or rates, all are largely warehoused in banking system itself and with economy growing, we need to diversify this risk across financial markets. This apart, in India, the time has now also decisively come to experiment with floating rate deposits with perhaps better incentivization. An alternative way to look into such an approach is to allow interest rates offered on deposits in India to be linked to perhaps an age-wise structure.



SBI LEADS THE PATH FOR EXTERNAL BENCHMARKING

- RBI has deregulated the interest rate structure and in the last decade, RBI 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 one of the external benchmark: (i) RBI's policy Repo rate; (ii) 91/182-days T-bills yield; or (iii) any other benchmark market interest rate produced by the Financial Benchmarks India Private Ltd (FBIL). However, RBI had left it to the individual bank to decide the spread over the benchmark rate, which would remain constant through the full tenor of the loan.
- For external benchmarking, it is not possible for banks to only link the asset side of the balance sheet creating ALM mismatch. 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. So, SBI has taken the lead in linking its key pricing decision for Savings Bank (SB) Deposits and Short Term Loans to the Repo Rate of RBI 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. The major steps taken in this direction are as under (effective from 1st May 2019):
    - Linking of Savings Bank Deposits, with balances above Rs 1.0 lakh to Repo rate with current effective rate being 3.50% p.a. (2.75% below Current Repo Rate of 6.25%)
    - All Cash Credit accounts and Overdrafts with limits above Rs 1.0 lakh also to be linked to the Repo Rate (Current Repo Rate 6.25% plus a spread of 2.25%). The Risk premiums over and above this floor rate of 8.50 % would be based on the risk profile of the borrower, as is the current practice.
    - Exempt Savings Bank account holders with balances up to Rs 1.0 lakh and borrowers with CC/ OD limits up to Rs 1.0 lakh from linkage to the Repo rate.
- It is expected that other banks might also follow the suit and will link their deposits with external benchmarks. With this, both assets and liabilities in the banks' balance sheet will move in same direction when there is a change in repo rate by RBI. The rationale for setting the limit as Rs 1 lakh is primarily to protect the small time depositors from the vagaries of market fluctuations. It may also be noted that RBI allows a differential interest rate structure for saving bank deposits only beyond Rs 1 lakh and the deposit insurance cover is also applicable upto Rs 1 lakh.

IMPLICATIONS OF EXTERNAL BENCHMARKING TO REPO RATE

- Indian banking sector has a deposits base (as of Mar'18) of Rs 1,14,345 billion out of which 32.9% or Rs 37,654 billion are savings bank (SB) deposits with almost 70% of SB deposits with Public Sector Banks. As per our estimates, nearly 75% of SB deposits are above Rs 1 lakh (amount-wise) and if the banking system implements this decision then a 25 bps change in repo rate will have impact of Rs 70.6 billion in either direction based on the direction of repo rate movement.
- SB deposits typically serve the transaction needs of the depositor. Thus, aligning the repo rate with the saving bank rate over the Rs 1 lakh threshold could be a win- win situation for the bank, the customer as well as the regulator. The option is always available with the customer to transfer the surplus SB balance to time deposits, which will help the banks to plan the ALM accordingly.
- From a banks point of view, a variable interest rate will have a positive outcome as it lowers NIM volatility, but the impact of this move would be well understood once we evaluate savings behavior during various rate cycles and reaction from competitors.

Bank Group-wise Savings Banks (SB) Deposits in Rs Billion

Bank Group	Deposits			SB Deposits morethan Rs 1 lakh	Impact of 25 bps Repo change
	Total Deposits	SB Deposits	SB % Total Deposits		
Public Sector Banks	76460	26294	34.4%	19721	49.3
Foreign Banks	4765	572	12.0%	429	1.1
Regional Rural Banks	3911	2010	51.4%	1508	3.8
Private Sector Banks	29037	8735	30.1%	6551	16.4
Small Finance Banks	170	43	25.1%	32	0.1
Total	**114345**	**37654**	**32.9%**	**28241**	**70.6**

Source: RBI; SBI Research

ADVANCES ALSO LINKED

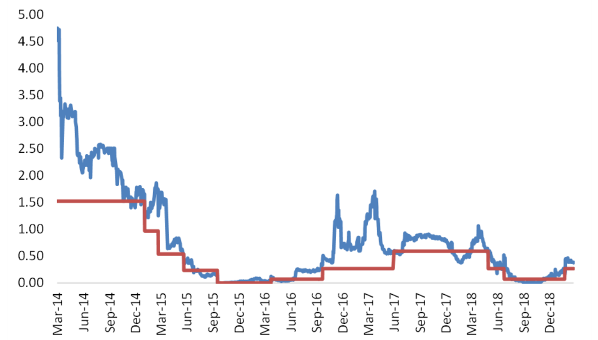
- SBI has also linked CC and OD to repo rate. For ASCBs, the outstanding cash credit (CC) and overdraft (OD) above Rs 1 lakh amount to 22.30% of the total ASCB advances. If all banks link CC/OD to repo rate and there is 25 bps change in repo, the net interest income of ASCB will change by around Rs 49 billion.
- Furthermore, MCLR will also get affected by change in repo rate. Thus 25bps change in repo will affect the remaining MCLR linked portfolio to the tune of Rs 22.7 billion, thereby taking the total impact on advances to Rs 71.5 billion which is almost similar to the impact on advances. Hence, the total impact of repo rate change is likely to be NIM neutral for the banking sector.

Classification of Outstanding SCB Credit (Rs Billion)				
As of March 2018	Cash Credit		Overdraft	
	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstanding
Upto 1 lakh	11194	1768	6281	861
Above 1 lakh	952	13678	906	5827
Total	12146	15446	7187	6689
Above 1 lakh (CC+OD)				19506
ASCB Advances				87460
Above 1 lakh (CC+OD) as % of Total Advances				22.30%
Impact of 25 bps repo rate change (A)				**48.76**
MCLR linked advances				46089
Impact on MCLR linked advances of 25 bps rate change (B)				**22.73**
Total impact of 25 bps repo rate change on advances (A+B)				**71.49**
Source: RBI, SBI Research				

WHY REPO RATE & NOT ANY OTHER BENCHMARK

- RBI has given the option of linking floating rate loans to policy repo rate, or GoI 91 days Treasury Bill yield, or - GoI 182 days Treasury Bill yield or any other benchmark market interest rate produced by the FBIL.
- One of the arguments is that by linking repo rate with saving bank rate, the interest rate structure will be solely determined by RBI policy decisions and thus the SB rates may not reflect liquidity mismatch / deposit and credit gap. However, by this logic, even as currently deposit growth significantly outpaces the credit growth, call rates are still aligned close to policy rate reflecting no apparent liquidity concerns. Therefore, any discussion relation to liquidity may require a comprehensive examination of the existing liquidity framework (*our forthcoming Ecowrap*).
- It may be noted that in India interest on deposits are an important source of income for many, particularly the rural and middle class segments. For example, SB interest income currently constitutes 1.8% of the Private Final Consumption Expenditure (PFCE) of individuals. However, interest income on time deposits are nearly 10% of PFCE and hence any effort to go beyond SB and subsequently link time deposits with market rates could introduce a significant spike in consumption patterns of individuals. This could actually result in a concomitant decline in income velocity of money as money could then be used more for precautionary purposes.

Variation in 91 Day T-Bill and Repo Rate



Source: SBI Research

- Instead, we believe that linking the SB rate with repo rate and not T-bills is the best option. Our analysis, shows that the T-bills are relatively more volatile than the policy repo rate and in a higher interest rate scenario, the volatility also remains on a higher side. This could introduce a noise element into income of individuals and hence consumption expenditure if T-bills are used as an external benchmark.
- A more compelling way to look into the entire story is that term deposits with ASCBs have an average balance of Rs 2.75 lakhs equivalent to a monthly interest income of Rs 1610 (@7% p.a.) as against a monthly income of Rs 9416 (per capita income of Indians are Rs 1.13 lakh). The interest income, therefore, forms upto 17% of the income, a too big an amount to be left to the whims of market determined rates.

Term Deposits - Number of Account and Amount					
Size of Term Deposits	Number of Accounts		Amount (in Rs Billion)		Average Amount per Account (in Rs)
	Million	% of Total	Rs Billion	% of Total	
Less than 25,000	67.6	28.3	791	1.2	11699
25,000 and above but less than 1 Lakh	78.4	32.8	4352	6.6	55518
1 Lakh and above but less than 15 Lakh	88.7	37.1	25913	39.3	292269
15 Lakh and above but less than 1 Crore	3.8	1.6	13451	20.4	3517826
1 Crore and above	0.5	0.2	21430	32.5	44835034
Total	**239.0**	**100.0**	**65938**	**100**	**275908**
Source: RBI, SBI Research					

Impact of Interest Income on PFCE	
Parameters	Mar'18 (Cr)
SCB Saving deposit	3765424
SB (> Rs 1 lakh) *	2824068
SCB Aggregate Deposit	11434451
Income from SB @3.5%	131790
PFCE (Mar'18)	7417489
SB Interest as a % of PFCE	1.8%
Avg Agg Deposit	11272925
Int earning on Avg AD (@6%)	676376
Deposit Interest as % of PFCE	9%
75% of SB deposit are >Rs 1 lakh	
Source: RBI, SBI Research	

CARVING WC LIMITS INTO LOAN COMPONENT AND RISING BOND MARKET

- The linking of lending rates to external benchmark also needs to factor two key important developments announced during last four years. In December 2018, the RBI announced guidelines on minimum level of 'loan component'. The key intent of the said guideline was to instill credit discipline among large borrowers that include the following:
  - Minimum Loan Component: Borrowers having aggregate fund based working capital limit of Rs 150 crore and above from the banking system, a minimum level of 'loan component' of 40% shall be effective from April 1, 2019.
  - Timeline: The 40% loan component will be revised to 60%, with effect from July 1, 2019
  - Carving Out WC into Loan: The outstanding 'loan component' (Working Capital Loan) must be equal to at least 40% of the sanctioned fund based working capital limit, including ad hoc limits and temporary O/Ds. Hence, for such borrowers, drawings up to 40% / 60% of the sanctioned total fund based working capital limits shall first be utilized from the 'loan component'.
- As can be seen from the table, the share of CC+OD above Rs.100 cr is around 25% i.e. Rs 5.55 lakh crore as on March 2018 of Rs 22.12 lakh crore. Assuming CC+OD share of limits of above Rs 150 crore at 20% i.e. Rs 4.40 lakh crore, an amount of Rs 1.7 lakh crore (at 40%) and from Apr'19 and an amount of Rs 2.65 lakh crore (at 60%) from July 2019 is to be compulsorily converted to loan component.

Short Term Credit (CC+OD+DL) O/s as on March'18

Description	CC+OD	Demand Loan	Total	Share of demand loan
Upto 100 cr	1657578	996144	2653722	37.54%
Above 100 cr	555883	247549	803432	30.81%
Total	2213461	1243693	3457154	35.97%

Source: RBI; SBI Research; Rs. In Crore

- The above needs to be read in context of Aug'16 RBI guideline / norms to enhance and broad-base credit supply to large borrowers (group borrowing or single borrower) announced in Aug'16 out of banking system. As per the guidelines, which came into effect from 01/04/2017, incremental exposure of banking system to a specified borrower beyond Normally Permitted Lending Limit (NPLL) will be deemed to carry higher risk requiring additional provisioning and higher risk weights. As a result, borrowers were encouraged to seek alternate funding sources. Large corporates responded to the RBI intent. As can be seen from the table alongside, corporate bond issuances swelled from Rs. 5.84 lakh cr in FY16 to Rs 6.77 lakh crore in FY18 reporting roughly ~8% CAGR. During the 9MFY19 period, Rs 4.70 lakh crore has been mobilised.
- Raising corporate bonds / CPs / ECBs / Masala bonds / NCDs etc at fine pricing for large well perceived borrower meant rate transmission of rates was already being factored through competitive market offerings, allowing market deciding price discovery. The process of tapering aggregate fund-based credit limit (ASCL) within the timeline as specified below appears to be running its course.

Corporate Bond Issuances

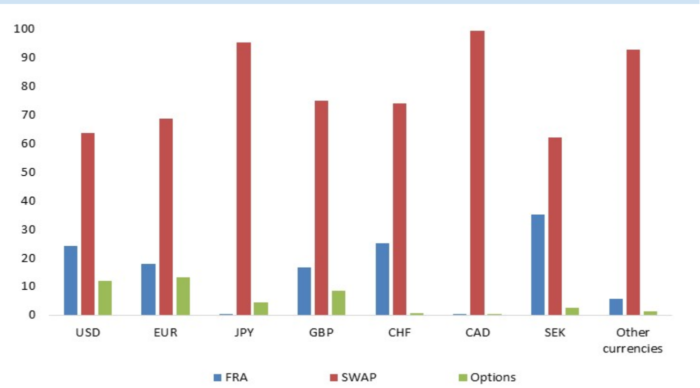
Period ended	No. of Issues	Amount Rs. Crore
2010-11	4280	270946
2011-12	5565	310070
2012-13	5578	388026
2013-14	4911	388151
2014-15	10941	478962
2015-16	8334	584592
2016-17	8723	702567
2017-18	6706	677064
2018-19 9M	4660	469789

Source: SEBI; SBI Research

INTEREST RATE DERIVATIVES: GLOBAL AND INDIA

- This step could also result in a push to derivative market in India.
- For example, the global interest rate derivate market is dominated by six currencies. The USD interest rate derivative market is largest. SWAPs dominate IR derivatives in all the markets. On the other hand, the Indian derivate market is mostly dominated by SWAPs. The share of the various IR derivate in Indian market is shown in figure. The MIBOR SWAP is largest trading contract. In terms of market participants, the PSBs are not an important player in this market even though they account for 70% of the banking.

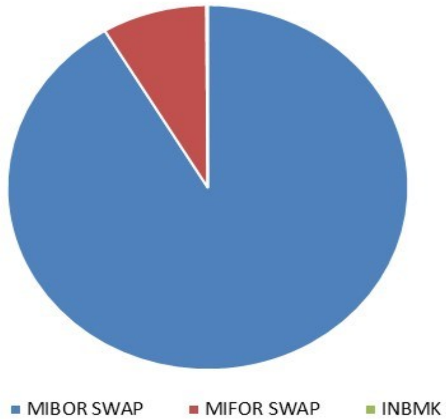
Global Interest Rate Derivative Markets



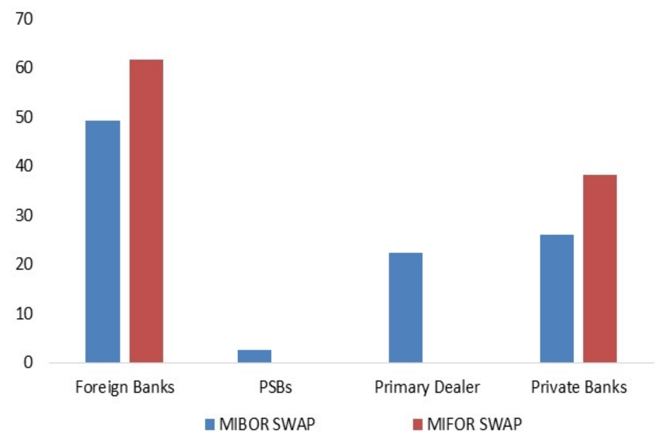
Source: BIS, SBI Research

- The SWAP markets in India have "on and off" start. However, the growth in the Indian IRS market has been expedited with the various market development initiatives by the regulator. The move for centralized reporting and clearing of OTC deals was envisaged long before associated systemic risks triggered global action in this direction and the benefits have been realized in the form of secured market expansion. Improvements in infrastructure like the ASTROID trading platform with its benefits of price discovery, risk mitigation, fair and transparent access for smaller participants are expected to boost liquidity in the market segment which provides an effective option for hedging interest rate risks in the underlying bond market.

Notional amount outstanding (Jan 19)



Share of Market Participants in INR SWAP (Jan 19)



Source: CCIL, SBI Research

WAY FORWARD

- Hopefully, we will see a vibrant, deep and liquid financial market with all these recent changes. In the last policy, RBI announced setting up of a task force to get off-shore volume shift to India and also to review Interest Rate Derivatives instruments.
- Specifically, with India currently a $2.6 trillion economy, it is imperative that the interest rate derivative market expands. Just to put in a different way - currently, all kinds of risk be it FX, credit or rates, all are largely warehoused in banking system itself and with economy growing, we need to diversify this risk across financial market at arms length and the current step could just be a beginning.
- This apart, in India, the time has also come to experiment with floating rate deposits with perhaps better incentivization. Separately, the linkage of the savings bank rate with the repo rate will ensure a stability and predictability to the interest rate structure and insulate the small time depositors and borrowers from market fluctuations. For example, our estimates show that interest income from time deposits could be as much as 17% of the monthly income of an average Indian household and hence it may be too risky to expose the entire term deposit structure to market fluctuations.
- Separately, interest rates offered on deposits in India are demography agnostic (barring the separate rate for senior citizens). However, going forward, in our view, this approach needs to shift to an age-wise interest rate structure, with rates linked to long-term bank deposit rates till a certain age group, and offering a higher than market rate over that age group. This could, in one go, serve the multiple purposes of (a) ensuring a lower lending rate structure, (b) adequate returns for senior citizens, (c) lower interest expenditure and (d) an alternative to floating rate deposits.

*****

ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

CONTACT DETAILS

Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India
Corporate Centre
Madam Cama Road
Nariman Point
Mumbai - 400021

Email: soumya.ghosh@sbi.co.in
gcea.erd@sbi.co.in
Phone: 022-22742440

: @kantisoumya