Savings bank accounts- 'interest'ing issues[*]

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Abstract

India's present method of computing interest on savings bank accounts has an effective yield much below the declared rate of interest. The method which was adopted during the pre-computer era has continued much after computerization of the banks. An alternative method is suggested which keeps the yield at par with the declared rate of interest. A trend analysis of the savings deposit interest rate vis-à-vis other rates like PLR, term deposit interest rates, repo & reverse repo rates and CRR indicates that it is time to take corrective measures and increase the rate of interest on savings bank accounts. Finally, some related issues are analysed and remarks made.

1. Introduction

As on March 2005, the scheduled commercial banks held a staggering 320 million savings bank accounts attributing to 69% of total number of different types (current, savings and term) of deposit accounts, and majority of such depositors are by and large small holders.

The manner of calculating interest on savings bank deposits is such that it ignores the interests of the depositors and facilitates hidden access of cheap money to the banks. Ms. Kishori J. Udeshi Chairperson, Banking Codes and Standards Board of India (BCSBI) recently raised the issue, once again, in her lecture "Protecting the Banking Rights of the Common Man" at the World Consumer Day 2007 function. An excerpt from her lecture is as quoted below.

"According to statistics published in the RBI, Bulletin, July 2006, as on 31st March 2005, Savings Bank deposits amounted to Rs.472,147 crore forming 26 per cent of total deposits of scheduled commercial banks. The savings bank deposits of <u>individuals</u> amounted to Rs.364,869 crore or 77 per cent of the total savings bank deposits. These savings bank deposits are remunerated at 3.5 per cent per annum; in fact, the effective rate is as low as 2.8 per cent approx. This is because the manner of calculating interest on savings bank deposits is such that a part of these deposits are not given any interest. (Interest is paid

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only on the <u>minimum</u> balance between the 10th and the end of the month). These low cost funds are leveraged by banks and lent at high rates of interest, which is a main source of their profits. In these days of electronic wizardry is it necessary to continue to follow this methodology for the ease and convenience of banks at the cost of the depositor?

Regrettably, depositor interests have received low priority even from the Government. Why is it that income earned through savings bank deposits at a mere 3.5% rate of interest attracts income tax, whereas income earned through investments in equities and mutual funds are tax free. Moreover, longer-term bank deposits, at relatively higher interest rates, enjoy the 80C deduction from income while this is not available to savings bank accounts. The system, therefore, appears to be stacked against the Aam Admi."

Being the chairperson of BCSBI Ms. Udeshi, to a great extent, represents the depositors of the country. She has raised two independent issues: firstly the method of computation of interest in savings accounts and secondly the quantum of interest applied in savings account.

As early as April 29, 2002, RBI's Monetary and Credit Policy, presented by Dr. Bimal Jalan, was clear on both aspect of the issue as quoted below:

"Interest Rate on Savings Account - No Change

In the recent years, banks have been given freedom in fixing interest rates on various deposit liabilities, and flexibility in offering interest rates depending upon tenor and size of deposits with the approval of their Boards. The only interest rate on deposits side, which is regulated by RBI is on 'savings account' with cheque facility. This rate is at present 4.0 per cent per annum.

However, although the nominal interest rate is 4.0 per cent per annum, the yield on such deposits works out to 3.4 per cent per annum only as interest is payable on the minimum balance between tenth and last day of each month. Nearly four-fifths of such saving deposits are held by households.

In view of the present deregulated interest rate environment and the reduction in interest rates on Government's small savings schemes in the recent period, there is an apparent case for deregulation of interest rates on savings account also. However, considering the fact that bulk of such savings deposits are held by households, including households in rural and semi-urban areas, on balance, it is not considered as opportune time to deregulate the interest rate on savings account for the present. In any case, the present effective yield of 3.4 per cent is quite reasonable in relation to other prevailing interest rates on even short-term instruments."

2. Effect of interest computation methodology on yield

RBI mentions that the effective yield is 3.4% when the declared rate of interest is 4%. One wonders what could be the basis of BCSBI's effective rate of 2.8% (when the declared rate of interest is 3.5%) which, compared to RBI's earlier figure, has a significant 33% shift downwards (on the difference in nominal and effective interest rate relative to nominal interest rate).

There are two extreme scenarios through which a depositor can use his savings bank account to earn interest. On one hand, let us suppose that a customer deposits Rs. 1000 on 11th July and withdraws the money on 31st August. This way, on Rs. 1000 he gets an

effective rate of 0% p.a. for 51 days while the money is enjoyed by his bank for these 51 days. (Interestingly, even on a single day's overdraft, a customer is charged at high lending rate by the bank!) On the other hand, one may also argue that an adroit customer can deposit Rs. 1000 on 10th February and withdraw the money on 1st March and thus earn 3.5% rate on Rs. 1000 for one complete month by keeping the funds only for 19 days. This gives an effective rate of 5.603% p.a. for these 19 days. Though these are the two extreme cases, according to BCSBI (and RBI) the average scenario lies somewhere in-between with effective rate of about 2.8%.

While disapproving the present method of interest computation (at 3.5% per annum for the whole month on the minimum balance during the period from the 10th to the last day of the calendar month), it is not clearly understood what is BCSBI's suggested alternative. However, keeping the discussion of yield in mind, the most reasonable alternative is the daily balance method. The daily balance method adds each day's closing balance for the whole calendar month leading to a total value say, P. The interest amount for the month then is $P \times 3.5/36500$, computed through one day's interest on P at 3.5% p.a. This interest will be the same as that worked out based on the average balance of the month.

It is pertinent to add here that though interest is computed on a per month basis, it is finally credited into the saving bank account after every three months if not more. During the period 2002-03, RBI changed the interest application frequency from quarterly to monthly with respect to (i) interests on eligible CRR balances held by RBI; (ii) interests on loans taken by banks at RBI's prescribed bank rate; (iii) interest on loans taken by public from the banks. By reducing the interest application frequency, the yield increases. Thus banks gained while receiving interest (at monthly rests) on CRR balances or on loans to public. However, just because of the manner of compounding periodicity (presently quarterly or more) for calculating interest on savings bank deposits and term deposits, the depositors' yield on interests is relatively less. Thus interest application frequency is also an area where the depositors are presently getting a raw deal.

Thus presently when RBI thinks that 3.5% is the appropriate rate of interest on savings deposits, it is clearly understood that RBI is well aware that the correct yield to such a deposit is around 2.8%. In case one considers a change in method of computing interest, as correctly suggested by Ms. Udeshi, RBI would also bring down the interest rate to 2.8%. This is so since the rationale and reasons behind fixing the savings bank interest rate, based on old method, would not change.

It is not clear whether BCSBI is questioning RBI's policy on the present rate of 3.5% or effective rate of about 2.8%. As and when the market demands, RBI would revise the savings rate of interest. RBI makes policy statements every 3 months with the latest one being as recent as January 31, 2007. This time too RBI, in its monetary policy measures, must have taken a considered decision while not touching the savings bank interest rate. However, in case BCSBI feels that RBI's decision was not well considered, it has to, in the interest of general public, substantiate its reasoning vis-à-vis that of RBI.

Now, Ms. Udeshi's question "Is it necessary to continue to follow this methodology for the ease and convenience of banks at the cost of the depositor?" indicates a direct relationship between (a) convenience of banks and (b) cost to depositor. Thus with Rs. 587,216 crore as the average savings bank deposits during the one year period December 2005 through November 2006 *(refer statistics published in the March 2007 issue of the*

RBI Bulletin), this convenience of banks cost the depositors 0.7% of their savings bank deposits or about Rs. 4,111 crore. Thus, as also implicitly pointed out by BCSBI, is it necessary for RBI to allow banks to follow the existing methodology which has Rs. 4,111 crore of depositors' money at stake every year? Average yield is usually perceived to be higher than any given nominal rate. However, as per BCSBI, on an average, this is much lower for savings bank accounts. In the international scenario, it is understood that majority of the countries follow a daily balance method where such problems do not arise and the yield is not lower than the nominal rate.

3. Nominal rate of interest and some remarks

The declared net profit of scheduled commercial banks for 2005-06 stood at Rs. 24,592 crore. While deciding the interest rate on savings bank account RBI does consider its impact on bank's profit and this aspect plays a crucial role. As one would observe, in the above quoted Monetary and Credit Policy (2002-03), RBI had appropriately justified, to the banking sector, why it is unable to reduce the savings bank interest rate. Is it that RBI is conscientious only towards banks in such matters and can afford to ignore any unvoiced feelings among the public? There is quite a trade-off in any deal as there are two faces of a coin. An increase of 0.5% in the savings interest rate (i.e., from present 3.5% to 4%) would lead to an effective increase of about 0.4% which would cause the banking industry to additionally part with around 9% of their net profits towards interest payments.

Apparently, since 2002-03 there was a strong feeling among a section of the banks to deregulate the savings rate in line with the term deposit rates. That never came through (probably to protect select banks from aggressive competition). Even, safeguarding the interests of the common man, benchmarking of a minimum rate never saw light of the day. Thus, the system then and, as rightly pointed out by Ms. Udeshi, the system now, both appears to be stacked against the common man.

Effective April 1, 2000, RBI reduced savings deposit interest rate by 0.5 percentage points from 4.5 to 4.0 which remained at that level till March 1, 2003. However, during this period the PLR showed a decreasing trend in the range 12.00-12.50 to 10.75-11.50; CRR showed a decreasing trend in the range 8.00-4.75; repo rate showed a decreasing trend in the range 10.00-7.50; reverse repo rate showed a decreasing trend in the range 8.00-5.50; and the term deposit rate showed a decreasing trend in the range 8.50-10.50 to 4.25-6.25.

In view of macroeconomic and overall monetary conditions and consistent with announcements made by the Finance Minister regarding certain administered interest rates, RBI, effective March 1, 2003, reduced the interest rate on savings account further from 4.0 per cent to 3.5 per cent. Since then the savings deposit rate had not been changed while during this period the PLR showed an increasing trend in the range 10.25-10.75 to 12.25-12.50; CRR showed an increasing trend in the range 4.50-6.50; repo rate showed an increasing trend in the range 6.00-7.75; reverse repo rate showed an increasing trend in the range 4.50-6.00; and the term deposit rate showed an increasing trend in the range 4.00-5.50 to 7.50-9.00.

By now there was a clear case for an increase in the savings bank rate. However, surprisingly, the Reserve Bank's Annual Policy Statement for the Year 2006-07 said: "Based on a review of current monetary and interest rate conditions, including a careful

consideration of the suggestions received from the IBA, it is considered appropriate to maintain the *status quo* while recognising that deregulation of this interest rate is essential for product innovation and price discovery in the long run". This raises several questions: (a) How long can RBI maintain this *status quo* by focusing only to banks' interests? (b) Is it an opportune time to completely deregulate the interest rate? (c) Is it time to partially regulate through prescription of only a minimum interest rate (thereby protecting bulk of such savings depositors held by households, including households in rural and semi-urban areas)? (d) Is it time to increase the interest rate by 0.5 percentage points?

A trend analysis of the savings deposit interest rate vis-à-vis other rates like PLR, term deposit interest rates, repo & reverse repo rates and CRR indicates that it is time to take action and to give depositors their dues. And this action most desirably would be to act affirmatively to a combination of (c) and (d), i.e., deregulate the ceiling on savings deposit rate and increase the floor rate by at least 0.25 percentage points from 3.5% to 3.75%.

Regarding desired change of interest computation methodology in savings account, BCSBI may be aware of the opposition that banks may have to it, not because of any additional expenditure in interest terms (there would in fact be no additional expenditure in interest terms since RBI would modify the interest rate keeping in mind the method of computing interest), but because of the resources banks would have to put, in order to make such a switch. It is possible that they may, to begin with, start with all computerised branches. But that would create disparity among depositors in computerised branches and in non-computerised branches (though very few in numbers now). On balance, it is certainly desirable, and now over time it has become necessary, that RBI comes up with a road map for a proper transition in the method of computing interest. Furthermore, over years this would also apply to term deposits. As rightly pointed out by Ms. Udeshi, it is indeed high time to move towards improving accounting standards in conformity with international standards.

Even during her tenure in RBI as deputy governor, Ms. Udeshi was face to face with such an issue which resulted in a regulation set by RBI to deregulate any existing norms on an appropriate standard to compute interest on term deposits (RBI circular DBOD BC. 69 dated February 13, 2004 and subsequent item 3 of recent Master Circular on Interest Rates on Rupee Deposits, July 2006). RBI chose not to set a sensible standard then. And now Ms. Udeshi is advocating for a change in standards. One can't agree with Ms. Udeshi more on moving towards correct and prudent accounting standards. For a related and detailed study on the method of computing interest for term deposits and savings deposits, one may refer to the Indian Statistical Institute technical report by Das and Das (2002), and its updates.

Regarding government's role on taxing such interest amounts, one may note that TDS, under Section 194A of the finance act, does not apply to interests on savings deposits. Thus, that covers by-and-large a major part of small depositors and the government was judicious in deciding so. What BCSBI is probably suggesting now is to bring back past norms on Section 80L and keep certain part of the bank interest income outside the income for tax computation. From a depositor's point of view, such a thought is most welcome.

Surely, it is not desirable to ignore the needs of the majority and continue with faulty accounting standards that line the pockets of a favoured few. Thus, it is actually for some one in the RBI and in the bureaucracy to ponder on the issues discussed here.

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