

Savings Bank Accounts- Interest Rate Deregulation

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Abstract

For long, the regulated savings bank (SB) interest rate remained downward sticky even when the market conditions were favourable for an increase. This could be attributed, among other reasons, to commercial banks' prevail in convincing the Reserve Bank of India (RBI) on its excessive cost in maintaining such accounts. However, with the advent of technology in servicing the account (like ATM, NEFT, Core Banking Solutions, Net-Banking, Inter-Bank Mobile Payment Service, etc.), the cost to serve, for the providers, has drastically reduced. This fact never got discounted appropriately while arriving at the SB interest rate or even the service fees. As a consequence banks gained considerably (net profit of scheduled commercial banks for 2009-10 being ₹ 57,109 crore) through unwarranted high net interest margins and service fees and commissions.

The SB interest rate was decreased in March 2003, from 4% to 3.5%, when inflation was around 3%. In April 2010, after RBI changed the method of calculating interest on SB accounts, the depositors saw an increase in their returns on savings. However, the fluctuating inflation has been very high in recent years. The SB deposits are the major source of savings (investment) for many depositors, including pensioners, small savers and senior citizens. Not having the ability to be good money managers, such persons are getting high negative returns on their hard earned monies.

This raises several questions: (a) How long can RBI maintain *status quo* by focusing only towards banks' interests and depriving depositors by not offering meaningful net return? (b) Is it an opportune time to completely deregulate the SB interest rate? (c) Is it time to partially regulate through prescription of only a floor on the SB interest rate (thereby protecting bulk of such savings depositors held by households, including households in rural and semi-urban areas)? (d) What are the related regulatory issues concerning SB accounts? We attempt to address these in this note.

* The views expressed in the paper are those of the author and not necessarily of the institution to which he belongs.

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I. Introduction

1. As on March 2009, the scheduled commercial banks held a staggering 492 million savings bank (SB) accounts attributing to 74% of total number of different types (current, savings and term) of deposit accounts, and majority of such depositors are from the household sector.

2. The Reserve Bank of India (RBI) has recently initiated a discussion on the deregulation of interest rates on SB deposits. The SB interest rate, being decided by RBI, is one of the few administered rates in India.

3. The issue of interest rate deregulation of SB account is not new. As early as April 29, 2002, RBI's Monetary and Credit Policy, presented by Dr. Bimal Jalan, raised this 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.”

4. The decision to decrease the SB interest rate, from 4% to 3.5%, was taken in February 2003 when the inflation for the period January-December 2002 averaged 2.5%. The SB rate remained downward sticky even when the market conditions were favourable for an increase. In April 2010, after RBI changed the method of calculating interest on SB accounts, the depositors saw an increase in their returns on savings. However, the fluctuating inflation has been very high in recent years. Even though, starting October 2009, RBI had been exiting from the accommodative mode and had increased the repo rate 9 times leading to market driven increase in the term deposit rates, RBI chose to peg the SB interest rate at 3.5% throughout the period. The SB deposits are the major source of savings (investment) for many depositors, including pensioners, small savers and senior



citizens. Not having the ability to be good money managers, such persons are getting high negative returns on their hard earned monies.

5. Apparently, since 2002-03 there was a strong feeling among a section of the banks to deregulate the SB 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 the system now, both appear to be stacked against the common man.

II. Interest Rates and its Application

6. RBI, since March 2003, maintained the SB interest rate at 3.5% per annum. Due to the then existing oblique method of computing such interest, the effective rate of interest had been much lower (approximately 3%). The change in the method of computing interest since April 2010, aligned the effective rate to the declared rate of 3.5%. Thus, effectively, RBI fixed the banks' interest cost on savings deposits, the raw material for them to do business, at very low levels, viz.:

- 3.8% during November 1, 1994 through March 31, 2000;
- 3.4% during April 1, 2000 through February 28, 2003;
- 3.0% during March 2, 2003 through March 31, 2010;
- 3.5% during April 1, 2010 through May 2, 2011;
- 4.0% during May 3, 2011 till date.

Effective SB rates even lower than declared rates

7. The various transitions of nominal rates and the corresponding effective rates of interest on SB account, since 1978, are presented in Table 1 below. It can be seen that until April 2010, the effective SB rates were lower than the corresponding declared rates.

Rate of Interest on Savings Bank Deposit		
Effective from	Rate per annum (%)	Effective Rate per annum (%)
March 1, 1978	4.5	3.8
September 13, 1979	5.0	4.3
April 24, 1992	6.0	5.1
July 1, 1993	5.0	4.3
November 1, 1994	4.5	3.8
April 1, 2000	4.0	3.4
March 2, 2003	3.5	3.0
April 1, 2010	3.5	3.5
May 3, 2011	4.0	4.0



8. Moreover, the nominal effective SB interest rate does not reflect the time value of money as over time inflation erodes the value of money. Real interest rates, on the other hand, adjust for inflation and thus measure the time value of money. Since year-on-year (y-o-y) inflation reflects the behaviour of prices at two specific points of time, it does not give a proper feel of the prevalence of inflation in the recent period. We therefore take a 12 month moving average of y-o-y inflation of WPI. This gives a better picture of how the inflation had behaved in the recent past. We define the real rates = nominal effective SB interest rates minus 12 month moving average y-o-y inflation of WPI, i.e. $i = r + M(I)$, where

i = nominal effective SB interest rate;

r = real rate;

$M(I)$ = 12 month moving average WPI y-o-y inflation

Regulated low rates pinching pockets of poor persons

9. Based on past WPI inflation data, we see that every time the real rate turned positive, the regulator reduced the SB rate¹, never to take corrective action (in terms of increasing the SB rate) even on subsequent high negative real rates. Chart 1 provides this picture in very clear terms. From 2003 to 2009 the real rates on SB accounts remained at historically low levels and persisted there for six years. Barring the transitory reversal in end 2009, this high negative real rate continues to pinch the small savers till date. One can clearly see that at least during April 2005 and later in April 2007, there had been sufficient grounds to increase the SB rate from 3.5% by 50 to 100 basis points. This rate was artificially kept low to facilitate the banks in keeping their cost of deposits low (with small depositors having no bargaining power).

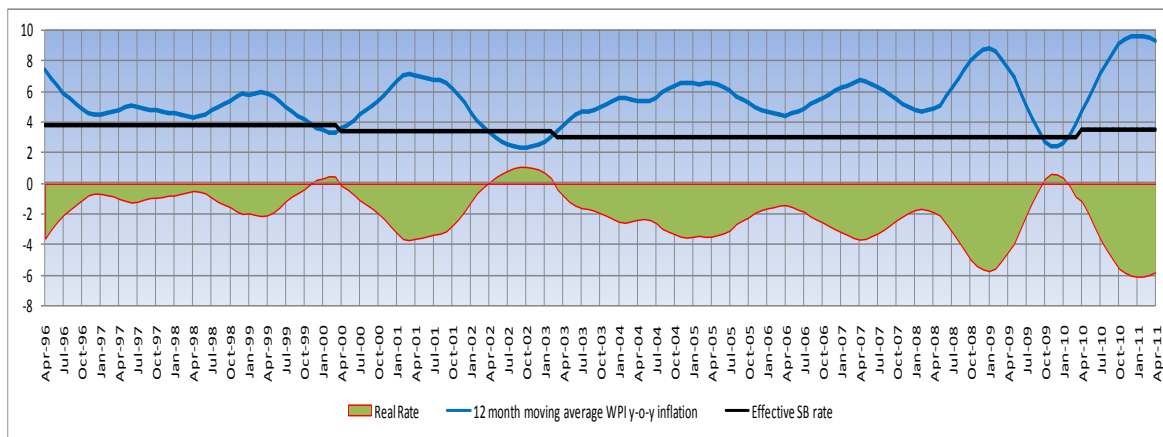


Chart 1

¹ The short period around end-2009 should be seen as an exception. During this period though the inflation was low due to base effects, the inflationary expectations were high and assessing that RBI had initiated its exit from its crisis driven expansionary stance.



Deregulated service charges increase savers' agony

10. On one hand RBI regulated to keep these SB rates unreasonably low and on the other hand RBI left prescription of service charges to the individual banks. Though RBI asked banks to ensure that these charges are reasonable and are not out of line with the average cost of providing these services, it could not make the costing analysis transparent with respect to what component of service fees attributed to true cost and what attributed to profit margin. Thus unreasonableness in fixing the SB rates and the service charges on SB accounts persisted, leading to high net interest margins (NIMs) for banks and high profits in return.

Deregulation would help tame inflation too

11. A trend analysis of the SB interest rate vis-à-vis other rates like term deposit interest rates, SBI advance rates, repo and reverse repo rates indicate that the SB rates were due for an increase not in 2011 but much earlier. Charts 2 and 3 show that during 2007-08, the situation was similar to what prevailed in 2001-02, when SB rate was 4%. Still RBI preferred to let the SB rates remain downward sticky.

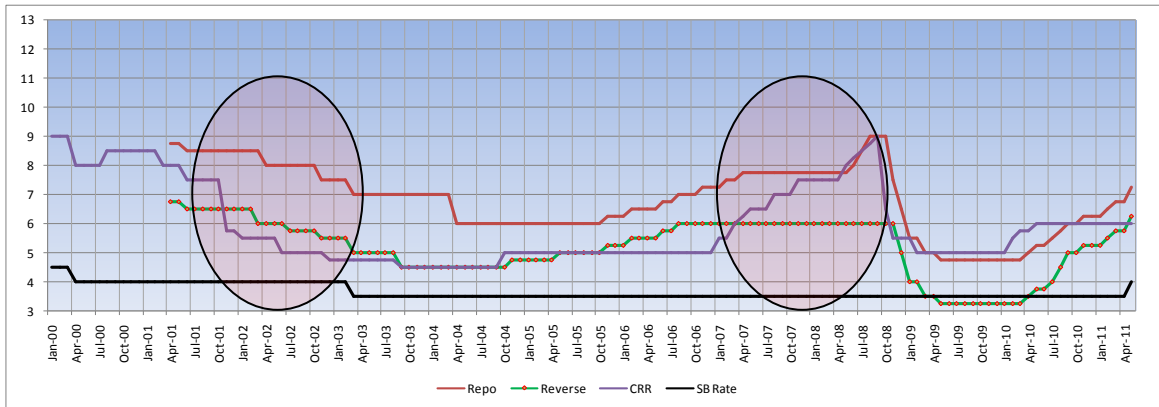


Chart 2

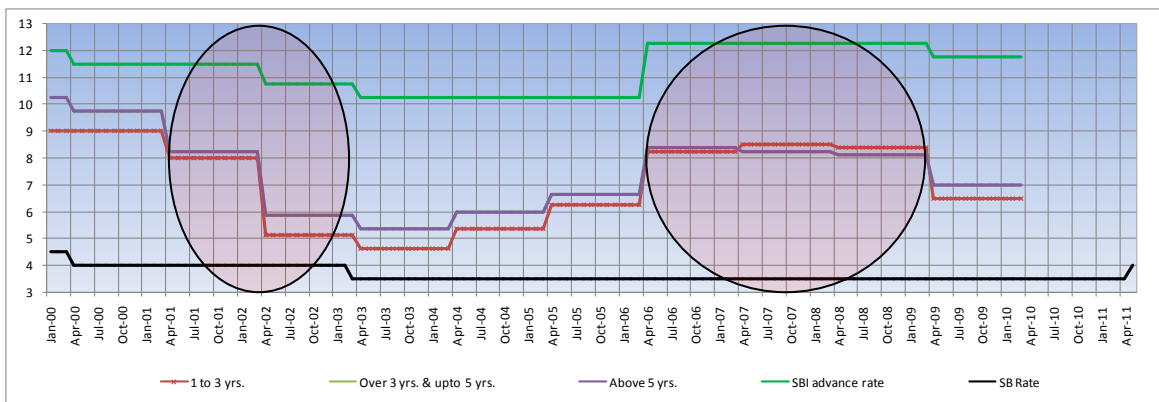


Chart 3



12. However, keeping in mind that SB interest application method had undergone a revision (daily balance method, effective April 1, 2010) in effect a rate of 3.5% is similar in return to 4% of pre-revised method of interest application.

13. Having said this, it may be noted that RBI has been taking baby steps to hike their policy rates (in order to strike a balance between containing inflation and ushering growth) resulting in persistence of inflation at a very high level for very long. One way to contain inflation is through making deposits more attractive, thereby reducing currency in circulation. A hike in SB rate would increase the cost of funds for the banks, thereby increasing their lending rates, leading to contracted demand and softer inflation. This will additionally bring a two pronged relief to the people - an increase in the returns on their savings (reducing the significantly high negative real rate) and a lower inflation.

Interest application frequency – merciless for small savers

14. It is pertinent to add here that though interest is computed on a per annum rate basis, it is finally credited into the SB account after every three months *if not more*. In other words, throughout RBI's regulated regime of SB interest rate, there had been lack of standards on interest application frequency leading to annual percentage yield for such accounts being different for different banks. There is no good reason for introducing such flexibility in interest computation standards which keeps much scope for non-transparency and inconvenience of artificially created comparison requirement.

15. 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 of the product increases. Thus banks gained while receiving interest (at monthly rests) on CRR balances (that has since been discontinued) 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 their deposits is relatively less. Thus interest application frequency is an area where the depositors are presently getting a raw deal.

III. Service Charges on SB Account

16. An important aspect that needs to be kept in mind is fees attached to such SB deposit accounts. Few of the basic needs and services for which fees are already deregulated are:

- a) *Minimum balance required to maintain the savings bank account (both for with and without cheque facility).*
- b) *Charges levied for not maintaining minimum balance.*
- c) *Debit card annual fee*



- d) *Cheque book / leaf charges*
- e) *Demand draft charges*
- f) *Cash deposit charges*

17. Thus, if one looks at the SB account in totality, the banks already enjoy freedom on how they would like to set their net costs (or net profits) for maintaining such SB accounts. A major concern is for small deposit accounts where a deposit of ₹ one crore with a bank may be associated to 50,000 SB accounts. In other words, on an average, balance maintained in these accounts is ₹ 200. Such accounts really do not deserve to receive high interests and if they do, that can be taken back in form of charges levied for not maintaining minimum balance. However, such charges that are levied for not maintaining minimum balance should not exceed the interest paid on the account. This led to the genesis of ‘no-frill zero balance accounts’, attracting small depositors to become financially included.

Discourage paper based transactions – price them high

18. Except for electronic transactions, most of the paper based transactions, related to SB accounts, should be discouraged and thus charged appropriately. However, in situations where there is lack of facilities for electronic transactions, corresponding paper based transactions should be priced reasonably.

Reduce costs by transiting to electronic modes of payment

19. Electronic payments, being cost efficient, can also enhance financial inclusion by extending financial services to the unbanked communities that were hitherto out of reach due to high operational costs. In so doing, such communities would be brought into the formal financial system and into the economic mainstream. This would enable them to enjoy lower cost of financial services and better means of savings.

Migration to core banking – a need for survival

20. Core banking solutions (CBS) were conceived to reduce the operational cost of banks and to ensure their existence in the ever increasing competitive environment. The banks that do not transit will perish in the modern world. The transition to CBS was not aimed at generating additional revenue for the banks. Its objective was to replace inefficient and expensive manual and paper based systems. The savings for the banks come as the cost for this computer intensive CBS is far less than a corresponding inefficient manual system.

Deregulate savings rate and mandate fee for basic services

21. The NIMs in India is among the highest compared to the developed and big developing countries. Banks should reduce their NIMs and service fees and maintain



profits through evaluating their lending portfolio more intensely thereby reducing the provisioning burden. Banks should strive to migrate to cost efficient work processes so as to bring in reduction in their operation costs. The unreasonable NIMs and unwarranted high IT based electronic transaction costs should be curtailed. The Reserve Bank has rightly indicated in one of its communications "... given the cost and risks involved in handling paper instruments, banks need to favourably price electronic products and a situation where electronic products are costlier than paper products is inexplicable..." — the vital question now is wouldn't proper policies like deregulation of SB rate and proper RBI mandated fees on electronic transactions be the right path ahead in the public interest and the economy?

IV. Conclusion and Recommendations

22. It is felt that deregulation will lead to an increase in SB rates. Based on 12 private sector banks, accounting for 86% of the deposits of that sector, it is observed that as of March 2010 the sector's average share of current account and savings account (CASA) deposits to total deposits is 31%, with bigger players like HDFC Bank, ICICI Bank and Axis Bank having respectively 52%, 42% and 47% of such deposits. In contrast smaller private sector banks like Yes Bank have very small CASA share (about 10%). Such banks may like to exploit the deregulation of SB interest to attract more CASA deposits by hiking their SB rate (as their cost of operations is low on account of efficient use of technology), benefiting the depositors both in terms of returns and services. This is fair competition, though the organisations that are not in favour of deregulation call this unfair or unhealthy competition.

23. The prime question that one needs to address now is whether it is necessary to continue regulating SB interest rate, a rate which has mostly been downward sticky? While deciding the interest rate on SB account, RBI does consider its impact on bank's profit with due care. As one would observe (see, Section I), in the monetary and credit policy (2002-03), RBI had appropriately justified to the banking sector as to why it is unable to reduce the SB interest rate. Again, the RBI's April 2006 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”.

24. However, when in the next annual policy statement for the year 2007-08 (in April, 2007), though there was a clear case for an increase in the SB interest rate, surprisingly, RBI preferred not to provide any reasons to the depositors as to why it decided against increasing the SB rate. This provides convenience and comfort only to the Banking Sector and not to the masses.



25. 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. In 2007-08, with declared net profit of scheduled commercial banks at ₹ 42,731 crore and the average SB deposits at ₹ 7,28,306 crore, an increase of 50 basis points (then, effective 40 basis points) in the SB interest rate (from 3.5% to 4%) would have caused the banking industry a reduction of around 7% of their net profits.

26. Again, with ₹ 12,39,762 crore as the average SB deposits during the one year period January 2010 through December 2010 (*refer the March 2011 issue of the RBI Bulletin*), this convenience of banks cost the depositors 0.5% of their SB deposits or about ₹ 6,200 crore. With ₹ 13,80,995 crore being the savings bank deposits as of December 2010, and with market conditions indicating SB rate to be 4%, rather than 3.5%, it amounts to the banking sector gaining at least ₹ 580 crore every month at the cost of their SB depositors. Was it necessary for RBI not to increase the SB rate by 50 basis points even when the situation so demanded and let the banks pocket ₹ 580 crore of depositors' money every month?

27. So what are the consequences of deregulation of interest rates on SB deposits and should it be done now? The trend analysis of the savings deposit interest rate and other related rates indicate that it is time to take action and to give depositors their dues. And this action most desirably would be to act affirmatively to deregulate the ceiling on SB rate and maintain a floor rate of 4% per annum. Moreover, RBI should set appropriate standard to compute interest on savings and term deposits through prescription of monthly periodicity of interest disbursement. This would allow India to move towards correct and prudent accounting standards in conformity with international standards.

28. Surely, no one would like to ignore the needs of the majority in order to 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.

Issues for feedback from public

29. In light of pros and cons of deregulation of SB interest rate set out in RBI's Discussion Paper, the Central Bank has asked for feedback from the general public on few issues. Below we provide summary of the responses.

- *Should savings deposit interest rate be deregulated at this point of time?*
 - **Yes, SB interest rate should be deregulated now. However, RBI should mandate alignment of interest disbursement at monthly periodicity in conformity with international standards and most of the domestic lending products.**



- *Should savings deposit interest rate be deregulated completely or in a phased manner, subject to a minimum floor for some time?*
 - **Deregulate in a phased manner (protecting bulk of depositors, including households in rural and semi-urban areas), maintaining a floor rate of 4%.**
- *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?*
 - **Concerns of the savers would be protected by maintaining a regulated floor rate and setting reasonable benchmarks on the service charges of IT based banking services. RBI should monitor the floor rate and change it as per market scenario.**
- *How serious are concerns relating to a possible intense competition amongst banks and asset-liability mismatches if savings deposit interest rate is deregulated?*
 - **The concern on asset-liability mismatches is insignificant as revealed from past experience of deregulation of term deposit rates. Moreover, true competition, which is transparent, is always good.**
- *Should higher interest rate be paid on savings deposits without a cheque book facility?*
 - **No. Instead have fee for cheque leaves. However, banks should have the freedom to offer higher rates for those maintaining higher SB deposits.**

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