Deregulation of Savings Bank Deposit Interest Rate:
A Discussion Paper

Introduction

As a part of financial sector reforms, the Reserve Bank has deregulated interest rates on deposits, other than savings bank deposits. The interest rate on savings bank deposits has remained unchanged at 3.5 per cent per annum since March 1, 2003. Keeping in view progressive deregulation of interest rates, it was proposed in the Second Quarter Review of Monetary Policy 2010-11 announced on November 2, 2010 to prepare a Discussion Paper to delineate the pros and cons of deregulating the savings bank deposits interest rate. It was proposed to place a Discussion Paper on the Reserve Bank's website for feedback from general public. Accordingly, this Discussion Paper is an attempt to deal with pros and cons of deregulating savings deposit interest rate and take on board the suggestions of various stakeholders for either maintaining the *status quo* or deregulating the savings deposit interest rate.

2. The Discussion Paper is organised as follows. Section II provides a historical account of deregulation of deposit interest rates in India. Section III analyses the trend in savings bank deposits in India. Section IV sketches out the international experiences with regard to the impact of deregulation of savings products in select countries. This is followed by a detailed analysis of pros and cons of deregulation of savings deposit interest rate in India in Section V. Section VI presents an analytical perspective on some of the concerns raised by banks relating to deregulation of savings deposit interest rates. Section VII sums up the discussion and sets out some specific issues for feedback from general public.

Section II: A Historical Account of Deregulation of Deposit Interest Rates in India

3. India pursued financial sector reforms as a part of structural reforms initiated in the early 1990s. A major component of the financial sector reform process was deregulation of a complex structure of deposit and lending interest rates. The administered interest rate structure proved to be inefficient. It, therefore, became necessary to reform the interest rate structure. Deregulation of interest rates was intended to strengthen the competitive forces, improve allocative efficiency of resources and strengthen the transmission of monetary policy. The process of deregulation of interest rates, which began in the early 1990s, was largely completed by October 1997. A few

categories of interest rates that continued to be regulated on the lending side were small loans up to ₹ 2 lakh and rupee export credit, and on the deposit side, the savings bank deposit interest rate. The rates on small loans up to ₹ 2 lakh and rupee export credit were deregulated in July 2010, when the Reserve Bank replaced the Benchmark Prime Lending Rate (BPLR) system with the Base Rate system. With this, all rupee lending rates were deregulated. On the deposit side, the only interest rate that continues to be regulated now is the savings deposit interest rate (Box 1).

Box 1: Deregulation of Deposit Interest Rates in India – A Historical Account

The process of deregulation of deposit interest rates had begun in the 1980s. In April 1985, banks were allowed to set interest rates for maturities between 15 days and up to 1 year, subject to a ceiling of 8 per cent. It was expected that with reasonable rates of interest on maturities, banks would be able to achieve a better distribution of term deposits rather than highly skewed distribution around longer maturities at relatively higher costs. However, when a few banks started offering the ceiling rate of 8 per cent even for maturities of 15 days, other banks followed suit without regard to consideration of profitability and set a single rate of 8 per cent for maturities starting from 15 days and up to one year. The consequence was a shift of deposits from current accounts and, to a lesser extent, from savings accounts to 15-day deposits. As a result of price war among banks, the freedom to set interest rates subject to a ceiling was withdrawn in May 1985**.** The process of deregulation resumed in April 1992 when the existing maturity-wise prescriptions were replaced by a single ceiling rate of 13 per cent for all deposits above 46 days. The ceiling rate was brought down to 10 per cent in November 1994, but was raised to 12 per cent in April 1995. Banks were allowed to fix the interest rates on deposits with maturity of over 2 years in October 1995, which was further relaxed to maturity of over 1 year in July 1996. The ceiling rate for deposits of '30 days up to 1 year' was linked to the Bank Rate less 200 basis points in April 1997. In October 1997, deposit rates were fully deregulated by removing the linkage to the Bank Rate. Consequently, the Reserve Bank gave the freedom to commercial banks to fix their own interest rates on domestic term deposits of various maturities with the prior approval of their respective Board of Directors/Asset Liability Management Committee (ALCO). Banks were permitted to determine their own penal interest rates for premature withdrawal of domestic term deposits and the restriction on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of deposits was removed in respect of deposits of ₹ 15 lakh and above in April 1998. Now banks have complete freedom in fixing their domestic deposit rates, except interest rate on savings deposits, which continues to be regulated and is currently stipulated at 3.5 per cent.

4. The issue of deregulation of savings deposit interest rate has arisen from time to time. The Annual Policy Statement of 2002-03 had weighed the option of deregulation of interest rate on savings bank deposit accounts but the time was not considered opportune considering that a large portion of such deposits was held by households in semi-urban and rural areas. It was, however, argued that deregulation would facilitate better asset-liability management for banks and competitive pricing to benefit the holders of savings accounts.

5. The issue was again revisited in the Annual Policy Statement for the year 2006-07. In this context, the Indian Banks' Association (IBA) while making out a case for deregulation of savings bank deposit rates in the long run, suggested for *status quo* in 2006. The Reserve Bank on a review of the then prevailing monetary and interest rate conditions, including a careful assessment of the suggestions received from the IBA, considered it appropriate to maintain the *status quo*, although the Policy stated that "in principle, deregulation of interest rates is essential for product innovation and price discovery in the long run" (Para 109, Annual Policy Statement, 2006-07).

6. In pursuance of the announcement made in the Annual Policy Statement for the year 2009-10, the Reserve Bank advised scheduled commercial banks to pay interest on savings bank accounts on a daily product basis with effect from April 1, 2010. Prior to the introduction of a daily product method, the interest on savings deposit account was calculated based on the minimum balance maintained in the account between the 10th day and the last day of each calendar month and credited to the depositor's account only when the interest due was at least ₹ 1/- or more. After the change, the effective interest rate on savings bank deposits increased, thereby benefitting the depositors.

Section III: Savings Deposits – A Concept and Trend

Savings Deposits – A Hybrid Product

7. A savings deposit is a hybrid product which combines the features of both a current account and a term deposit account. While a current account is primarily meant for transaction purposes and is maintained by companies, public enterprises and business firms for meeting their day-to-day requirement of funds, savings accounts are maintained for both transaction and savings purposes mostly by individuals and households. A savings account being a hybrid product provides the convenience of easy withdrawals, writing/collection of cheques and other payment facilities as well as an avenue for parking short-term funds which earn interest (Box 2).

Box 2: Restrictions on Operation of Savings Bank Accounts

The Credit Policy of May 27, 1977 for the first time drew a distinction within savings deposit accounts in that a part was considered as functionally transactions-oriented vis-à-vis the remaining part that had features akin to savings. Accordingly, the Reserve Bank, with effect from July 1, 1977, fixed the interest rate on savings deposits with cheque facilities, considered as transactions-oriented accounts, at 3.0 per cent and the interest rate on savings deposits without cheque facilities, considered as pure savings accounts, at 5.0 per cent. However, the Credit Policy of March 2, 1978 merged these two accounts into a single savings account, on account of many depositors opening multiple accounts. Accordingly, the Credit

Policy fixed the interest rate on savings deposit at 4.5 per cent. In April 24, 1992, the interest rate on savings deposit was fixed highest at 6.0 per cent per annum. The restrictions imposed by the Reserve Bank on the operation of savings bank account were withdrawn and banks were given the flexibility to stipulate such restrictions. The interest rate on savings bank deposit has been progressively reduced by the Reserve Bank. It now stands at 3.5 per cent that has remained fixed since March 2003.

Broad Features:

The operation of a savings bank account differs from bank to bank. However, still some broad features could be identified:

- One, number of free withdrawals are generally stipulated on a half-yearly/quarterly basis. Total numbers of withdrawals vary between 30 and 120 per half year.
- Two, no ceiling has been stipulated on the maximum amount that can be drawn per transaction.
- Three, there is generally no limit on the number of cheques that can be drawn per month. However, some PSBs have restricted the number of cheques that can be drawn on about 20 to 25.
- Four, minimum balance is stipulated, irrespective of whether the account holder is with or without cheque facility. The public sector banks have stipulated the minimum balance amount at ₹ 1000 for metro, urban and semi-urban areas, and ₹ 500 for rural areas with cheque book facility. The minimum balance amount stipulated without cheque book facility is ₹ 500 for metro/urban/semi-urban areas and ₹ 250 for rural areas. The minimum balance required to be maintained by private sector and foreign banks is generally much higher than those by public sector banks.

Source: Websites of select six public sector banks.

8. The maintenance of savings bank deposit accounts, however, entails transaction costs for banks. Although the exact cost structure of maintaining savings bank account is not readily available, some idea of this could be had from the fee structure imposed by banks for non-adherence to the stipulated conditions by the savings bank depositors. The charges for non-maintenance of minimum balance by select public sector banks vary between ₹ 20 and ₹ 225 for urban areas and ₹ 20 and ₹ 100 for rural areas per quarter. The charges for select private sector banks vary around ₹ 750 for urban areas and ₹ 500 to ₹ 750 for rural areas per quarter. While some banks charge ₹ 1 to ₹ 3 per leaf for additional cheques beyond the stipulated number of cheques per quarter; some public sector banks have no limit on the number of cheques that can be withdrawn per month. With regard to the number of free transactions for using other banks' ATM for cash withdrawal and balance enquiry up to a maximum of five per month, select banks charge ₹ 18 to ₹ 20, subject to the maximum of ₹ 20 per transaction as stipulated by the Reserve Bank.

Trend in Savings Bank Deposits in India

9. Savings deposits are an important component of bank deposits. The average annual growth of savings deposits, which decelerated in the 1990s as compared with that of the 1980s, accelerated sharply in the decade of the 2000s. In this decade, the average growth rate of savings deposits exceeded that of both demand deposits and term deposits, notwithstanding the growth in term deposits outpacing that of savings deposits during the period 2005-10 (Table 1).

Table 1: Average Annual Growth Rates: Aggregate Deposits and Components

(Per cent)

Period	Demand Deposits	Savings Bank Deposits	Term Deposits	Aggregate Deposits
1	2	3	4	5
1981-1990	19.5	17.1	19.8	18.9
1991-2000	12.5	15.7	17.4	16.1
2001-2010	16.2	19.4	18.2	18.2
(a) 2000-05	12.8	18.8	14.8	15.4
(b) 2005-10	19.7	20.1	21.7	21.0

Source: Calculations based on data in Statistical Tables Relating to Banks in India, RBI, Various Issues.

10. Savings account penetration (number of savings accounts for 100 persons), which remained broadly unchanged between March 1996 and March 2005, increased significantly by March 2009. Per capita savings bank deposits also increased from ₹ 1,067 in March 1996 to ₹ 7,767 for March 2009. However, in recent years, the growth in per capita savings deposits was lower than that of aggregate deposits as reflected in the decline in the ratio of per capita savings deposits and per capita aggregate deposits (Table 2).

Table 2: Savings Bank Deposits: Number of Accounts and Per Capita Savings Bank Deposits

Year	Savings Bank Deposits (₹ crore)	No. of Accounts per 100 persons	Per Capita Savings Bank Deposits (₹)	Per Capita Aggregate Deposits (₹)	Ratio of Col.4 to Col.5 (Per cent)
1	2	3	4	5	6
End-March 96	99020	26.0	1067	4932	21.6
End-March 00	231956	23.9	2317	8994	25.8
End-March 05	440339	25.3	4044	16874	24.0
End-March 09	896301	36.2	7767	35210	22.1

Source: Basic Statistical Returns of Scheduled Commercial Banks in India and Handbook of Statistics on the Indian Economy, RBI, Various Issues.

11. As expected, data on the ownership pattern of savings deposits during 1998-2009 reveal that savings deposits are predominantly held by the household sector (Table 3).

Table 3: Ownership Pattern of Savings Deposits

(per cent)

Sector	**1998**	**2009**
1	2	3
I. Household Sector	84.8	83.6
II. Government Sector	8.4	9.1
of which:		
State Government	3.3	5.3
Local Authorities	1.9	1.7
Public Sector Corporations and Companies	1.7	1.2
III. Foreign Sector	5.3	6.0
IV. Private Corporate Sector (Non-financial)	0.2	0.4
V. Financial sector	1.4	0.8
VI. Total	100	100

Source: Statistical Tables Relating to Banks in India, RBI, Various Issues.

12. An analysis of distribution of savings deposits by population groups reveals that between 2000 and 2009, savings deposits held in rural and semi-urban areas declined sharply, while those held in metropolitan areas increased. In 2009, the share of savings deposits held in metropolitan areas was more than that held in rural and semi-urban areas (Table 4).

Table 4: Savings Bank Deposits –According to Population Groups

(Per cent)

Year	**Rural and Semi-urban**	**Urban**	**Metropolitan**	**Total**
1	2	3	4	5
1991	42.7	25.7	31.6	100
1995	39.3	24.4	36.3	100
2000	40.1	25.4	34.5	100
2005	39.2	26.1	34.6	100
2009	36.2	26.1	37.8	100

Source: Basic Statistical Returns of Scheduled Commercial Banks in India, RBI, Various Issues.

13. Savings deposits also constitute a significant share of financial assets of the household sector. Their share ranged between 10 and 16 per cent of financial assets of the household sector between 2000-01 and 2008-09 (Table 5).

Table 5: Household Savings: Financial and Physical

(As per cent of GDP at current market prices)

Item	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
1	2	3	4	5	6	7	8	9	10
Gross Domestic Savings	23.7	23.5	26.3	29.8	32.2	33.1	34.4	36.4	32.5
Household Sector	21.6	22.1	22.9	24.1	23.3	23.2	22.9	22.6	22.6
Of which:									
1. Financial Assets	10.2	10.9	10.3	11.4	9.8	11.4	10.9	11.2	10.4
2. Physical Assets	11.4	11.3	12.6	12.7	13.5	11.8	11.9	11.5	12.2
Memo:									
Share of Bank Deposits in Household Financial Assets (per cent)	38.1	38.1	38.3	37.6	36.4	46.0	47.9	50.4	54.9
Share of Savings Bank Deposits in Household Financial Assets (per cent)	10.3	11.2	12.1	13.3	13.7	16.0	11.8	12.7	12.8
Share of Currency in Household Financial Assets (per cent)	6.3	9.5	8.9	11.3	8.5	8.9	10.2	11.4	12.5

Source: Reserve Bank of India.

14. To sum up, savings deposits are held largely by households. Savings deposits are a popular product and they constitute about 22 per cent of total deposits of scheduled commercial banks and about 13 per cent of financial savings of the household sector.

Section IV: International Experience

15. This section provides a summary of the experience on deregulation of savings bank deposit accounts in select developed and emerging market countries.

16. Interest rates on savings account in developed countries such as Canada, Japan, Australia, New Zealand, UK, and USA are all deregulated and determined by the commercial banks themselves on the basis of market interest rates. Most savings bank accounts may carry customer charges if the number of transactions exceeds the permissible level.

17. Many countries in Asia experimented with interest rate deregulation to support overall development and growth policies. Interest rates were fully deregulated in Singapore in the mid-1970s, and in the Philippines, Indonesia and Sri Lanka in the early 1980s. Malaysia, Thailand

and the Republic of Korea engaged in a gradual deregulation process, characterised by more frequent adjustments and the removal of some ceilings[1].

18. Although several countries deregulated interest rates on savings bank deposits long ago, Hong Kong did so recently and may particularly be relevant for India. Interest rates on bank deposits in Hong Kong, which were regulated by a set of interest rate rules (IRRs) issued by the Hong Kong Association of Banks (HKAB), were deregulated in phases by July 2001. This involved the removal of the interest rate cap on savings accounts and the prohibition of the payment of interest on current accounts. In response to the deregulation, a number of banks launched new products such as combined savings and checking accounts and Hong Kong inter-bank offered rate (HIBOR) linked savings products. Some also revised fees and charges and minimum balance requirements, and introduced tiered structures of interest rates.

19. Based on an examination of the effects of interest rate regulation and subsequent deregulation on the efficacy of monetary policy and rigidity of retail bank deposit rates in Hong Kong, Chong (2010) found that interest rate deregulation had increased the efficacy of monetary policy by improving the correlation between retail bank deposit rates and market interest rates and increasing the degree of long-term pass-through for retail bank deposit rates[2]. He also showed that the adjustments in retail bank deposit rates were asymmetric and rigid upwards during the regulated period, but tended to be rigid downwards during the deregulated period. The spreads between retail bank deposit rates and market rates also narrowed sharply after the removal of interest rate controls.

20. Rates on savings accounts in China are regulated by the Peoples' Bank of China, which specifies ceiling interest rates on these accounts. Currently, the cap is at 0.5 per cent per annum. The account provides easy access to deposited funds. Interest rates are calculated on a daily product basis. The savings account comes with a choice of either a passbook savings or a statement savings account. There is no charge for the transactions carried out in the savings account and the minimum balance in these accounts is very low at RMB 1.

21. Following deregulation in Taiwan, a fee is charged for each transaction. DBS Bank, Singapore provides a facility that combines the current account and savings account, but has a

1 Glower, Carlos J (1994), "Interest Rate Deregulation: A Brief Survey of the Policy Issues and the Asian Experience", *Asian Development Bank*, Occasional Papers, July.

2 Chong, Beng Soon (2010), "Interest Rate Deregulation: Monetary Policy Efficacy and Rate Rigidity," *Journal of Banking & Finance*, Vol. 34, Issue 6, June, Pages: 1299-1307.

higher minimum balance to be maintained and the customer is charged if the minimum balance is less than stipulated. The account also carries monthly charges for operating the account.

22. In countries in which financial sector reforms also included interest rate deregulation, the action was primarily taken because real rates were negative, and were being propelled by inflationary pressures. The most immediate result of financial deregulation in these select Asian economies was the enhancement and maintenance of positive real interest rates, which, in turn, contributed to an increase in financial savings. It also forced a diminution in the financial market segmentation exemplified by smaller dispersion of interest rates. The deregulatory process on the interest rate structure combined with the central banks' credible monetary policy measures for anchoring inflation expectations led to positive real rates of interest at least temporarily for Asian countries, *viz.*, Indonesia, Malaysia and the Philippines, although only the first two countries sustained a positive real interest rate structure.

23. On the whole, cross-country experience shows that in most countries, interest rates on savings bank accounts have been deregulated and are now fixed by commercial banks based on the market interest rates. Banks generally offer variable interest rates on savings deposits. Savings bank deposits have similar characteristics such as simple procedures with no limit on the length of the maturity. Further, there is a low or no minimum amount for opening of the savings accounts and banks generally charge fees for various services offered to the depositors.

Section V: Pros and Cons of Deregulation of Savings Bank Deposits Interest Rate in India

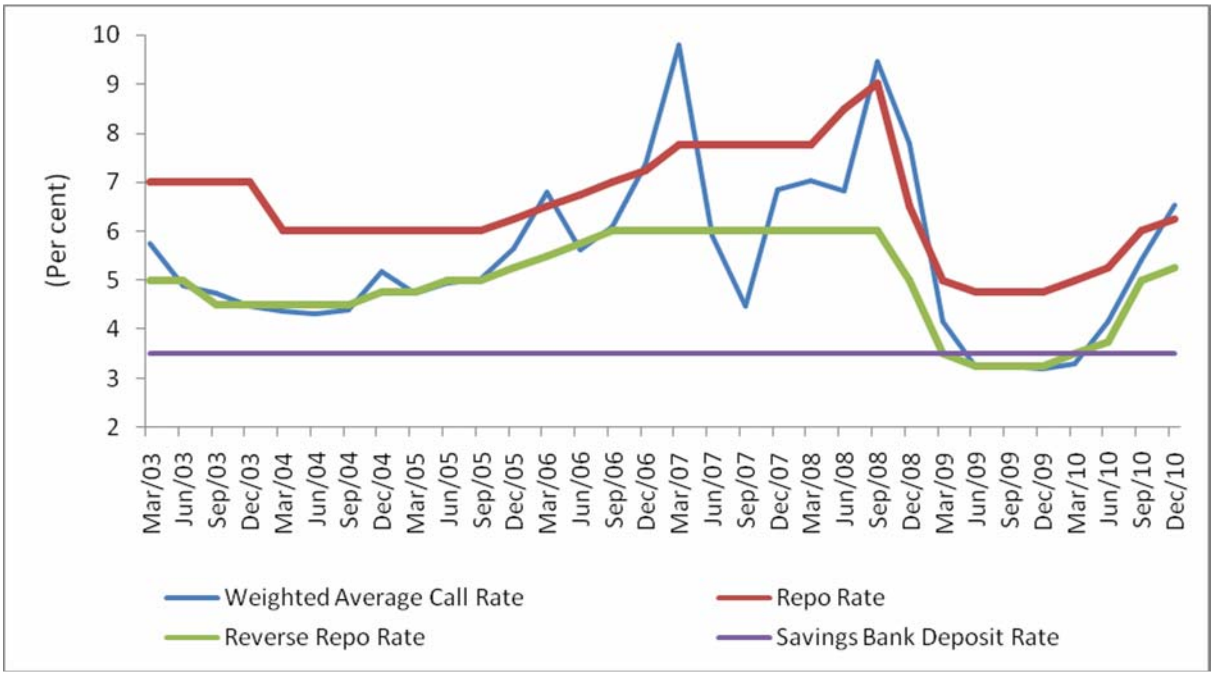
24. Deregulation of savings bank deposits has both pros and cons as described below.

Pros

May Enhance Attractiveness of Savings Deposits

25. Regulation of interest rates imparts rigidity to the instrument/product as rates are either not changed in response to changing market conditions or changed slowly. This adversely affects the attractiveness of a product/instrument. In the case of savings bank deposits, its interest rate has remained unchanged at 3.5 per cent since March 1, 2003 even as the Reserve Bank's policy rates and call rates (representing a proxy for operative policy rate as at a time, only one rate – either the repo rate or the reverse repo rate – is operative depending on liquidity conditions) moved significantly in either direction (Chart 1).

Chart 1: Movement of Policy Rates, Call Money Rate and SB Rate

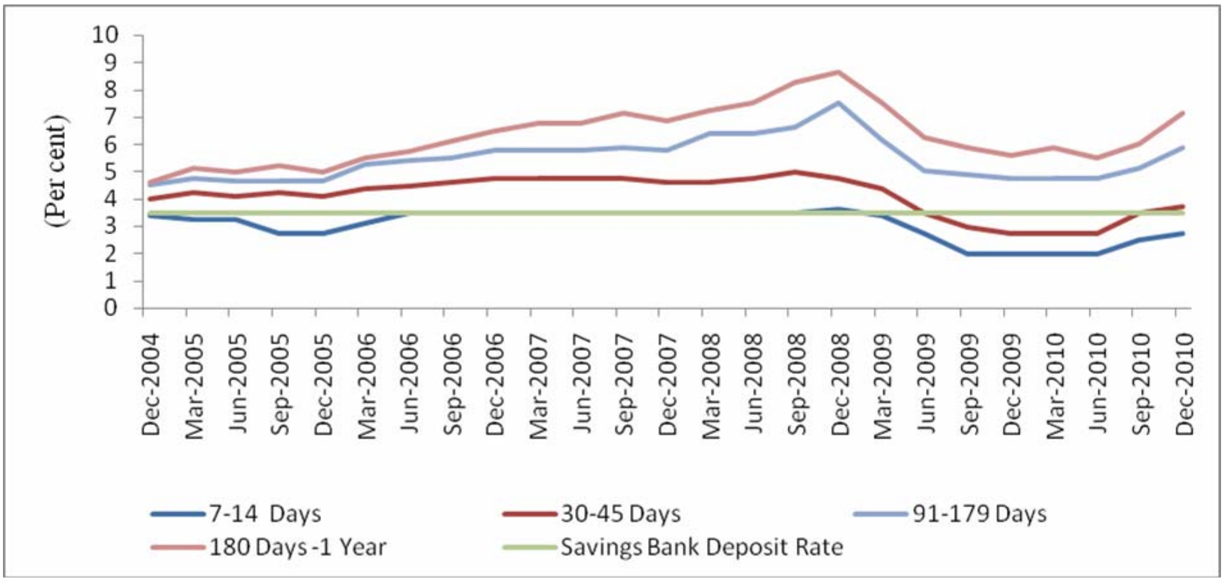


26. As the administered savings deposit interest rate has not moved in sync with the changing market conditions, it has generally been unfavourable to savers. In order to assess the relative attractiveness of savings deposits *vis-a-vis* other deposits, there is a need to know two aspects - the savings component of savings deposits (as a part of savings deposits is also for transaction balance) and the average maturity of savings component of savings deposits (as there is no fixed maturity for savings deposits). It is significant to note that about 90 per cent of savings deposits are held for savings purposes (see also Table 12 and Para 46). However, the average period for which balances in savings deposits (time component) is held for savings purposes is not available. In the absence of such information, the task of comparing interest rate on savings with that on term deposits is rendered difficult.

27. A comparison of interest rate on savings deposit and term deposit with maturity up to one year during December 2004 to December 2010 reveals some interesting patterns (Chart 2). First, during most of the period since December 2004, the interest rate on savings deposits has been equivalent to interest rate on term deposit of 7 - 14 days maturity, barring two brief periods (December 2004 - June 2006 and March 2009 – December 2010) when it was marginally higher. Second, interest rate on savings deposit were lower than those on term deposit of all other maturities up to one year, barring a brief period (June 2009 - September 2010) when the

interest rate on savings deposits was higher than that of term deposit with maturity of 30-45 days.

Chart 2: Interest Rates for Savings Bank Deposit vis-à-vis Select Term Deposits

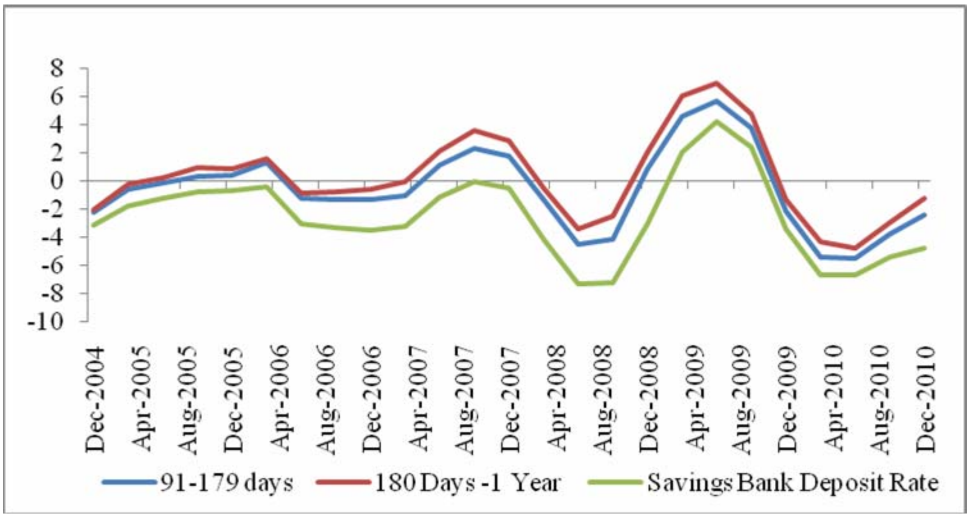


Note: Data pertain to 5 major public sector banks.

28. An analysis of real deposit interest rates[3] shows that the real savings deposit rate was persistently negative during the period December 2004 – December 2010, barring a brief period of March - September 2009 when WPI inflation itself turned negative. However, more or less, the same pattern was observed in respect of term deposits up to one year maturity as well (Chart 3).

[3] Real rate is calculated as the difference between interest rates of respective maturities and year-on-year WPI inflation.

Chart 3: Real Interest Rates for Select Deposits



29. Empirical evidence suggests that widening of interest rate differential between term deposits and savings deposits leads to reduction in the share of savings bank deposits in total deposits. This trend is also clearly discernible in respect of population groups (rural, semi urban, urban) other than metropolitan areas, where savings deposits are not responsive to the interest rate differential[4]. This perhaps suggests that savings deposits in metropolitan areas are held less

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[4] In order to examine the interest rate responsiveness of savings deposits, the following regressions were estimated:

I. Aggregate Analysis

i. Quarterly data for the period Q4:2004 and Q3:2010
SB share = 29.3 – 1.2 INTDIFFQUART
(44.7) (-5.5)
Adj. R^2 = 0.56

ii. Annual data for the period 1979-80 to 2009-10.
SB share = 25.8 – 0.7 INTDIFF
(37.3) (-4.9)
Adj. R^2 = 0.43

II. Population Group-wise Analysis for period 1991-2009 (annual data)

iii. Rural Areas
Rural SB share = 40.5 – 1.1 INTDIFF
(13.4) (-1.9)
Adj. R^2 = 0.12

iv. Semi Urban Areas
Semi Urban SB share = 37.6 – 1.1 INTDIFF
(13.0) (-1.9)
Adj. R^2 = 0.13

v. Urban Areas
Urban SB share = 31.4 – 0.8*INTDIFF
(21.5) (-2.8)
Adj. R^2 = 0.27

for savings purposes and more for transaction purposes and hence, are less responsive to interest rate changes.

30. Deregulation of the interest rate on savings deposit will make the rate flexible along with other interest rates depending on the market conditions. Since savings bank deposits in rural, semi-urban areas and urban areas are held largely for savings purposes, deregulation of interest rate is likely to enhance its attractiveness in these areas.

Will Improve Transmission of Monetary Policy

31. Regulation of savings deposits interest rate has not only reduced its relative attractiveness but has also adversely affected the transmission of monetary policy. For transmission of monetary policy to be effective, it is necessary that all rates move in tandem with the policy rates. This process, however, is impeded if the interest rate in any segment is regulated. Savings deposit constitutes a sizeable portion (about 22 per cent) of total deposits. The fact that the savings deposit interest rate has not been changed since March 1, 2003, *prima facie* implied that changes in policy rates did not transmit to savings bank deposits. However, before arriving at a firm conclusion in this regard, it is necessary to consider two possibilities here. One, even though the savings deposit interest rate is fixed, what matters for banks is the overall cost of deposits and not cost of any particular component. And if the overall cost of deposits moves in tandem with the policy rates, then monetary transmission is not adversely affected. The other possibility, however, is that banks independently decide interest rates on freely determined components, disregarding the cost of savings deposits, in which case the overall cost of deposits does not move in sync with changes in the policy rates, thereby affecting the monetary transmission. This is a behavioural issue and it is difficult to find a precise answer to this question. However, the evidence in Table 6 is revealing. The correlation coefficients of savings deposit interest rate with both the call money rate (the operating target) and the lending rate of scheduled commercial banks were much lower than those of term deposits. This suggests

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vi. Metropolitan Areas

$$\underset{(20.0)}{\text{Metropolitan SB share} = 17.3} + \underset{(0.8)}{0.1\ \text{INTDIFF}}$$

Adj. $R^2 = 0.13$

Where

SB share = percent share of savings deposits in aggregate deposits in the respective categories.

INTDIFFQUART = difference between the term deposit rate of the maturity for 6 months to 1 year and the savings bank rate.

INTDIFF = difference between the term deposit rate of the maturity for 1 to 3 years and the savings bank rate.

Note: All coefficients are significant at conventional level other than that in equation vi.

that regulation of the interest rate on savings deposits has impeded the monetary transmission and that deregulation of interest rate will help improve the transmission of monetary policy. This is also corroborated by the Hong Kong experience as indicated in Section IV wherein following the deregulation of savings deposit rate, the correlation between retail bank deposit rates and market interest rates improved and their spread also narrowed significantly.

Table 6: Correlations Among Various Rates

Pair of Interest Rates	**Correlation Coefficient**
1	2
I. Weighted Term Deposit Rate and Call Rate	0.82
II. Weighted Savings Deposit Rate and Call Rate	0.18
III. Weighted Term Deposit Rate and Weighted Lending Rate	0.45
IV. Weighted Savings Deposit Rate and Weighted Lending Rate	0.23

May Lead to Product Innovations

32. Savings deposits constitute about 22 per cent of total deposits. However, owing to regulation of interest rate, there is hardly any competition in this segment with both banks and depositors acting passively. This has inhibited product innovations. The requirements of different banks and different depositors are not necessarily the same. Just as each bank may like to tailor the savings product to suit its requirement, each depositor may like to choose a product which suits his requirements.

33. To create competition and encourage banks to introduce innovative products, it is, therefore, necessary to deregulate savings deposit interest rate. Product innovations may include a variety of modes of operations such as branches, web-based channels, ATMs etc. Rates offered may also differ based on the flexibility of operation of savings bank account and the degree of liquidity offered such as notice period for withdrawal, number of deposits and/or withdrawals allowed per month and percentage of amount that can be withdrawn in any given month, among others. It may be noted here that in response to the deregulation of savings deposit interest rate in Hong Kong in 2001, a number of banks launched new products such as combined savings and checking accounts and HIBOR linked savings products. Some also revised fees and charges and minimum balance requirements, and introduced tiered structures of interest rates.

Cons

Possibility of an Unhealthy Competition

34. A major attraction of savings deposits for banks is that it offers a low cost source of funds. This is evident from the fact that bank groups with higher share of CASA (current account and savings account) deposits (of which savings deposit is a major component) enjoy relatively low cost of deposits. However, the distribution of CASA deposits among banks is not uniform (Table 7).

Table 7: Frequency Distribution of CASA Deposits among Bank Groups - March 2010

(Per cent)

Share of CASA	No. of Banks	Average Cost of Deposits
1	2	3
A . Scheduled Commercial Banks		
1-30%	32	5.61
30-40%	23	5.40
40-50%	10	4.39
50% and above	10	2.20
B. Public Sector Banks		
1-30%	12	6.19
30-40%	13	5.83
40 - 50%	2	5.41
50% and above	0	NA
C. Private Sector Banks		
1-30%	12	6.66
30-40%	5	5.59
40-50%	4	5.18
50% and above	1	4.51
D. Foreign Banks*		
1-30%	8	4.45
30-40%	5	4.07
40-50%	4	3.10
50% and above	9	2.16

*: Excluding one bank which is an outlier. NA: Not applicable.

Note: Cost of Deposits = Interest paid on deposits/average of current and previous year's deposits.

Source: Reserve Bank of India.

35. It has also been observed that 49 banks, which have below average CASA deposits, constitute about 50 per cent of total asset of the banking sector. Therefore, given the attractiveness of savings deposits, it could be argued that deregulation may lead to unhealthy competition amongst banks. Should it really happen, it will have implications in that it will push up the cost of funds of the banking sector. This, if passed on to the borrower, will raise the cost

of borrowings and if not, it will affect the interest margins and profitability of the banking sector.

Risk of Asset Liability Mismatches

36. One of the issues often raised by banks in the context of deregulation of savings bank interest rate is that in the event of such deregulation, it would result in an asset-liability mismatch. This is because, although savings bank deposits represent short-term savings and withdrawable on demand, a large part of savings deposits is treated as 'core' deposits, which together with term deposits have been used by banks to increase their exposure to long-term loans, including infrastructure loans. This is reflected in the increase in the share of term loans in total loans, barring foreign banks, during the period between 2001 and 2009 (Table 8).

Table 8: Share of Term Loans in Total Advances

(Per cent)

Bank Group	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
1	2	3	4	5	6	7	8	9	10
I. State Bank of India & its Associates	32.9	35.3	39.2	45.2	52.0	53.9	54.9	55.2	52.2
II. Nationalised Banks	37.2	37.3	39.3	45.0	51.2	52.7	54.9	55.6	56.0
III. Private Sector Banks	32.5	60.5	64.0	65.0	65.8	68.4	70.3	69.7	69.4
IV. Foreign Banks	46.1	48.7	47.9	45.0	49.2	48.0	49.3	48.9	46.9
V. All Scheduled Commercial Banks	36.7	42.2	44.5	49.0	54.1	55.9	57.7	58.0	57.1

Source: Statistical Tables Relating to Banks in India, RBI, Various Issues.

37. Significantly, during the same period (2001-2009), the share of long-term deposits (more than 3 years) in total term deposits declined almost steadily (Table 9).

Table 9: Movements in Key Ratios of SCBs

(Per cent)

End-March	Savings Bank Deposits/ Aggregate Deposits	Term Deposits of More than 3 years Maturity /Total Term Deposits	Term Loans/ Total Advances
1	2	3	4
2001	20.0	31.7	36.7
2002	20.5	28.7	42.2
2003	22.3	23.9	44.5
2004	23.7	27.8	49.0
2005	24.2	26.5	54.1
2006	25.1	24.5	55.9
2007	23.4	22.6	57.7
2008	22.4	23.1	58.0
2009	21.5	20.2	57.1

Note: Data in column 3 are inclusive of RRBs.
Source: Statistical Tables Relating to Banks in India, RBI, Various Issues.

38. In particular, public sector banks (which constitute 75 per cent of total assets) with a higher share of CASA deposits have higher exposure to term loans (Table 10).

Table 10: Frequency Distribution of Public Sector Banks' CASA Deposits and Term Loans

Share of CASA	No. of Banks*	Term Loan/Total Advances (%)	
		Average	Range
1	2	3	4
20-30 per cent	11	52	44-67
30-40 per cent	13	60	44-76
40-50 per cent	2	64	56-72

*: Excludes one bank which is an outlier.
Source: Reserve Bank of India.

39. In a scenario when savings deposits are used to finance long-term assets, deregulation of savings bank interest rate, it is argued, would have implications for asset liability management of banks. Any unhealthy competition, arising out of deregulation may have the potential to create asset liability mismatches as some banks with large dependence on savings deposits for financing long-term assets may lose savings deposits to some other banks.

May Lead to Financial Exclusion

40. Should unhealthy competition result in increase in interest rate and the overall cost of funds, banks might be discouraged from maintaining savings deposits with small amounts due to the associated high transaction costs. This could particularly be the case with public sector banks, which have a large number of savings accounts and which allows depositors to maintain very low balances. Thus, it is likely that banks either increase the minimum balance to be maintained or reduce the number of transactions permitted free of cost and increase the customer service charges too. This will discourage small savers, especially in rural and semi-urban areas from opening savings deposits accounts. The campaign for "No Frills Accounts" could also suffer a setback. In sum, deregulation of savings bank deposit rate might have adverse implications for the process of financial inclusion.

Could Adversely Affect Small Savers/Pensioners

41. Many senior citizens, pensioners, small savers, particularly in rural and semi-urban areas, depend on interest as a source of regular income. In the recent period, interest rate on savings deposits has been lower than that on term deposits and deregulation may push up savings deposits higher, in which case small savers/pensioners would benefit. However, there could be occasions, especially when the liquidity is in surplus, when savings deposit interest rates may decline even below the present level. This will affect the income flow to small savers/pensioners. However, considering the fact that such occasions have been few and far between and on most recent occasions, savings interest rate was lower than short-term deposits, concerns about the impact of deregulation of savings deposits on pensioners/small deposits need not be over-emphasised.

Possibility of Introduction of Complex and not so Easily Understood Savings Products

42. Although deregulation of savings deposit interest rate may lead to product innovation, which, in general, will benefit savers, it is also possible that banks introduce some complex products, which may not be so easily understood by savers. These strategies may result in increase in the mis-selling of savings bank products, which will also result in increase in the number of customer complaints.

Section VI: Analytical Perspective

43. Two important issues, which, from banks' point of view, need to be considered before deregulating savings deposits interest rate are the possibility of unhealthy competition and asset-liability mismatches. This section analyses historical data to ascertain as to how far these apprehensions are justified.

44. The risk of possible unhealthy competition arising out of deregulation of savings deposits interest rate should be no different from the one when interest rate on term deposits were deregulated in 1997. An attempt, therefore, is made to analyse the trends in term deposit interest rates before and after they were deregulated. The evidence of unhealthy competition in interest rates, if any, can be gauged from the spread of interest rates on term deposits over the policy rate. Unhealthy competition among banks should result in widening of spreads. Table 11 sets out data on the contemporaneous and one-year lagged spread between the term deposit interest rate and the relevant policy rate (as transmission of policy action to deposit rates takes place with some lag).

45. As may be seen from Table 11, there is no evidence of any unusual spread in term deposits immediately after interest rates on such deposits were deregulated in 1997. Although the spread tended to widen in a deregulated environment as compared with when interest rates were regulated, this was not unusual as similar or somewhat higher spreads were observed in more recent years. If deregulation of term deposits interest rate did not lead to any unhealthy competition, it is unlikely that deregulation of savings deposit rate will result in any unhealthy competition.

Table 11: Deposit Rate of Major Banks for Term deposits of more than 1 year maturity

(per cent)

Year	Range of Interest Rate on term deposits	Average Interest Rate	Bank Rate/ Repo Rate/ Reverse Repo	Average Spread (3-4)	Average Spread (Lag 1 year)
1	2	3	4	5	6
Mar-91	9.0-11.0	10.0	10.0	0.0	-
Mar-92	12.0-13.0	12.5	12.0	0.5	2.5
Mar-93	11.0-11.0	11.0	12.0	-1.0	-1.0
Mar-94	10.0-10.0	10.0	12.0	-2.0	-2.0
Mar-95	11.0-11.0	11.0	12.0	-1.0	-1.0
Mar-96	12.0-13.0	12.5	12.0	0.5	0.5
Mar-97	11.0-13.0	12.0	12.0	0.0	0.0
Mar-98	10.5-12.0	11.3	10.5	0.8	-0.7
Mar-99	9.0-11.5	10.3	8.0	2.3	-0.3
Mar-00	8.5-10.5	9.5	8.0	1.5	1.5
Mar-01	8.5-10.0	9.3	7.0	2.3	1.3
Mar-02	7.5-8.5	8.0	6.5	1.5	1.0
Mar-03	4.3-6.3	5.3	5.0	0.3	-1.3
Mar-04	4.0-5.5	4.8	4.5	0.3	-0.3
Mar-05	5.3-6.3	5.8	4.75	1.0	1.3
Mar-06	6.0-7.0	6.5	5.5	1.0	1.8
Mar-07	7.5-9.0	8.3	6.0	2.3	2.8
Mar-08	7.5-9.0	8.3	6.0	2.3	2.3
Mar-09	7.8-8.8	8.3	5.0	3.3	2.3
Mar-10	6.0-7.5	6.8	5.0	1.8	1.8
Mar-11	7.8-9.5	8.6	6.75	1.9	3.6

Note: (i) Data on deposit term deposits of more than one year maturity in column 2 relate to five major banks.
(ii) Average interest rate in column 3 refers to the mid-point of interest rates range in column 2.
(iii) In column 4, the policy rate used is the relevant policy rate at the given time. Bank Rate was used for the period prior to 2003 when it was in active use. For the subsequent period, repo/reverse repo rate was used depending on the prevailing liquidity conditions in the system.

Sources: Weekly Statistical Supplement and Handbook of Statistics on the Indian Economy, RBI, various issues.

46. A deeper analysis of the data also suggests that the fear of asset liability mismatch arising out of deregulation of savings bank deposits interest rate is misplaced. Quite a sizeable part of savings deposits indeed constitutes ‘core’ deposits. This is recognised in the asset-liability management (ALM) guidelines where 90 per cent of savings bank deposits are considered as ‘core’ savings deposits and is also borne out by the behaviour of actual bank-wise data culled out from supervisory returns submitted by banks (Table 12).

Table 12: Core Component of Savings Deposits*

Year	Ratio
1	2
2006	0.98
2007	0.92
2008	0.93
2009	0.92
2010	0.89
2011	0.92

*: The core component of savings deposit relates to scheduled commercial banks and it has been arrived at by taking average monthly minimum balance in a financial year. Data for 2006 and 2011 are based on monthly data for January-March, 2006 and April 2010-January 2011, respectively.
Source: Supervisory returns of banks.

47. Now, the issue is whether the 'core' component of savings deposits could undergo a substantial shift if savings bank deposits interest rate are deregulated. A large shift in the 'core' component of savings deposits is possible if there is an unhealthy competition. However, as has been discussed earlier, if deregulation of term deposits interest rate is any guide, the possibility of unhealthy competition arising out of deregulation of savings deposits interest rate is low. Further, the experience of deregulation of interest rates on term deposits also suggests that there was some shift of term deposits from public sector and foreign banks to private sector banks. The average share of term deposits held by public sector banks and foreign banks declined, while that of private sector banks increased. It is, however, significant to note that some shift was also noticed in savings deposits even as interest rate on savings deposits was regulated (Table 13). In this context, it needs to be noted that some shift in favour of private sector banks was also on account of new private sector banks, which in any case could have captured some market share of business of existing banks. Thus, it is difficult to indicate as to how far deregulation of term deposit interest rate resulted in shift of term deposits from public and foreign banks to private sector banks. In any case, the shift in deposits was not significant so as to destabilise the system. Thus, if deregulation of interest rate for term deposits, which constituted more than 60 per cent of deposits, did not have any destabilising impact, deregulation of interest rate for savings deposits, which constitute about 22 per cent of total deposits, may not have a significant adverse impact on the system. Thus, the concern relating to asset liability mismatch may not turn to be as serious as it has been made out to be.

Table 13: Bank Group-wise and Category-wise Share in Aggregate Deposits of Scheduled Commercial Banks

(per cent)

Bank Group	1990-1997 (Average)	1998-2009 (Average)
1	2	3
I. Public Sector Banks		
Share of Current Deposits	87.6	72.5
Share of Savings Deposits	92.8	86.6
Share of Term Deposits	85.7	77.0
II. Private Sector Banks		
Share of Current Deposits	5.5	16.6
Share of Savings Deposits	4.9	10.4
Share of Term Deposits	6.6	17.7
III. Foreign Banks		
Share of Current Deposits	6.9	10.8
Share of Savings Deposits	2.3	3.0
Share of Term Deposits	7.7	5.3
IV. Scheduled Commercial Banks*		
Share of Current Deposits	16.5	12.3
Share of Savings Deposits	21.1	22.2
Share of Term Deposits	60.9	64.5
Memo:		
Growth of Term Deposits		
Average	16.6	19.1
Standard Deviation	2.6	5.8
Growth of Aggregate Deposits		
Average	15.9	18.4
Standard Deviation	3.0	3.6

*: Excluding RRBs.
Source: Statistical Tables Relating to Banks in India, RBI, Various Issues.

Section VII: Summing Up

48. The process of deregulation, which began in the early 1990s, was largely completed by 1997. A few categories of interest rates that continued to be regulated were small loans up to ₹ 2 lakh and rupee export credit on the lending side, and savings deposit interest rate on the deposit side. The small loans up to ₹ 2 lakh and rupee export credit were deregulated in July 2010 when the Reserve Bank replaced the benchmark prime lending rate (BPLR) system with the Base Rate system. The only interest rate that continues to be regulated now is the savings deposit interest rate. Deregulation of interest rates in India since the early 1990s has improved the competitive

environment in the financial system, imparted greater efficiency in resource allocation and strengthened the transmission mechanism of monetary policy.

49. Savings deposit interest rate has not been deregulated for the reason that a large portion of such deposits is held by low income households in rural and semi-urban areas. It is more than 13 years when the deposit interest rates, other than savings deposits, were deregulated. The issue, therefore, is how relevant are these concerns in today's context and what will be the implications if savings deposit interest rate is deregulated.

50. Regulation of savings deposit interest rate has imparted rigidity as savings deposit interest rate has not been changed since March 1, 2003 although other interest rates have moved in either direction. Interest rate paid on savings deposits was lower than those on term deposits of all maturities, other than for term deposits at very short end for a brief period. Thus, it is the saver who has been affected adversely because rate of return on savings deposit has generally been negative and unattractive vis-à-vis short term deposits.

51. The empirical evidence suggests that unlike metropolitan areas, savings deposits in rural, semi-urban and urban areas are responsive to interest rate changes in savings deposits. Therefore, market-based interest rate may be beneficial to savers. Since savings deposit is a hybrid product which combines the features of both current account and term deposit, a market based rate of interest on this product has the potential to attract large savings from low income households. Deregulation will also allow banks to introduce product innovations which could also benefit the depositors. Deregulation will have another major advantage in that it will help improve the monetary transmission. Since savings deposits constitute a significant portion of aggregate deposits, regulation of interest rate on such deposits has impeded the transmission of monetary policy impulses.

52. However, some concerns have also been raised with regard to deregulation of savings deposits interest rate. Savings deposits have been a source of cheap funds for banks. This is reflected in the low cost of deposits in respect of those banks which hold relatively high proportion of CASA deposits (a major portion of which is savings deposits). In addition, banks treat a large portion of savings deposits as 'core' deposits, which has been used to finance long-term assets. However, distribution of savings deposits is skewed among banks with some banks enjoying relatively high share of savings deposits than others. It has also been observed that a large number of banks (accounting for about half of the size of the banking sector) hold CASA deposits lower than the average CASA deposits. In view of this pattern, banks have often raised the concern that deregulation may lead to an unhealthy competition. This, in turn, may result in

large shift of deposits from some banks exposing them to a serious risk of asset-liability mismatch.

53. However, analysis of interest rates on term deposits after they were deregulated did not result in any unhealthy competition amongst banks. Although spreads (the difference between the term deposits interest rate over the relevant policy rate) tended to widen somewhat in a deregulated environment in comparison with when interest rates were regulated, this was not unusual as similar or somewhat higher spreads were observed in recent years. Thus, if deregulation of term deposits did not lead to any unhealthy competition, deregulation of savings deposit rate may also not result in any unhealthy competition.

54. The experience with deregulation of term deposits interest rate also suggests that deregulation resulted only in a marginal shift of deposits from public sector banks and foreign banks to private sector banks. Thus, if deregulation of term deposits interest rate is any guide, deregulation of savings deposit interest rate may not result in an unhealthy competition and a large shift of deposits from one bank to another, thereby destabilising the system. Further, the Reserve Bank has deregulated the entire asset side and bulk of liability side of banks' balance sheets. In such a scenario, continuing regulation of savings deposit interest rate leads to distortions in the system, which need to be avoided.

55. Concerns have also been expressed with regard to the interests of low income households in a deregulated environment. There is a risk that in a deregulated environment when the cost of maintaining such deposits becomes high, banks may introduce such features as may prevent small depositors from accessing such accounts. While attractive returns may encourage low income households to open such accounts, it may also reduce accessibility of such accounts for small savers if banks impose some restrictions on the operation of such accounts. However, such issues are better addressed by regulatory prescriptions rather than by regulation of interest rates.

56. In sum, deregulation of savings deposit interest rates has both pros and cons. Savings deposit interest rate cannot be regulated for all times to come when all other interest rates have already been deregulated as it creates distortions in the system. International experience suggests that in most of the countries, interest rates on savings bank accounts are set by the commercial banks based on market interest rates. Most countries in Asia experimented with interest rate deregulation to support overall development and growth policies. These resulted in positive real interest rates, which in turn contributed to an increase in financial savings. Deregulation of savings bank deposit interest rate also led to product innovations.

Issues for Feedback from Public

In light of pros and cons of deregulation of savings deposit interest rate set out in this Discussion Paper, the Reserve Bank seeks feedback from the general public on the following issues:

1. *Should savings deposit interest rate be deregulated at this point of time?*
2. *Should savings deposit interest rate be deregulated completely or in a phased manner, subject to a minimum floor for some time?*
3. *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?*
4. *How serious are concerns relating to a possible intense competition amongst banks and asset-liability mismatches if savings deposit interest rate is deregulated?*
5. *Should higher interest rate be paid on savings deposits without a cheque book facility?*