Press Release

The Curious Case of Higher Deposit Rates

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Some large banks have increased their medium term deposit rates over the last few weeks by 15-20 bps. While some have raised the rack FD rates directly, a few others have put it through special deposit schemes or bulk deposit offers. Prima facie, such a deposit rate hike appears counter-intuitive given the adequate system liquidity and the expectation of an accelerated release of funds by the Government after the temporary hold-up due to the general elections. It is all the more glaring since most of the market stakeholders expect RBI to cut interest rates by the third quarter of the current fiscal year in the backdrop of a very high likelihood of Fed slashing rates by 50-75 bps by Dec-24. Additionally, the domestic bond yields have also seen a consistent softness since the Union Budget July 2024, with the ten year benchmark paper slipping to a 28 month low of 6.85% in the current week.

So why are banks raising deposit rates near the interest pivot point? Clearly, the deposit growth rates have been lagging behind the credit growth rates for a sustained period and putting pressure on the liability position of the banking sector. Let's take the last 3 years – while bank credit advances grew by 15.6%, aggregate deposits grew by only 10.9% (CAGR: July 21- July 24, RBI), reflecting a substantial gap of 470 bps. In the last one year, the credit-deposit growth gap has reduced somewhat to 270 bps but is still significant. The credit: deposit (CD) ratio of the Indian banking system has reached a high of 79.4% as on July'24 and the incremental CD ratio stood at 95.8%. These metrics have not been really music to the ears of the central bank and it has also raised concerns on such a trend.

What is wrong with the banking deposit mobilization drive? In our opinion, the issue is largely structural and can be attributed to the following factors:

- From May 2022 to February 2023, RBI had raised the repo rate by 250 bps from 4.00% to 6.50%; however, such a hike was not fully transmitted to the deposit holders by most of the banks. The highest deposit rate for the largest banks currently is around 7.25% which translates into a post-tax yield of only 5.1%. Low yields have impacted the share of banking deposits in household savings.

- While bank deposit yields continued to be low, households have been deriving consistently higher returns from the equity markets and equity mutual funds (SIP et all) over the last 3 years. The 3 yr index fund returns have ranged between 15%-30% depending on the type of index and the tax payouts are lower for capital gains (even after the latest hike). Understandably, expectation of much higher medium term returns have induced depositors to divert an increasing part of their savings to the equity and the commodity related (mainly gold) asset classes.

- Further, competition for bank deposits has increased materially with the rise and growth of small finance banks (SFBs). Many SFBs are offering term deposit rates which are 100-200 bps higher than the larger banks. Given the improved track record of these SFBs, depositors are perhaps increasingly comfortable in investing in their deposits.

- Additionally, ease of financial services driven by technology has been a game changer in the banking industry. Today, it's very easy to undertake transactions and transfer funds from bank accounts to the equity markets and mutual funds digitally and within a short period of time. With internet banking and particularly mobile applications becoming popular with depositors and investors, the shift in asset allocation can be immediate. Such digital technologies are not only impacting the deposit base but also reducing the float in CASA accounts very significantly. The stability of CASA deposits possibly is not as robust as it had been considered in the past. The advent of instantaneous digital transfer of funds for a transaction is also enabling account holders to give lower balances in savings or current accounts and earning better yields on their treasury balances.

- Recently, RBI has also revised the LCR (Liquidity Coverage Ratio) for banks wherein they now require to assign an additional run-off factor of 5% on retail deposits with internet and mobile banking facilities to factor in the increased volatility in such deposits. This is likely to have an impact on the LCR of banks to the extent of 10%-15% depending on the deposit pattern of the banks. This may also push banks to attract more longer term and stabler deposits, resulting in an increased competition in this segment.

Given the emergence of such structural developments, the mobilization of deposits by banks will remain challenging particularly for longer tenures (>3 yrs). Some of the measures that we expect from the banks to step up deposit growth and meet the increasing credit requirements from the corporate and the infrastructure sector are:

- Banks need to keep deposit rates adequately attractive for the retail depositors in the context of higher risk adjusted returns from several financial asset classes.

- Enhancement of the deposit premium on longer tenor and stable deposits (non-callable for example) needs to be considered given the gradually increasing share of longer term project loans in the banks' books

- Banks should also step up the issuance of long tenor infrastructure bonds to fund their longer term assets. While the costs of such bonds will be higher, they will add stability to the ALM position and can be also distributed to the retail segment.

Needless to say, the era of the seamless flow of deposits to the bank branches is almost over! Indian banking sector may need to review their optimum liability structure. Banks have to work far harder to mobilise deposits and make them grow in double digits, ensuring funds to the productive sectors of the economy and sustainable economic growth.

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