Implications of FCNR-B outflow for financial markets and banking system

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Between September and November of this year, India will witness a likely $26 billion outflow of FCNR-B deposits, raised under a special Reserve Bank of India (RBI) scheme in 2013 aimed at boosting reserves. Given the absence of any similar offering from the central bank and that most of these deposits were leveraged, this is a reasonable hypothesis. This article attempts to analyse the implications of the outflow for the financial markets and the banking system.

FX markets and banking liquidity: Under the terms of the original swap contract, RBI would sell dollars to Banks in exchange for INR when the deposits come for maturity. This dollar outflow should lead to a fall in the country's FX Reserves. However, to avoid this, RBI has been buying dollars from the banking system in the inter-bank FX forward market. The plan is that RBI sale of dollars to banks under the original FCNR-B swap agreement will be cancelled by Banks' sale of dollars to RBI under the inter-bank market deals, resulting in no dip in the FX Reserves. It would also mean INR liquidity in the Banking system remains unaffected.

However there is a risk: It is unlikely that the inter-bank market will be able to deliver large amounts of dollars to the RBI as there are clients (exporters) who hedge their receivables through forward dollar sale contracts with Banks and not all of them deliver the dollars. Many roll over to future dates. Also, if this period coincides with additional importer hedging or portfolio outflows from FIIs, it could further accentuate the dollar demand. So, while RBI may not see any change in the FX reserves when the FCNR-B deposits mature, there is a possibility of the banking system being short of sufficient dollars, which will result in a sharp fall in the USD/INR FX forward points. To avoid this it would be better for the RBI to use its reserves in the short term and ensure a reasonable portion of dollars required to pay off depositors comes from FX reserves. Once the event passes and markets stabilise, RBI can build back the reserves, given that one expects a BOP surplus for the year.

Implications for deposit costs and lending rates: As these deposits mature, Banks have to substitute them with alternate deposits to avoid deterioration in the credit /deposit and LCR ratios. The FCNR deposits represent about 1.7% of aggregate deposits in the banking system. Banks will of course plan individually in their ALCOs and each of them may believe they are well covered for this outflow. However, when taken together at a systemic level, replacing such large amount of concentrated deposit outflow will not be easy, especially as credit growth picks up and with Banks' LCR target for next year being 10% higher.

The deposit outflow is actually on the dollar balance sheet of banks and the direct impact is likely to be on dollar borrowing costs. But INR deposit rates too may harden, as banks with INR funding needs start to bid up deposits to cover their gap. To proactively asses and mitigate volatility, it may be prudent for the RBI to collate the substitution plan from all banks and assess for any systemic round-tripping - if many banks have a plan to sell liquid assets or raise deposits at the same time in the market, that would be difficult to achieve without a material impact on market prices. All banks acting in a similar manner in a concentrated time frame may end up pushing up interest rates, counter to the policy objectives of the Central Bank.

Finally, touching upon the possibility of rollover of the special scheme: The country's external balance situation is significantly better than 2013 and hence there is no case to seek continuation of the original scheme. Having said which, simply letting the outflows happen would also border on complacency. We are still in a highly uncertain world and no amount of FX reserves can be deemed high enough. It would be prudent of the policy makers to look at options to retain a portion of these funds with alternate options. For example, RBI may provide specific incentives in the form of reserve and PSL relief to Banks for new FCNRB deposits raised this year.

The government directly or through institutions such as IIFCL or IRFC may consider the option of issuing dollar bonds around the time of FCNRB maturity, offering an alternate deployment route for the funds and raising money for funding the infrastructure needs of the country.

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