

Stop fiddling with small savings rates

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Money matters Let's not make it difficult for her GN RAO

Whimsical fixing of rates may end up benefiting one set of market players at the cost of small investors

Minutes of the Monetary Policy Committee Meeting held on June 6 and 7, aside from revealing the long-drawn debate on inflation versus growth, touched upon another less contentious issue. RBI governor Urjit Patel, while reiterating the need to avoid premature policy action, made a passing remark on the need to align interest rates on small savings schemes to the 'committed formula'.

Given that the governor has been relentlessly prodding banks to transmit its rate action more effectively, the remark on small savings is not without context. In his earlier recommendations (Urjit Patel committee report 2014 on Monetary Policy Framework) the governor, among other structural changes, has been rooting for intra-year review of rates on small savings schemes, to align them to the benchmark G-Sec yield.

The rationale? To narrow the wide gap between interest rates offered on small savings and bank deposits. These schemes, offering much better post-tax returns, have always enjoyed a competitive edge over bank deposits, leaving little headroom for banks to tinker with their deposit rates beyond a point. In a rate easing cycle, scope to cut lending rates is hence limited.

Money around

Some would argue that in the current scenario when liquidity is sloshing around the system, the need for such a move may not be as compelling. Banks flush with funds are free to cut deposit rates.

Be that as it may, the need to bring rates on small savings in sync with market rates, is nonetheless imperative to serve the long-term policy objective. After all, only if interest rates across different segments are aligned to market-determined rates, can transmission happen seamlessly. For the small investors too, adhoc fixing of rates can be unsettling. After acknowledging the need to align rates on small savings schemes with market rates and wielding the scissors on various schemes, last April, the Centre's somewhat slipshod action since then calls for attention.

After the sharp cut in the April-June 2016 quarter, the Centre has only tinkered with rates through 2016-17, bringing them down by a mere 10 basis points across schemes. For the April-June 2017 quarter, and now for the July-September 2017 quarter, the Centre has again reduced rates only by 10 basis points, despite the yield on G-sec falling by nearly a percentage point between April 2016 and March 2017.

An edge?

Since April 2012 until March 2016, interest rates on small savings scheme were hardly tweaked. The five-year post office deposit offered 8.4-8.5 per cent for four consecutive years until April 2016.

Similarly, the humble old public provident fund continued to offer an attractive 8.7-8.8 per cent, despite the yield on government bonds swinging wildly between 8.5 per cent and 6.75 per cent across two rate easing cycles and one rate hike cycle during this period. Interest rates on bank deposits up to five years, on the other hand, dutifully moved up and down between 7 and 9 per cent. So have higher rates on small savings impacted flows into bank deposits?

Data by the RBI show that five-year post office deposits have grown by about 24 per cent annually between 2011-12 and 2015-16. Bank deposits of similar maturity have grown at a lower 14 per cent during this period. But given that (even after including balances in five-year National Savings Certificates) the outstanding amount in five-year post office schemes is just about a tenth of that in comparable bank deposits, growth in per cent terms may mean little.

Nonetheless, security and attractive returns of post office schemes remain a big draw for investors and can sway their investment decisions. Consider this.

Effective April 2016, the Centre slashed rates by 40-130 basis points, across post office schemes and had decided to revise them every quarter based on the prevailing rates on government bonds.

But after the first blow, the Centre hardly tweaked the rates, despite the yield on G-sec falling by nearly a percentage point between April 2016 and March 2017. Is this why receipts under small savings scheme continued to remain healthy through most of last fiscal?

The Centre had announced its sharp rate cut effective April 2016 last March. Receipts in that particular month (March) did dwindle. Under all post office schemes put together, receipts that were averaging about Rs. 28000-35,000 crore every month until Feb 2016, fell to a low of Rs. 1,900 crore in March last year. But inflows picked pace once again. By October 2016 (pre-demonetisation) receipts were back to Rs.30,000-34,000 crore levels per month.

While five-year bank deposits offered returns comparable with five-year post office deposits, NSC that offered 8-8.1 per cent through 2016-17 continued to trump bank deposits. PPF too offered rates similar to NSC (remember interest on PPF is completely tax-free).

Transmission worries

The Urjit Patel Committee report talks at length about aligning interest rates across different segments to market-determined rates. Aside from small savings scheme, the report also suggests the need to bring down banks' statutory liquidity requirement (SLR) — government securities held by banks — to do away with a captive market for government securities.

The Centre now needs to create a more conducive environment for monetary transmission, by aligning the rates on small savings schemes with market rates. But its task does not end there. Being transparent in the manner in which it carries out its rate action is imperative too. Last year, while the Centre had issued a comprehensive note on the rate structure for each scheme, lack of access to the underlying benchmark rates made it difficult to reconcile rates.

Rates on small savings were pegged to FIMMDA G-Sec rates of similar maturity. FIMMDA (Fixed Income Money Market and Derivatives Association of India) is a market body for the bond, money and derivatives markets.

Its data on G-sec rates is only accessible to members, who could be banks, financial institutions and dealers, for a fee. If rates on small savings are to be tweaked every quarter, it is only fair that such data be made available to a small

investor.

The rationale for different spreads for various schemes and the diversity in rates must be spelt out clearly. Lest whimsical fixing of rates can well be used to benefit one set of market players at the cost of small investors.

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