Bye bye banks! Sold on new money, India dumps its long-time savings favourite

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Over the past five decades, term deposits in banks have emerged as the primary instrument of financial savings for the average Indian after former premier Indira Gandhi embarked on a mission to nationalise the lenders — 14 in the first tranche — on a rainy afternoon in July 1969.

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Coming with an unsaid sovereign guarantee of sorts, fixed deposits (FDs) seemingly offered investors liquidity — and safety — as nationalisation sought, in part, to arrest the 40-odd bank failures a year.

Now, however, deposits must burnish their allure to retain leadership status in an increasingly crowded financial marketplace that offers choice. Take Ahmedabad's Abhishek Sharma, for instance. The 50-yearold businessman moved his savings from fixed deposits to fixed maturity plans (FMPs), reflecting the increasing appeal of diversified and longer-duration financial products, such as mutual funds and pensions.

"I was paying a huge amount of tax on fixed deposits: So, I locked the bulk of my savings into FMPs and a small portion in tax-free bonds," said Sharma.

While gross financial savings rose to 11.1% last fiscal from 10.8% in FY16, the share of deposits fell to 2.9% from 4.6% during the same period. The portion of shares and debentures rose to 0.9% from 0.3% and currency doubled to 2.8% from 1.4%, data from the Reserve Bank of India shows.

Savers are looking at mutual funds and provident funds for higher return. “We have moved many people from FDs to FMPs and tax-free bonds as these are taxefficient and generate higher returns,” said Suresh Sadagopan, Founder Ladder7 Financial Advisories.

“We are moving money to perpetual bonds and NCDs in the secondary market for better returns. These bonds offer guarantees and some even quarterly returns.”

A PRONOUNCED CULTURE SHIFT

People are becoming aware of more asset classes that offer better returns, and the quest for such assets became more pronounced after interest rates fell substantially over the past four years.

Money is now flowing into both equity and debt funds. Stock indices hit record highs before the recent weakness: In FY18, the benchmark Sensex rose 10.23% when bank fixed deposits yielded about 6%.

Of course, equity market corrections would reduce the flows. The big cultural shift that has happened is that money is moving in the form of systematic investment plans. Some of this is permanent rather than temporary, said bankers.

In 2016-17, there was a sharp decline in hard currency holdings because of demonetisation. Today, savers invest as much in bank deposits as they hold cash. Currency as a percentage of gross financial savings was 2.8%, up from a negative 2%, while bank deposits were 2.9% down from 6.3%.

DEPOSIT RATES AND CREDIT DEMAND

“Since the banks did have surplus liquidity for the last two-three years, credit growth was lower and some liquidity came in at the time of demonetisation, lower savings moving into deposits would not be a concern yet,” said PK Gupta, managing director of State Bank of India.

“If it does become a concern, then banks will have to start raising deposit rates,” said Gupta. “If credit growth continues to grow at a decent rate, banks will have to raise deposit rates.”

As per the latest central bank data, deposit growth is 8% while credit growth is 13%. The trend has changed this year. “Banks will look for deposits at various places — retail savings, HNIs and some institutions will be the target areas — depending on the cost of funds as credit growth picks up," said Saugata Bhattacharya, chief economist at Axis Bank.

SLOWING COMPANY DEMAND

Demand for funds from banks fell as companies tapped commercial papers and the corporate bond market. Well-rated companies sold commercial papers to raise working capital. Better-rated companies went to the corporate bond markets for term loans.

Bank credit fell to 4% in February 2017 on poor demand as corporates were deleveraging and new investments were not coming up. To keep up credit growth, banks focused on small and medium enterprises and retail.

While SMEs would drive growth, banks are likely to move back into corporate lending as investment climate improves, capacity utilisation enhances, and demand for new capacity revives.

"As liquidity gets tightened in the system and market interest rates increase, there is rediversion of funds from market instruments into the banking products," said Bhattacharya.

Returns on Financial Instruments

Products#	Institutions	Tenure	Annualised Pre-tax Rate of Return
Bank Fixed Deposits	State Bank of India	3y/5y	6.80-6.85%
Public Provident Fund~	Banks / Post Office	15y	8%
Pradhan Mantri Vaya Vandana Yojana	Banks / Post Office	10y	8.7%
Senior Citizen Scheme	ICICI Banks & PSU Banks	5y	8.7%
Secondary Market Offerings*			
Perpetual Bonds	10.75% DHFL PERP 2026	8y	10.13%
Tax Free Bonds	7.51% HUDCO 2028	10y	6.39%
Primary Market Offerings*			
Tax Free Bonds	8.80% TCFSL 2021	3y	8.80%
Fixed Maturity Plans (FMPs)~	Various AMCs	3y	8.30%
Debt Mutual Funds	Various AMCs	Open ended	Market linked
Equity Mutual Funds	Various AMCs	Open ended	Market linked

*Payments annually; #Monthly, quarterly, annually; ~Cumulative

Source: Ladder7 Financial Planner

"That was one reason why bank credit rate started to increase. As investment climate improves and companies begin to consider new investments, banks are beginning to refocus again. Not the large infra projects, but we will see a return of corporate lending into the system."

The cost of funds for banks would rise if there is a broader shortage of money in the system, tight liquidity conditions because of foreign reserve operations, and lower government spending. "Money that we put in mutual funds, stock markets and bonds gets back to banks," said Bhattacharya. "It stays with the banking system. But the money that households put into mutual funds and other instruments is finding way into the banking system through deposits by other institutions."

THE TAX EDGE

The three-year fixed deposit is not exempted from tax at maturity. Similarly, there are a number of taxes levied, like dividend distribution tax, short-term securities transaction and longterm securities transactions tax on mutual funds, debt mutual funds, stocks, gold, and real estate.

"We are advising people, who would have invested in bank FDs to move to perpetual bonds and tax-free bonds, because in the secondary market perpetual bonds are giving 9% return, with some bonds offering 10%," said financial planner Sadagopan. Adjusting for taxation, tax-free bonds or mutual funds give 7% post-tax returns, compared with 5.5% to 6% on fixed deposits.

Financial Savings of Household

	2017-18	2016-17	2015-16
Gross Financial Savings*	11.1	9.1	10.8
Of which:			
Currency	2.8	-2	1.4
Deposits	2.9	6.3	4.6
Shares and Debentures	0.9	0.2	0.3
Claims on Government	0	0.4	0.5
Insurance Funds	1.9	2.3	1.9
Provident and Pension Funds	2.1	2	2.1

***As percentage of GDP;** Source: CSO and RBI

“Youngsters want to invest in equities to create value and they are looking at mutual funds in a serious way,” said Sadagopan. “They are investing in fixed maturity plans on a monthly basis and some are looking to invest in equities directly.”

If FDs are giving 7.5% and the effective tax rate is 10%, one gets close to 5-5.2% return. Similarly, in case of FMP, if the rate is 7.5%, effective taxation comes to 10%, one gets 6.75%. It is higher than the effective returns on bank deposits.

Will banks’ role shrink to advisory and fees as in the US? Probably not. Loans are an integral part of bank lending in India. “The US is a very bondcentric system,” said Bhattacharya. “Credit in US is taken from corporate bonds. Banks buy corporate bonds and syndicate them.”