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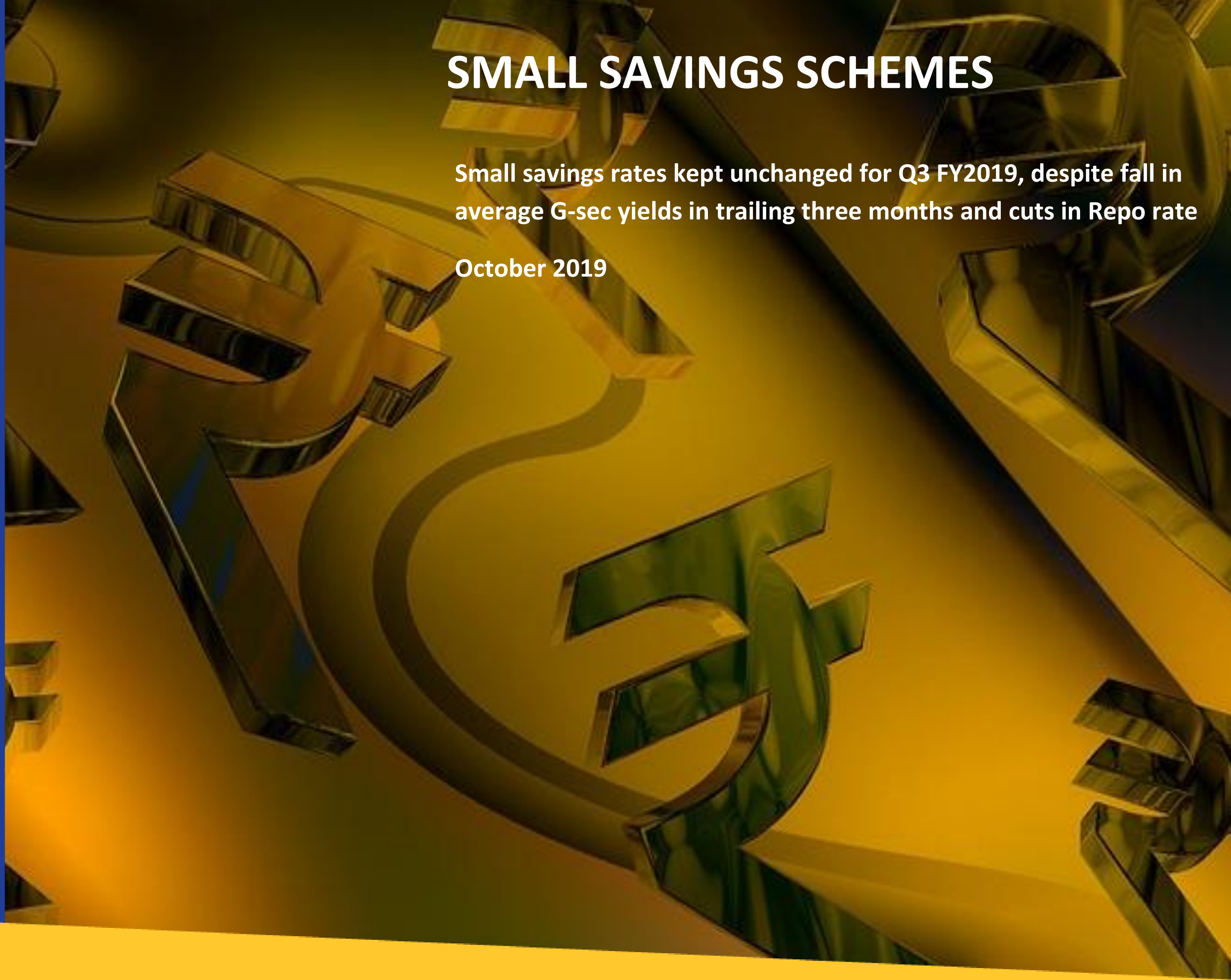

SMALL SAVINGS SCHEMES

Small savings rates kept unchanged for Q3 FY2019, despite fall in average G-sec yields in trailing three months and cuts in Repo rate

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Aditi Nayar
+91 124 4545 385
aditin@icraindia.com

Soumyaditya Pal
+91 124 4545 848
soumyaditya.pal@icraindia.com

Medha Sinha
+91 124 4545 399
medha.sinha@icraindia.com

HIGHLIGHTS

- *Interest rates on small savings schemes were left unchanged for the quarter starting October 1, 2019 relative to the quarter starting July 1, 2019, which was at odds with the considerable easing in the average end-month yields for Government of India securities (G-Sec) for the trailing three-month period.*

- *As a result, the interest rate offered by the one-year time deposit small savings scheme (6.9%) exceeds the one-year median deposit rate offered by banks (6.73%). Moreover, the interest rates on small saving schemes with higher maturities will have substantial spreads of 33-210 bps over bank deposits rates of corresponding maturities.*

- *The anticipated rate cut in the October 2019 policy review, in conjunction with the rising focus on facilitating monetary policy transmission, and the easing of bank credit growth would further nudge the banks to cut their lending and deposit rates, going forward.*

- *Subsequent revisions in the small savings rates would lag the significant reduction in the Repo rate, as well as the decline in banks' deposit rates, in ICRA's opinion, which would help to maintain the relative attractiveness of the former. Accordingly, this would ensure that the GoI has adequate room to avail the net budgeted amount of Rs. 1.3 trillion, or higher from the NSSF.*

- *Recent announcements by the GoI for supporting economic growth and business sentiment are likely to lead to a shortfall in the its revenues compared to the Revised Budget Estimates (RBE) for FY2020, while also raising the expenditure outgo to some degree. Based on our estimate of the GoI's tax revenues, non-tax revenues, and nominal GDP of Rs. 208 trillion for FY2020, the extent of fiscal slippage may be as high as 40 bps unless expenditure cuts are undertaken.*

- *The extent of the shortfall in the GoI's tax revenues relative to the RBE for FY2020 would become clearer by the end of Q3 FY2020, both in terms of corporate tax revenues as well as the GST collections. Additionally, the funds collected through the NSSF would guide whether additional domestic dated securities need to be issued in Q4 FY2020*

Small saving schemes are categorised under three broad heads (i) postal deposits, comprising savings account, recurring deposits, time deposits of varying maturities and monthly income scheme (MIS); (ii) savings certificates, including National Small Savings Certificate (NSC) and Kisan Vikas Patra (KVP); and (iii) social security schemes such as public provident fund (PPF) and Senior Citizens' Savings Scheme (SCSS). These schemes provide an alternative avenue to saving in banks, often at interest rates that tend to be higher than bank deposits of a comparable maturity. Therefore, such schemes have at times been highlighted as a factor that hampers transmission of monetary easing to bank deposit and lending rates. To reduce the hindrance posed by small savings schemes to the process of monetary transmission, it was decided to recalibrate the interest rates on such schemes on a quarterly basis and link them to average end-month G-Sec yields of corresponding maturity in the trailing three months, since Q1 FY2017[1].

In a somewhat unexpected move, the GoI retained the interest rates on small savings schemes for Q3 FY2020, at the levels prevailing in Q2 FY2020 (refer Exhibits 1 and 2), as per the notification released by the Ministry of Finance on September 30, 2019. This is at odds with the moderation in the average G-Sec yields of various maturities, during the trailing three-month period. For instance, the average month-end G-Sec yields for one-year, two-year and five-year bonds fell by around 50 bps, 49 bps and 54 bps, respectively, in June-August 2019 relative to the average end-month yields during March-May 2019. Previously, the interest rates on various small savings schemes had been reduced by 10 bps for Q2 FY2020, tracking the fall of 16 bps in the 10-year benchmark G-Sec yield.

Exhibit 1: Trends in Interest Rates on Selected Small Savings Schemes

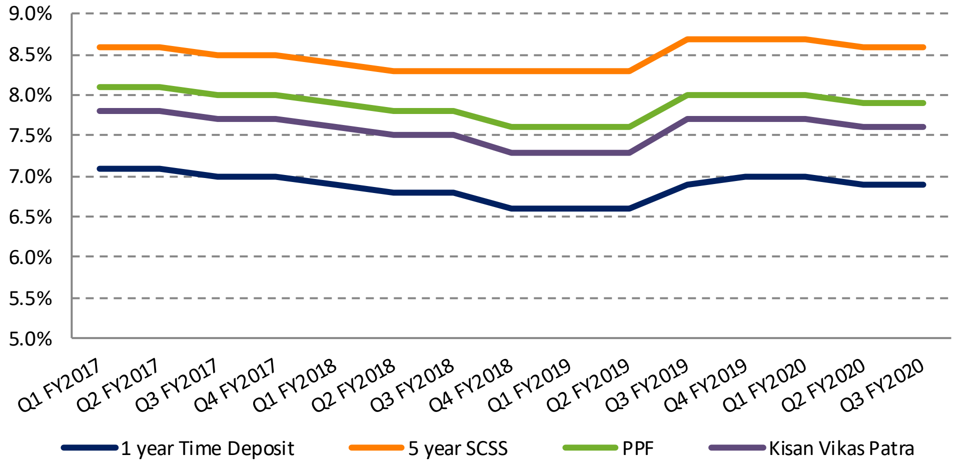
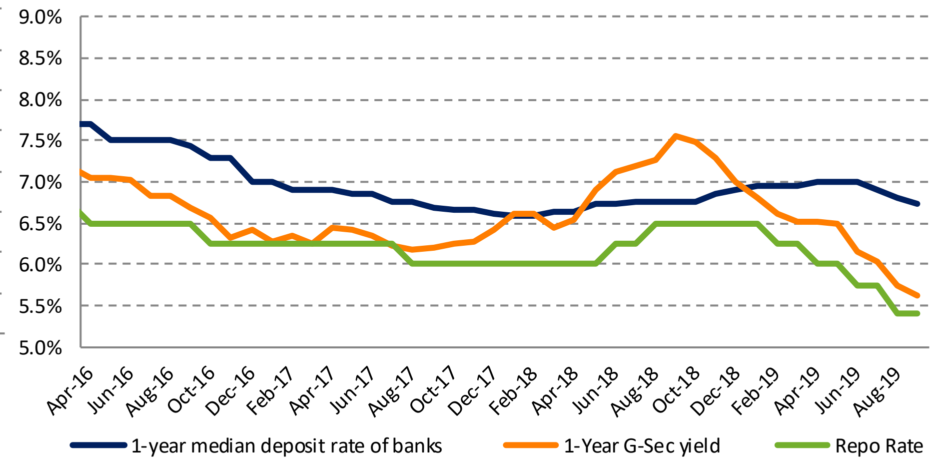


Exhibit 2: Trends in Repo Rate, 1-year G-sec Yield and 1-year Median Deposit Rate



Source: Ministry of Finance, GoI; RBI; CCIL; CEIC; ICRA research

[1] The interest rate on one-year, two-year and three-year term deposits, KVPs and five-year recurring deposits had a spread of 25 bps over G-sec of comparable tenures till FY2017. However, it was decided to remove this spread to make the interest rates of such schemes closer to the comparable instruments of the banking sector w.e.f. April 1, 2016, The GoI also decided to recalibrate the interest rates of the aforementioned small saving schemes quarterly from FY2017, to align the small saving interest rates with the market rates of the relevant GoI securities

With the GoI's decision to keep the rates unchanged for Q3 FY2020, the interest rate offered by the one-year time deposit small savings scheme (6.9%) exceeds the one-year median deposit rate offered by banks (6.73%). Moreover, the interest rates on small saving schemes with higher maturities will have substantial spreads of 33-210 bps over bank deposits rates of corresponding maturities, for schemes such as five-year SCSS, Sukanya Samriddhi Account Scheme etc. Therefore, we expect a healthy inflow of funds into such schemes in the ongoing quarter.

The Union Budget 2019-20 indicated that the GoI would borrow a net amount of Rs. 1.3 trillion from the NSSF to fund its fiscal deficit in FY2020, marginally higher than the Rs. 1.25 trillion included in the revised estimates for FY2019. The provisional data released by the Controller General of Accounts for April-August FY2020, indicates that inflows into savings deposits and certificates, and PPF, rose by a substantial 35.0% to Rs. 876.2 billion in that five-month period from Rs. 648.9 billion in April-August FY2019.

The decision to keep the small savings rates unchanged is also at odds with the significant cuts of 110 bps in the Repo rate by the Monetary Policy Committee (MPC) since the beginning of 2019, including 60 bps during June-August 2019. The cumulative Repo rate cuts of 110 bps in 2019 (25 bps each in February 2019, April 2019 and June 2019; 35 bps in August 2019) have only been partly transmitted to bank deposit rates; since the beginning of 2019, banks have cut interest rates on one-year, three-year and five-year deposits by 23 bps, 23 bps and 28 bps, respectively.

The CPI inflation rose mildly to a 10-month high 3.21% in August 2019 from 3.15% in July 2019, while remaining below the MPC's medium-term target of 4.0% for the thirteenth month in a row. The core-CPI inflation dipped marginally to 4.35% in August 2019 from 4.37% in July 2019. ICRA expects the CPI inflation to inch up over the remainder of this year. However, headline inflation is expected to average a benign 3.5% in FY2020. In contrast, the moderation in economic growth is emerging as a considerable cause for concern. ICRA expects the GDP growth to fall to a seven-year low 6.2% in FY2020 from 6.8% in FY2019. The subdued outlook for economic growth amidst expectation of benign inflation suggest a high likelihood of a fifth consecutive rate cut by the MPC in the October 2019 policy review, the magnitude of which is likely to be 25 bps according to ICRA.

The systematic liquidity under the Liquidity Adjustment Facility (LAF) has been in surplus since June 2019 (refer Exhibit 3). The average liquidity surplus through the LAF window rose from Rs. 480.9 billion in June 2019 to Rs. 1.3 trillion, each in July 2019 and August 2019, respectively, before easing to Rs. 1.2 trillion in September 2019 (on account of advance tax payments).

Going forward, the magnitude of the systemic liquidity surplus is expected moderate somewhat in H2 FY2020 due to cyclical factors related to the upcoming harvest, festive and marriage season, and state elections in H2 FY2020. Nevertheless, the anticipated rate cut in the October 2019 policy review, in conjunction with the rising focus on facilitating monetary policy transmission through various mechanisms, such as external benchmarking of banks' floating rate loans, and the easing of bank credit growth would further nudge the banks to cut their lending and deposit rates, going forward. Subsequent revisions in the small savings rates would lag the significant reduction in the Repo rate, as well as the reduction in banks' deposit rates, in ICRA's opinion, which would help to maintain the relative attractiveness of the former. Accordingly, this would ensure that the GoI has adequate room to avail the net budgeted amount of Rs. 1.3 trillion, or higher from the NSSF.

The recent announcements by the GoI for supporting economic growth and business sentiment, such as reducing corporate tax rates, upfronting of GoI's expenditure, faster processing of GST refunds etc. are likely to lead to a shortfall in the GoI's revenues compared to the Budget Estimates for FY2020, while also raising the expenditure outgo to some degree. Based on our estimate of the GoI's tax revenues (post the reduction in the corporate tax rate), its non-tax revenues (post the higher than budgeted transfers from the RBI), and nominal GDP of Rs. 208 trillion for FY2020, the extent of fiscal slippage may be as high as 40 bps unless expenditure cuts are undertaken[2].

The Union Budget 2019-20 had placed the GoI's market borrowings at Rs. 7.0 trillion for FY2020, higher than Rs. 5.7 trillion in FY2019. In H1 FY2020, the GoI borrowed Rs. 4.2 trillion through its market borrowing programme. Subsequently, the GoI's borrowing calendar for H2 FY2020 retained the gross borrowings at Rs. 2.7 trillion, despite concerns related to fiscal slippage in FY2020, which has led to some easing in the benchmark G-sec yield (refer Exhibit 4). In addition, the notification mentioned that the RBI would be conducting switches of securities through auction in every month in H2 FY2020.

The extent of the shortfall in the GoI's tax revenues relative to the BE for FY2020 would become clearer by the end of Q3 FY2020, both in terms of corporate tax revenues as well as the GST collections. Additionally, the funds collected through the NSSF would guide whether additional domestic dated securities need to be issued in Q4 FY2020.

Exhibit 3: Daily LAF, MSS and CMB Outstanding

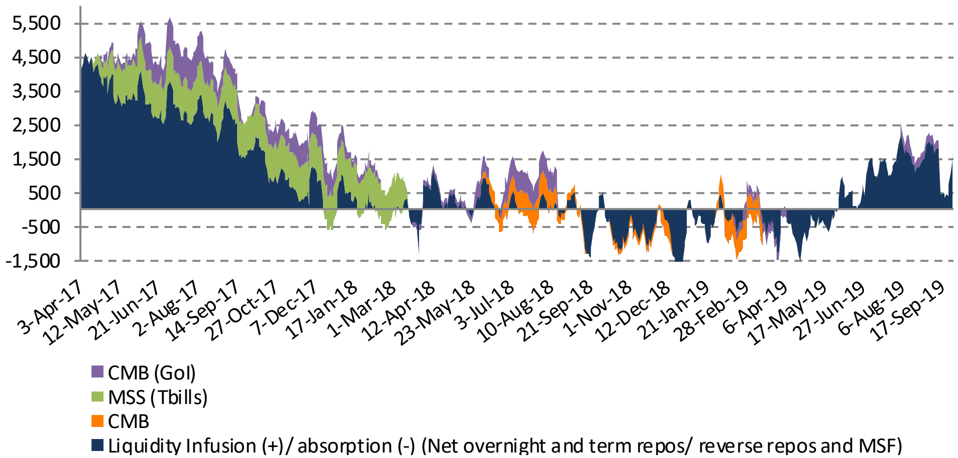
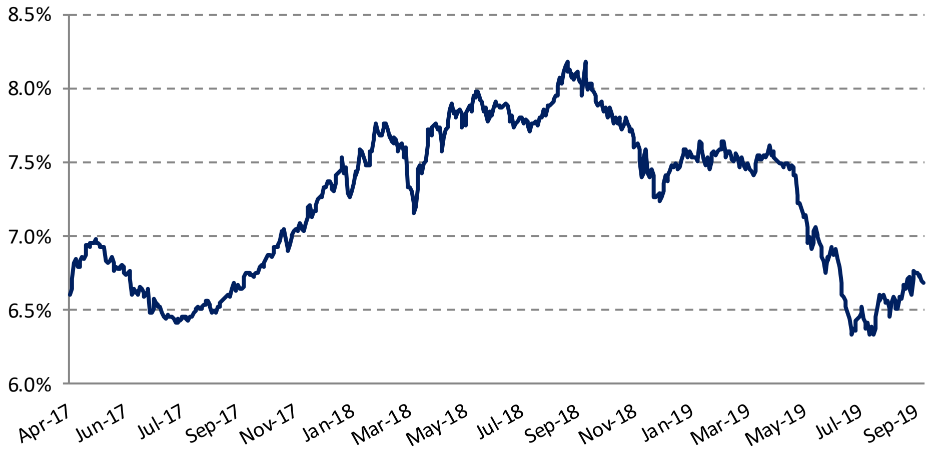


Exhibit 4: Movement in 10-year Indian G-sec Yields



Source: RBI; Bloomberg; CEIC; ICRA research

[2] Refer to ICRA's publication, *Cut in corporate taxes to boost sentiment, although pickup in private investment, GDP growth likely to be back-ended*, published in September 2019

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ICRA

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: communications@icraindia.com
Tel: +91 124 4545 860

Registered Office:

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi - 110 001
Tel: + 91 11 2335 7940-45

Corporate Office:

Building No.8, 2nd Floor,
Tower A, DLF Cyber City Phase II,
Gurgaon- 122 002
Tel: +91 124 4545300

Ahmedabad

1809-1811, Shapath V,
Opposite Karnavati Club
S.G. Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/01

Bengaluru 1

'The Millenia', Tower- B, Unit No. 1004,
10th Floor,1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber,
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre,
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Hyderabad 2

4A, 4th Floor, SHOBHAN,
6-3-927, A&B Somajiguda,
Raj Bhavan Road,
Hyderabad – 500082
Tel: +91 40 40676500

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony,
S. No. 210 CTS 3202 Range Hills Road,
Shivajinagar,Pune - 411 020
Tel: +91 20 2556 0194, 020 6606 9999

Email: info@icraindia.com
Helpdesk: 9354738909
Website: www.icra.in/ www.icraresearch.in