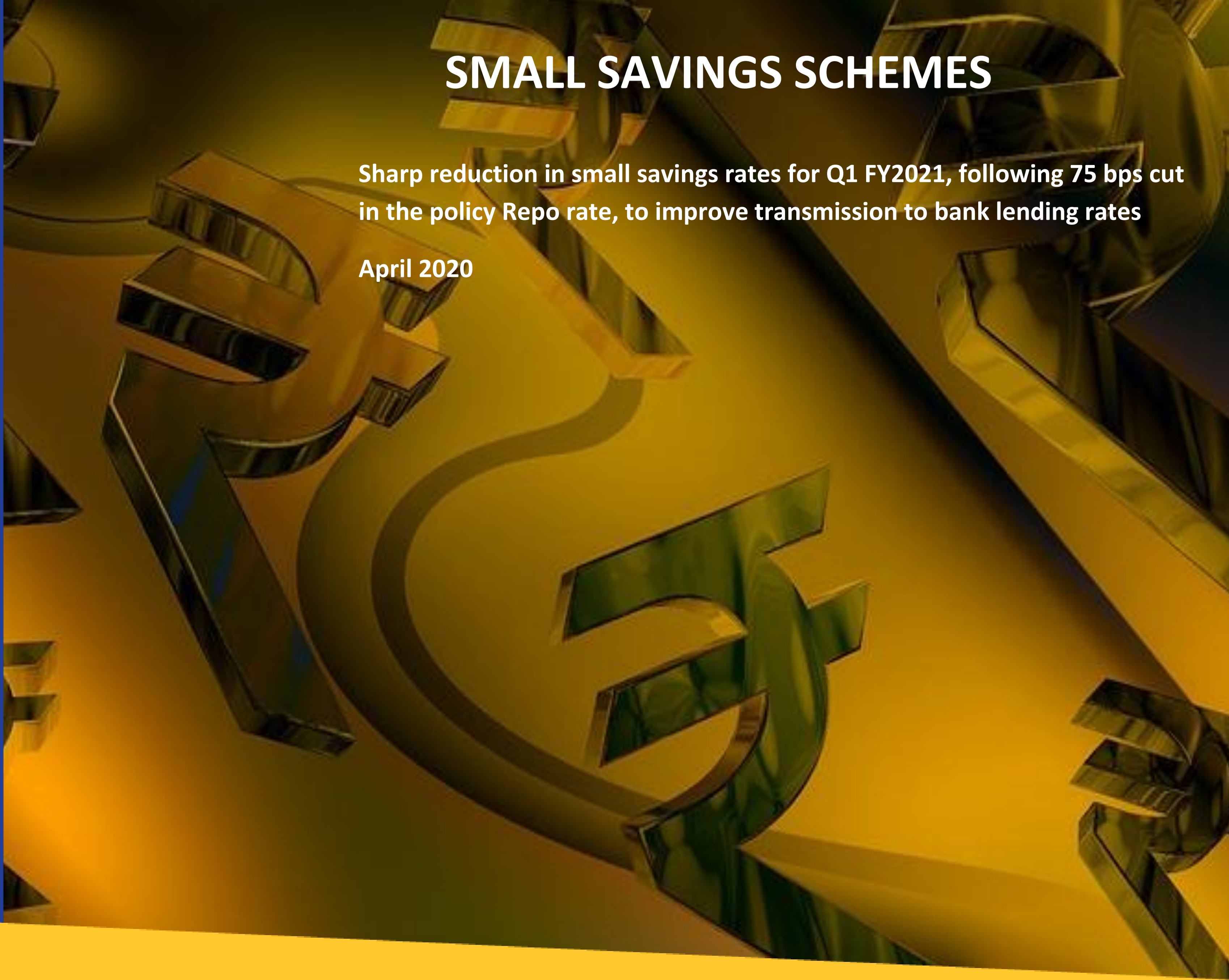
SMALL SAVINGS SCHEMES



Sharp reduction in small savings rates for Q1 FY2021, following 75 bps cut in the policy Repo rate, to improve transmission to bank lending rates

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

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

Aarzoo Pahwa
+91 124 4545 873
aarzoo.pahwa@icraindia.com

The decision to decrease the small savings rates for Q1 FY2021 by a sharp 70-140 bps, follows the significant reduction of 75 bps in the Repo rate to 4.40% by the Monetary Policy Committee (MPC) in March 2020, to address the growth concerns related to Covid-19 outbreak. Following the reduction in the small savings rates and expectations of deposit rate cuts of 50-70 bps during FY2021, we expect the transmission of the Repo rate cuts to bank lending rates to improve appreciably in a couple of quarters.

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

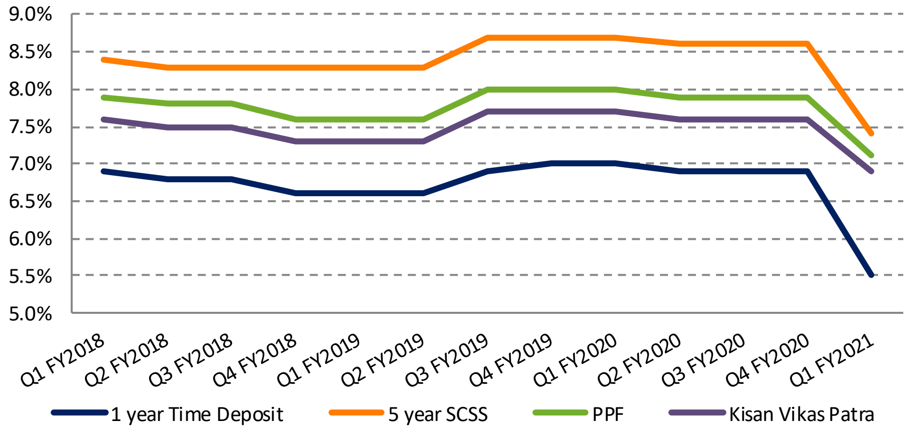
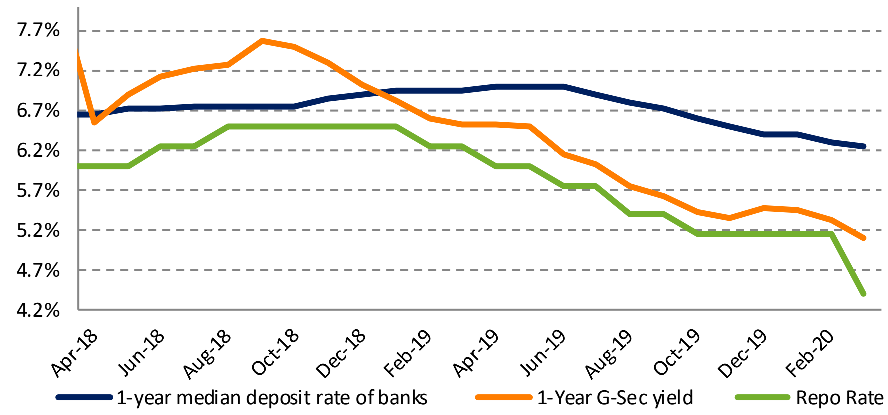


Exhibit 2: Trends in Repo Rate, 1-year G-sec Yield and 1-year Median Deposit Rate



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

Vide a notification released by the Ministry of Finance on March 31, 2020, the Government of India (GoI) has reduced the interest rates on small savings schemes[1] by a sharp 70-140 bps for Q1 FY2021, compared to the levels that were prevailing in Q4 FY2020 (refer Exhibits 1 and 2). This has followed the sizeable 75 bps cut in the Repo rate by the MPC in March 2020. The substantial reduction in small savings rates reflects the lagged catch-up with the fall in G-sec yields over the course of FY2020. For instance, the interest rates on various small savings schemes were kept unchanged in Q3 FY2020, in contrast to the sharp fall in the G-sec yields for the corresponding reference period (June-August 2019); the average month-end yields for the one-year G-sec, two-year G-sec and five-year G-sec had declined by a sharp 53 bps, 51 bps, and 55 bps, respectively, during that period. Similarly, the small savings rates were kept unchanged for Q4 FY2020, despite the fall of 50 bps, 38 bps,

[1] 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. 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

and 20 bps, respectively, in the average end-month G-sec yields for one-year, two-years and five-years tenures during the corresponding reference period (September-November 2019). For Q1 FY2021, the interest rates on time deposits for one-year, two-years and five-years have been cut by 140 bps, 140 bps and 100 bps, respectively (refer Exhibit 3), even as the movement in the average end-month yields on one-year G-sec (-5 bps), two-year G-sec (+4 bps) and five-year G-sec (+3 bps) yields was muted during the reference period (December 2019-February 2020).

Exhibit 3: Interest rate on Small Saving Schemes for Q4 FY2020 and Q1 FY2021

Instruments	Q4 FY2020 (%)	Q1 FY2021 (%)	Magnitude of change over previous quarter (bps)
Savings Deposit	4.0%	4.0%	0.0
1 year Time Deposit	6.9%	5.5%	-140
2 year Time Deposit	6.9%	5.5%	-140
3 year Time Deposit	6.9%	5.5%	-140
5 year Time Deposit	7.7%	6.7%	-100
5 year Recurring Deposit	7.2%	5.8%	-140
Senior Citizen Savings Scheme	8.6%	7.4%	-120
Monthly Income Account	7.6%	6.6%	-100
National Savings Certificate	7.9%	6.8%	-110
Public Provident Fund	7.9%	7.1%	-80
Kisan Vikas Patra	7.6%	6.9%	-70
Sukanya Samriddhi Account Scheme	8.4%	7.6%	-80

Source: Ministry of Finance, GoI; ICRA Research

With the GoI's decision to cut the rates sharply for Q1 FY2021, the interest rate offered by the banks continues to exceed the time deposit small savings schemes, with relatively shorter maturities. For instance, the one-year and three-year median deposit rate offered by banks during March 2020 stood at 6.3% each, which exceeds the corresponding maturity deposit rates on small savings scheme (5.5%, each), by a considerable 75 bps. With the recent cut of 75 bps in the Repo rate and 90 bps in the Reverse Repo rate during March 2020, the liquidity infusion measures announced by the RBI, and the surplus liquidity position of the banking system, banks have already reduced their deposit rates by 20 bps across various maturities. The cut in small savings rates for Q1 FY2021 will enable banks to further reduce their deposit rates in the coming months by an additional 20-30 bps. Overall, we expect a 50-70 bps reduction in bank deposit rates during FY2021 (70 bps in FY2020).

However, the interest rates on small saving schemes with higher maturities such as five-year SCSS, Sukanya Samriddhi Account Scheme etc., continue to have substantial spreads of 35-115 bps over bank deposits rates of corresponding maturities, and these spreads will increase further given our expectations of a reduction in bank deposit rates. Therefore, we expect a healthy inflow of funds into such schemes in the ongoing quarter.

The Union Budget 2020-21 had indicated that the GoI would borrow a net amount of Rs. 2.4 trillion, each from the NSSF to fund its fiscal deficit in FY2020 and FY2021. The provisional data released by the Controller General of Accounts indicates that inflows into savings deposits and certificates, and PPF, had already risen by a substantial 34.9% to Rs. 2.0 trillion in April-February FY2020 from Rs. 1.5 trillion in corresponding period for FY2019.

The systemic liquidity under the Liquidity Adjustment Facility (LAF) rose from ~Rs. 2.3 trillion in Q3 FY2020 to ~Rs. 3.2 trillion in January 2020, before easing mildly to ~Rs. 3.0 trillion, each in February 2020 and March 2020 (till March 30, 2020). In Q4 FY2020, the RBI undertook various measures to enhance the liquidity in the economy and encourage banks to lend. For instance, it announced long term repo operations of Rs. 2.0 trillion, Twist OMOs of Rs. 200.0 billion in Q4 FY2020, variable rate term repos of Rs. 1.25 trillion, open market purchases of G-sec of Rs. 400.0 billion and USD-INR sell buy swaps of US$4.0 billion. Additionally, the RBI has so far conducted two tranches of Rs. 250.0 billion, each, out of the targeted long-term repo operations of Rs. 1.0 trillion that was announced in March 2020.

With the sharp Repo rate cut in March 2020, being followed by the significant reduction in the small savings rates, amid the rising focus on enhancing liquidity to facilitate monetary policy transmission through various mechanisms, banks are likely to cut their lending and deposit rates, going forward. Accordingly, this would help to ensure that the GoI has adequate room to avail the net budgeted amount of Rs. 2.4 trillion from the NSSF.

The Union Budget 2020-21 pegged the GoI's market borrowings at Rs. 7.8 trillion for FY2021, higher than Rs. 7.1 trillion in FY2020. In H1 FY2021, the GoI has indicated a 10.4% rise in its gross market borrowings to Rs. 4.88 trillion from Rs. 4.42 trillion in H1 FY2020. ***In our view, the meaningfulness of the revenue and expenditure growth assumptions made in the Union and various state budgets for FY2021, has significantly declined following the rapid escalation of the Covid-19 crisis. The loss of economic activity is expected to dampen tax collections in Q1 FY2021, which would constrain the cash flows of the Central and state governments. Additionally, expenditure may rise sharply in H1 FY2021, especially if additional stimulus programmes are provided to dull the impact of the ongoing crisis on livelihoods and economic activity. Therefore, the funds collected through the NSSF would guide whether higher domestic dated securities need to be issued in H2 FY2021 compared to the remaining amount of gross market borrowings (Rs. 2.92 trillion) that were specified in the Budget Estimates for FY2021.***

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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