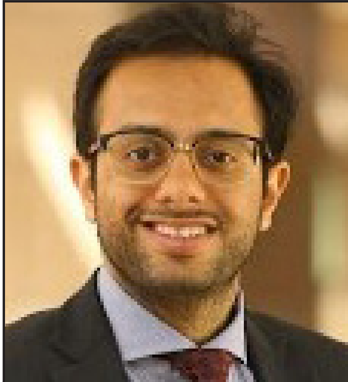
In Search of Deposits: A New Crises for Indian Banks?



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Access to stable, and relatively cheap deposits is what makes banks the king of the lending business and allows banks to capture the long-term lending market, as compared to a typical Non-Bank Financial Company (NBFC) which relies on other banks, and mutual funds in the potentially fragile wholesale funding market to support their lending activity. However Indian savings landscape is undergoing structural shift where more and more consumers are tapping into alternative financial assets than just the bank deposits which makes bank's job more difficult to attract new deposits and hold onto the existing ones. The article looks at these issues in detail.

One metric that is often used to gauge the bank's funding position is the Credit-Deposit (CD) ratio. That ratio on average has been around 70% over the last 20 years, dipped from 74% to 68% right after demonetization when deposits grew dramatically, and stayed around those levels until FY2022. But over the last two years, the ratio has been inching upwards and is now hovering around 80% now as per the latest data from RBI. How bad is this situation? Any bank has to set aside 4.50% of the deposits in the form of Cash Reserve Ratio (CRR) and another 18% in the form of Statutory Liquidity Ratio (SLR), leaving only 77.50 Rs out of 100 Rs of deposits it raises for lending. 80% CD ratio means that banks are themselves tapping the outside funding market to borrow so that they can lend, and it is as tight a treasury as it can get. This has happened as the credit has grown at a rate of nearly 17% over last year, but deposits grew only at about 11%. The situation has prompted both the RBI Governor and the finance minister to make statements asking banks to put more effort to raise more deposits. PSU banks have responded by increasing the deposit rates recently.

There are two factors behind this situation. First is the structural factor. As Indian financial markets are developing, and as consumer financial literacy is rising, there is a structural shift away from bank deposits towards alternative financial assets such as mutual funds, pensions funds, insurance cum investment products like ULIPS, and even hedge funds. RBI data shows that in 2020, 40% of Indian household's financial assets were held in deposits out of which 96% were in bank deposits. By the end of FY2023, those numbers have come down to 36% and 93% respectively. Not only households are moving away from deposits, but within deposits, they are tapping into NBFC deposits. The Assets Under Management (AUM) of mutual funds has grown to nearly 30 Lakh Cr INR now, with FY24-35 alone witnessing a rise of AUM by 5 Lakh Cr.

If one takes a step back and look at the broader portfolio of Indian households, their savings in financial assets have dwindled from 15% of GDP in FY2020 to 11% in FY 23, as households are investing heavily in real estate over last 3-4 years. This reduces the total pool of deposits banks can now hope to have with them.

Second factor is that with the growing financial literacy, and awareness about the alternative investment opportunities, banks can no longer consider the deposits as "durable" unless they are paid the market rate of return. Typically, when the central bank (Federal Reserve for the USA) increases the policy rate, banks are sluggish to increase the deposit rates offered to the consumers. For example, in the USA, major banks have passed only half of the Fed rate hikes to the consumers. This is also known as "deposit rate beta". This sluggish adjustment widens the "deposit spread" – which is the gap between the policy rate (which are typically higher) and the savings rate (which are typically lower), prompting savers to move away from bank deposits to alternative asset classes. Economists Itamar Drechsler, Alexi Savov, and Philipp Schnabl in their influential paper published in the Quarterly Journal of Economics published in 2017 estimate that for 1% rise in deposit spread, US banking sector loses 5.4% of their deposits. That is savings are very much responsive to how much savings rate are relative to alternative risk-free investment returns such as government bonds.

Traditionally, savings in Indian banks are considered as sticky – they do not respond if banks do not pass-through the rate hikes. But with RBI making it easier for a retail investor to park their money in G-Sec, as well as NBFC's offering 2%-3% higher returns on their deposits (albeit risky), growing financial literacy and awareness, and influence of social media, deposits in Indian banking sector can no longer be assumed to be sticky going forward. This has a straight implication that banks will have to pass-through more of rate hikes to sustain the deposit growth to support strong credit growth.

In summary, the Indian banking sector is at the cusp – and for the first time because of its funding or liability side, instead of troubles on its asset side (namely Non-Performing Assets) which it experienced in the last decade. Banks need to have a proactive strategy to manage deposits, create sustained way to raise non-deposit funding, and expect the deposits to flow away when rates start to rise in India next time. These developments have repercussions for the profitability and the net interest margins of the banking sector going forward.