RBI Highlights Deposit Challenges and Tightens HFC Liquidity Norms

For Prelims: **Reserve Bank of India**, **Housing finance companies**, **Non-banking financial companies**, **Mutual funds**, **Cash Reserve Ratio**, **Liquidity Coverage Ratio (LCR) framework**

For Mains: Concerns over slow deposit growth, Banking Sector Liquidity and Deposit Growth, Non-banking financial companies (NBFCs)

Source: IE

Why in News?

Recently, **the Reserve Bank of India (RBI)** Governor has urged banks to develop innovative product offerings to boost deposit growth.

- This comes in response to a **slower deposit growth rate compared to the surge in credit demand,** which poses potential risks to the banking sector's liquidity.
- In another development, the **RBI has tightened liquidity norms for housing finance companies (HFCs),** aligning them with regulations for **non-banking financial companies (NBFCs),** to strengthen the financial stability of these institutions.

What are the Concerns Regarding Deposit Growth?

- **Lending vs. Deposit Growth: The credit-deposit ratio has reached its highest in 20 years, with bank deposits growing at 11.1% year-on-year compared to credit growth of 17.4%.**
    - The growth of bank deposits has not kept pace with the surge in loan demand, creating a widening gap between credit and deposit growth.
- **Reliance on Short-Term Deposits**: Banks are increasingly using **short-term deposits** and other liability instruments to meet credit demand, potentially leading to structural liquidity challenges.
- **Shift to Alternative Investments:** Households are moving their savings from bank deposits to mutual funds, stocks, insurance, and pension funds. This shift, along with declining net financial assets (from 11.5% of GDP in 2020-21 to 5.1% in 2022-23) and surging inflation, contributes to slower deposit growth.
    - The strong **performance of the** Indian stock markets has led investors to **favour equities over traditional bank deposits.**
      This shift has contributed to the slower growth in deposits, as evidenced by the doubling of

the **mutual fund industry's** assets under management (AUM) from Rs 24.79 lakh crore in April 2019 to Rs 57.26 lakh crore in April 2024.
- **Regulatory Requirements: A portion of mobilised deposits is tied up in regulatory requirements like the** Cash Reserve Ratio (CRR) **and** Statutory Liquidity Ratio (SLR), **leaving banks with fewer lendable funds and increasing competition for deposits.**
  - The growing mismatch between deposit and credit growth could threaten the **banking system's stability if not addressed with proactive measures.**
- **Increased Competition:** Banks face competition not only from each other but also from high-return equity-linked products. Investors are increasingly shifting to equity markets due to strong performance and rising financial literacy.
- **Impact on Liquidity Risk Management:** Banks have attempted to bridge the credit-deposit gap by relying more on Certi**ficates of Deposit (CDs).** However, this increases their sensitivity to interest rate movements and complicates liquidity risk management, making the system more vulnerable to market fluctuations.
- **Need for Prudent Liquidity Management**: Proactive liquidity management is essential. The RBI is reviewing the Liquidity Coverage Ratio (LCR) framework to address these emerging challenges, with plans for public consultations to refine the approach.

What Strategies Can Banks Use to Increase Deposit Growth?

- **Focus on Core Business:** The Finance Minister of India emphasised that banks should concentrate on their primary functions of **deposit mobilisation and lending,** stressing that these activities are the **"bread and butter" of banking.**
  - Expanding **branch networks, especially in underserved or rural areas,** can help banks tap into new customer segments, increasing overall deposit inflows.
- **Innovative Deposit Mobilisation:** Banks were encouraged to be aggressive in deposit mobilisation by offering **attractive and innovative products**, leveraging the **liberty given by the RBI to manage interest rates.**
  - The Finance Minister urged banks to **avoid relying heavily on bulk deposits and instead focus on small savers,** which are critical for sustainable banking operations.
- **Flexible Products: Banks can consider reducing the lock-in period for tax-saving fixed deposits from five years to three years, making them more competitive with alternative investment options like mutual funds and equity-linked savings schemes (ELSS).**
- **Incentives and Promotions:** Offer attractive interest rates, bonuses, or cash incentives for new deposits to attract customers.
  - Offering **higher interest rates on savings accounts and fixed deposits can attract more deposits,** especially from **risk-averse customers** who **prefer stable returns over potentially higher, but uncertain, returns** from equities.
- **Technology: Banks can use data analytics to offer personalised savings and deposit products, making it easier for customers to manage and grow their savings.**
  - Mobile banking apps with user-friendly interfaces and financial planning tools can encourage more deposits.
- **Customer Engagement**: Strengthening customer relationships through targeted **marketing campaigns, and loyalty programs** can encourage existing customers to increase their deposits and attract new customers.
  - Conducting **financial literacy programs** that educate customers about the importance of

savings and the safety of bank deposits can help in increasing deposit growth.

What are the RBI's New Liquidity Norms for HFCs?

- **New Liquidity Requirements: HFCs that raise public deposits will now need to maintain higher liquid assets to ensure financial stability.**
  - The liquid asset requirement has been **increased from 13% to 15% in stages:** HFCs must raise liquid assets to 14% by 1st January 2025. This percentage must be further increased to 15% by July 2025.
  - HFCs will now be required to **obtain a minimum investment-grade credit rating at least once a year** to continue accepting public deposits.
    - If an **HFC's credit rating falls below the required grade**, it will not be permitted to renew existing deposits or accept new ones until the rating improves.
    - This measure ensures that **only financially sound HFCs can accept public deposits, reducing the risk to depositors.**
  - The maximum tenure for public deposits at **HFCs has been reduced from ten years to five years.**
    - Existing deposits with maturities beyond five years will be allowed to mature according to their original terms, **but new deposits cannot exceed the five-year limit.**
    - **This reduction in tenure helps mitigate long-term liquidity risks.**
  - The RBI has **lowered the ceiling on the quantum of public deposits that an HFC can hold,** from three times to 1.5 times its net owned funds (NoF). HFCs holding deposits above this new limit will not be allowed to accept new deposits or renew existing ones until they comply with the revised ceiling.
    - This measure aims to **prevent over-leveraging by HFCs,** ensuring they maintain a healthy balance between their liabilities and assets.
- **Alignment with NBFC Regulations: Previously, HFCs operated under more relaxed prudential norms compared to NBFCs, particularly in terms of deposit acceptance.**
  - The RBI's new guidelines aim to eliminate these discrepancies, **treating HFCs similarly to deposit-taking NBFCs**. This alignment addresses the uniform regulatory concerns associated with deposit acceptance across **all NBFC categories.**

Housing Finance Companies

- HFCs are specialised entities established under the **Companies Act 1956,** initially regulated by the **National Housing Bank (NHB).** However, in 2019, the regulatory authority over HFCs was transferred to the RBI.
- These companies were created to address the **rising demand for housing loans across various income groups.** Over time, HFCs have grown to become a major source of home loans, often surpassing traditional banks in loan disbursement volumes due to their more flexible lending practices.

Drishti Mains Question:

Q. Evaluate the impact of the shift from traditional bank deposits to alternative investment avenues on the Indian financial system. What measures can banks take to retain and attract deposits?

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q. Consider the following statements:

1. The Governor of the Reserve Bank of India (RBI) is appointed by the Central Government.
2. Certain provisions in the Constitution of India give the Central Government the right to issue directions to the RBI in public interest.
3. The Governor of the RBI draws his power from the RBI Act.

Which of the above statements are correct?

(a) 1 and 2 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (c)