

IS IT TIME TO INTRODUCE STANDING DEPOSIT FACILITY BY RBI?

In the past few weeks, RBI has taken a slew of measures by providing plethora of liquidity and regulatory support for the revival of the economy. With the continuous liquidity support by RBI, the system surplus liquidity position has increased significantly and banks have been parking a monthly average of Rs 6 lakh crores in May from Rs 3 lakh crores in March under the reverse repo window of RBI. Against this background, it may be noted that RBI in order to absorb surplus liquidity from the system without the need for providing collateral in exchange, has been planning to introduce a (low) remunerated standing deposit facility. The Patel committee recommended that the introduction of the standing deposit facility (analogous to the marginal standing facility for lending purposes) will require amendment to the RBI Act and may replace reverse repo in the long-run.

We believe the time has now come for having the necessary amendment in the RBI act be used effectively so that conduct of reverse repo and term reverse repo operations are completely non-collateralized. As lending to central bank has no credit risk, there is no need to provide Government securities as collateral when a market participant places its funds with RBI. Such a move will have multiple benefits.

- ◆ First, non receipt of Government securities in reverse repo and term reverse repo will boost the overall demand for Government securities for maintenance of requisite Statutory Liquidity Ratio (SLR), since securities obtained under reverse repo are eligible for SLR
- ◆ Second, this move might also ensure a lower supply of Government bonds through less issuance of CMBs.
- ◆ Third, absorption of additional surplus liquidity at a lower rate through SDF will pull down the entire interest rate structure. In particular, lower operative overnight rate, short term rate and lower supply and generation of additional demand will bring down the yield of long dated Government bonds also, thereby pulling down the sovereign yield curve. This will also reduce the interest cost of RBI.

We however, would urge that there should not be any cap on amount of funds placed at RBI window for reverse repo, rather it should be abandoned and SDF introduced. Capping the quantum of funds in reverse repo as was done in 2007 creates significant market distortions in the onshore rate pricing metric as well as the knock on impact on the FX pricing metric. These could be not beneficial for bank books like OIS , MIF etc.

Meanwhile, even as currency with the public has jumped significantly (this rise in CIC may be due to the a greater tendency among people to withdraw money to hoard cash amid the lockdown), Reserve Money has declined by Rs 14,161 crore during 20 Mar to 01 May, with the decline in Rs 1.62 lakh crore of 'Bankers Deposits with RBI'. This may be due to the 1% CRR cut by RBI. Due to the rise in M3 and decline in M0, the money multiplier has increased to 5.74 for the fortnight ended 10 Apr'20 from 5.46 in the fortnight ended 13 Mar'20. However, with the rise in M0 in the fortnight ended 01 May, MM has again declined to 5.64. a lower money multiplier indicates that the time is perfect and opportune for deficit monetization without any unintended consequences.

STANDING DEPOSIT FACILITY (SDF): NEW TOOL FOR LIQUIDITY MANAGEMENT

- ◆ In the past few weeks, RBI has taken a slew of measures to provide relief to the financial sector against COVID-19 crisis by providing plethora of liquidity and regulatory support for the revival of the economy. With the continuous liquidity support by RBI, the system surplus liquidity position has increased significantly and banks have been parking an average of Rs 6.0 lakh crore in May, compared to Rs 4.8 lakh crores in April and Rs 2.9 lakh crores in March under the reverse repo window of RBI. In order to nudge banks to deploy this surplus liquidity in investments and loans in productive sectors of the economy, RBI had first reduced the fixed rate reverse Repo rate by 25 basis points to 3.75% on 17 Apr'20, keeping the policy Repo rate at 4.40%. With this the LAF corridor changed to 90 bps (upper bound spread: 25 bps and lower bound: 65 bps). The widening of the LAF corridor and a surplus liquidity regime effectively implies reverse repo rate was the effective policy rate.
- ◆ Against this background, it may be noted that RBI in order to absorb surplus liquidity from the system without the need for providing collateral in exchange, has been planning to introduce a (low) remunerated standing deposit facility. The Patel committee recommended this instrument and indicated that this would be done with the discretion to set the interest rate without reference to the policy target rate. The committee recommended that the introduction of the standing deposit facility (analogous to the marginal standing facility for lending purposes) will require amendment to the RBI Act and may replace reverse repo in the long-run .
- ◆ As the RBI inventory of Government papers is getting depleted and it is unable to increase the stock of Government paper due to fiscal ramifications, this facility is a sine qua non. Also, unlike other countries, it is justified that the Indian central bank is not empowered to float its own securities.

Graph 1: System Liquidity Position (Rs bn)



Source: SBI Research

Table 1: Urjit Patel Committee Recommendation for Reverse repo rate

Phase-I	Phase-II
The floor of the corridor – but transition to standing deposit facility will start.	Reverse repo will be used in fine tuning operations i.e., to impound only daily surplus liquidity from the system to ensure that money market rates do not drop below the policy target rate. Standing deposit facility will replace reverse repo as the floor of the corridor , and reverse repo rates will be close to the policy rate.

Source: Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework

MOVE TO SDF IS ESSENTIAL NOW

- Given that 2020 is going to be an exceptional year with Government borrowings set to jump, we believe the time has now come for increasing the demand for bonds by having the necessary amendment in the RBI act used effectively so that conduct of reverse repo and term reverse repo operations are completely non-collateralized. As lending to central bank has no credit risk, there is no need to provide Government securities as collateral when a market participant places its funds with RBI. Additionally, since securities obtained under reverse repo are eligible for SLR, it will thus ensure an overall increase in the demand for bonds.
- We however, would urge that there should not be any cap on amount of funds placed at RBI window for reverse repo, rather it should be abandoned and SDF introduced. Capping the quantum of funds in reverse repo as was done in 2007 creates significant market distortions in the onshore rate pricing metric as well as the knock on impact on the FX pricing metric. These could be not beneficial for bank books like OIS , MIF etc.
- We believe that such uncollateralised absorption of liquidity by central bank will pave the way for the Government to suck out additional liquidity at lower cost (can be capped at even lower or as deemed fit than the reverse repo rate as Government enjoys better standing in terms of credit quality) through SDF. Interestingly since both SDF and Reverse Repo are proposed to be collateral free under our recommended monetary dispensation, this will justify a SDF rate setting lower than reverse repo rate. Also, this move will ensure a lower supply of Government bonds through less issuance of CMBs.

BENEFITS OF OUR SUGGESTIONS

Our recommended suggestions will help the Government and the Banks in multiple ways.

- First, non receipt of Government securities in reverse repo and term reverse repo will boost the overall demand for Government securities for maintenance of requisite Statutory Liquidity Ratio (SLR), since securities obtained under reverse repo are eligible for SLR
- Second, this move might also ensure a lower supply of Government bonds through less issuance of CMBs.
- Third, absorption of additional surplus liquidity at a lower rate through SDF will pull down the entire interest rate structure. In particular, lower operative overnight rate, short term rate and lower supply and generation of additional demand will bring down the yield of long dated Government bonds also, thereby pulling down the sovereign yield curve. This will also reduce the interest cost of RBI.
- Last but not the least, lower overall rate structure for Government bonds will also help the debt burdened corporates to replace its existing high cost debt with low cost and fresh borrowing at lower rates, thereby providing some relief on the NPA front.

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Table 2: Possible Rate for SDF Rate

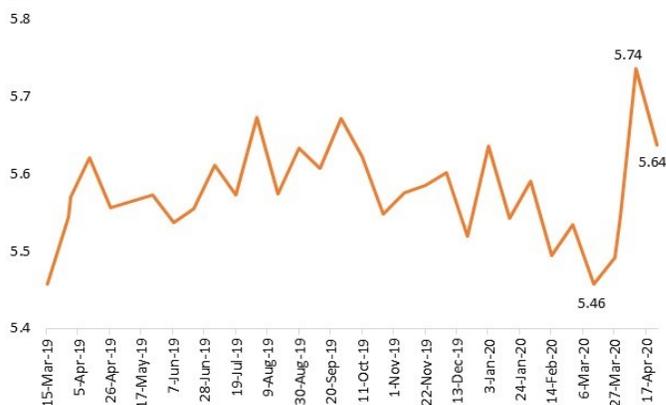
Instrument	Rate	Remarks
SDF	At Reverse Repo (3.75%)	Not Possible. Since Reverse Repo, which is a collateral based deposit is already at 3.75%, the non-collateral deposit at the same rate is irrational
	Below Reverse Repo (3.75%)	Possible and Logical.
	Between Reverse Repo (3.75%) and Repo (4.40%)	Not Appropriate.
	At par with advanced economies	Not Possible, as it will lead to collapse of bank deposit rates

Source: SBI Research

MEANWHILE MONEY MUTIPLIER INCREASED WITH THE DECLINE IN M0

- Due to various liquidity measures by RBI, there has been a significant jump in M3. During 13 Mar to 24 Apr'20, M3 has expanded by Rs 4.93 lakh crore and currency in circulation has expanded by Rs 1.25 lakh crore during 20 Mar to 01 May'20. This rise in CIC may be due to the a greater tendency among people to withdraw money to hoard cash amid the lockdown.
- However, M0 has declined by Rs 14,161 crore during 20 Mar to 01 May, with the decline in Rs 1.62 lakh crore of 'Bankers Deposits with RBI'. This may be due to the 1% CRR cut by RBI. Due to the rise in M3 and decline in M0, the money multiplier has increased to 5.74 for the fortnight ended 10 Apr'20 from 5.46 in the fortnight ended 13 Mar'20. With the rise in M0 in the fortnight ended 01 May, MM has declined to 5.64.

Graph 2: Money Multiplier Trend



Source: SBI Research

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