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Flexible Fixed Deposits

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Abstract

Can fixed deposits be flexible? Yes, why not? It is not just loans that can have rates of interest linked with the base rates. Term deposits more popularly known as fixed deposits too can have a flexible rate of interest linked with the banks base rate of interest. Of course, this is a recent development in India. But it opens up doors to more innovative products including options and swaps in deposits. Banks have always strived to attract deposits. One way to make them attractive is to offer a variety in terms of flexibility in interest rates. This paper studies the pros and cons associated with flexible rate fixed deposits. It also tries to explore possibilities such as options and swaps on fixed deposits.

Keywords : Flexible rate of interest, Fixed rate of interest, Options, Swap

Introduction

For a number of years a question kept on bothering me – if most of the lending rates are floating type why is it the case that the deposit rates are fixed type? On September 6th, 2010, State Bank of India, launched flexible or floating rates fixed deposits.[1] Departing from the age old tradition of keeping the rates of interest fixed on the fixed deposits, SBI has taken the initiative of offering an innovative product to investors. The interest rate would change in tandem with the base rate, as and when a revision in the benchmark rate takes place. The target segment is those investors who are willing to take a bit of risk. In return they would be in a position to enjoy higher returns as and when the base rate goes up. Of course, they will be penalized if the base rate goes down. Still these are early days for the product and not all the banks have offered floating rates on deposits. As of now they are watching for the response to this product. Reserve Bank of India's guidelines[2] does permit such deposits.

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However, RBI has objected to the use of internal or derived rates as a basis for determining the floating deposit rates. On the other hand, to ensure transparency it has stated that only market-based rupee benchmark rates, which are directly observable and transparent to the customer, should be used by banks for pricing their floating rate deposits. This product has been appreciated and criticized as well for different reasons : -

Benefits

1. This product caters to the requirement of that category of investors who are willing to take some risk as regards variability of the return. While the basic characteristic of the product that is of a “fixed deposit” has been retained, yet there is an opportunity available for investors who can afford to take some risk by opting for the floating version of fixed deposit. Thus this is a kind of product that has features of combining safety and risk.

2. Such a product is a good option to hedge against inflation. Imagine you have kept a fixed deposit for 3 years at 6% and within 6 months or so the rates are operating at 9%, thanks to inflation. In absence of the flexible rate, you will have to either go in for a premature withdrawal (that comes at a cost) or simply wait and watch and wish that the inflation and the interest rates would come down. Flexible rates will take care of this problem.

3. Most of the developed nations are already operating on a floating deposit rate system. From a banks point of view a floating deposit rate reduces the risk of asset-liability mismatch.

4. The product provides operational convenience for both the banks and the investor. In absence of a floating rate, investors often go in for pre-mature withdrawal. In the last six months or so when we have witnessed one of the steep rises in interest rates, banks have been flooded with requests for pre-mature withdrawal of deposits. This exercise of initiating a fixed deposit, then breaking it pre-mature and then again

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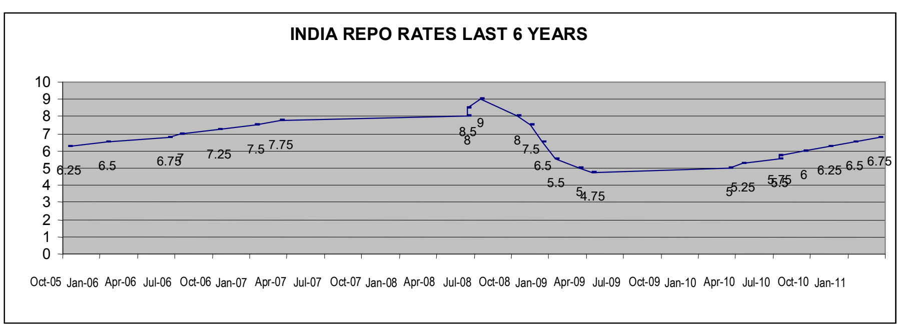
keeping it involves cost, time and energy and is a non-value adding activity for both the banks and the depositor. Floating rates will eliminate the need for this useless activity.

Problems

1. As long as the floating rate is optional it is all right. But if there is a move to make all the fixed deposits market linked, investors like pensioners who want an assured return from their investment will have a problem. Because there is always the risk of the interest rate going down and the returns in that case will start perishing.

2. If the rates are kept floating on the basis of "base rate", then strictly speaking there might be a violation of the RBI guidelines. Because after all, the base rate is an internal rate and it may be questionable on the grounds of transparency.

3. In a country like India where there are huge and frequent fluctuations in the interest rates, some kind of uncertainty will crop up. To get a feel of these fluctuations take a look at the following graph of repo rates in India for the last six years –



On 24 occasions during last 6 years, the repo rates have changed. That is, on an average, four times in a year.

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Possibilities

As per the latest statistics released by RBI[3], time deposits with all scheduled banks in India are to the tune of Rs.48 lac crores. This is by no means a small amount of market segment of investors and it certainly demands some variety of products to cater to the changing needs of the investors. Following are some of the variations that can be thought of –

1. **Option products** – Investors should have option to switch over from fixed to floating or vice versa during the tenure of the deposit. Right now there is rigidity in the deposit rates. Most of the rates are still of the fixed type and they remain fixed throughout the tenure of the deposit. Those who have gone for the floating type have offered to convert existing fixed rates into floating types. But once you do this you cannot revert back to fixed[4]. There is a scope for offering this option of conversion to the depositors in the form of a right rather than making it an obligation. This may be done at a cost to the investor. It is felt that the depositors would be more comfortable with this option.

2. **Swaps** – Depending on the risk/return appetite and perception of the depositors there may be a scope for offering swaps in the form of fixed for floating and vice versa to the depositors. Take a case of a family where the father has retired and is now looking for a fixed rate deposit and the son at the same time is willing to take risk for the sake of a higher return and wants a floating rate deposit. Between them they should be in a position to swap the interest rates on the deposits. Here, of course, we are challenging one basic feature of the deposit that is of transferability. But then when we want to meet the varying requirements of the depositors, we will have to bring some basic changes.

Deregulation of Savings Deposit Rate

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Recently RBI has deregulated savings account rates. For a long period the rates were pegged at 3.50% p.a. However since deregulation private sector banks have played aggressive tactics and some of them like Yes Bank have announced a rate as high as 7%[5]. Current Account and Savings Account (CASA) business plays an important role for banks. It is expected that with deregulation of the savings account rate, people will have some incentive to keep funds in the savings account. Apart from taking care of liquidity, savings deposit accounts now can offer some reasonable return to the account holders.

Conclusion

Some basic changes are happening in the structure of interest rates. Last year the concept of base rate was introduced in case of lending rates. Similarly, banks also took initiative to offer flexible fixed deposit rates. Savings rate have been recently deregulated. Thus, we are passing through an important phase where banking in India is witnessing reforms on the interest rate front. If RBI adopts a more liberal approach, we might see some more sweeping changes which would make our banking system more attractive and vibrant.

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