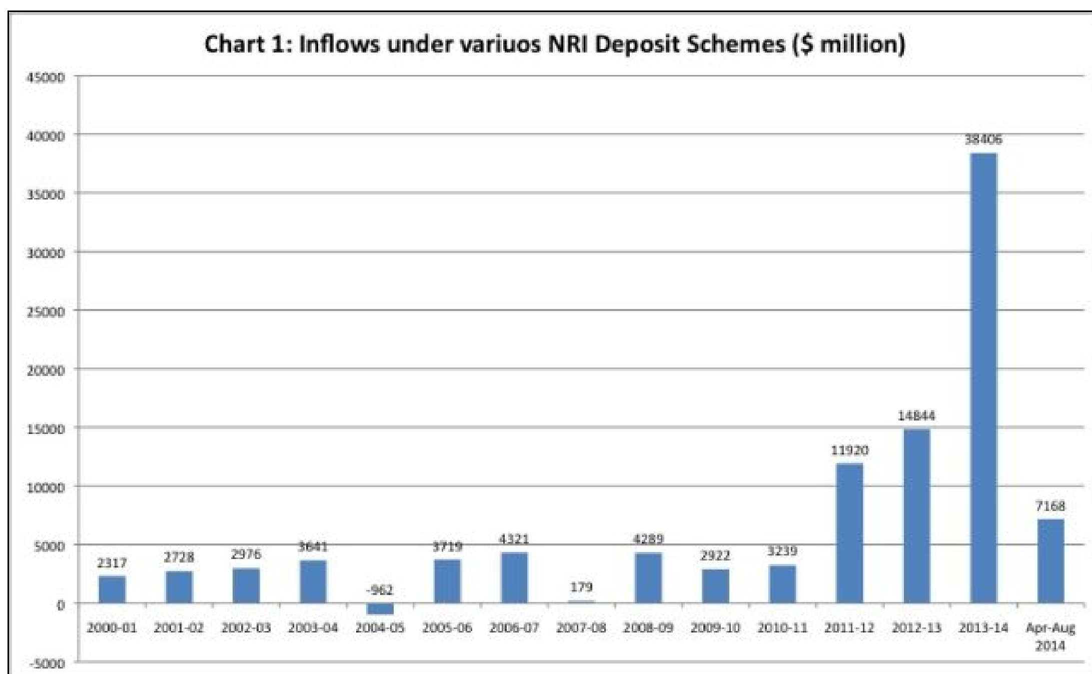
Wooing the NRI Depositor*

C.P. Chandrasekhar

Inflows into deposit schemes for Non-resident Indians (NRIs) are shrinking. They peaked at $38,406 million in financial year 2013-14, with monthly average inflows of $3,200 million in that year (Chart 1). As compared to that, inflows during April to August 2014 or the first four months of the current financial year stood at just $7,168 million or a monthly average of $1,792 million.

Since 2006 three kinds of NRI deposits have been permitted by the RBI. The simplest of them is the Non-Resident Ordinary (NRO) deposit account, which is similar to domestic deposits and available to eligible non-residents to receive rupee receipts from legitimate local transactions. But from a balance of payments point of view, the two sets of deposit accounts of relevance are the Non-Resident External Rupee (NRER) Account and the Foreign Currency Non-resident (Banks) Account [FCNR(B)]. Capital from both these types of accounts are repatriable, but the principal difference between the two is that the former is designated in rupees and the latter in dollars. As a result the foreign exchange risk on NRER accounts are carried by the NRI depositor who has on maturity to convert rupee capital to dollars, but that in the FCNR account is carried by the bank which has to settle the deposit in dollars at maturity.

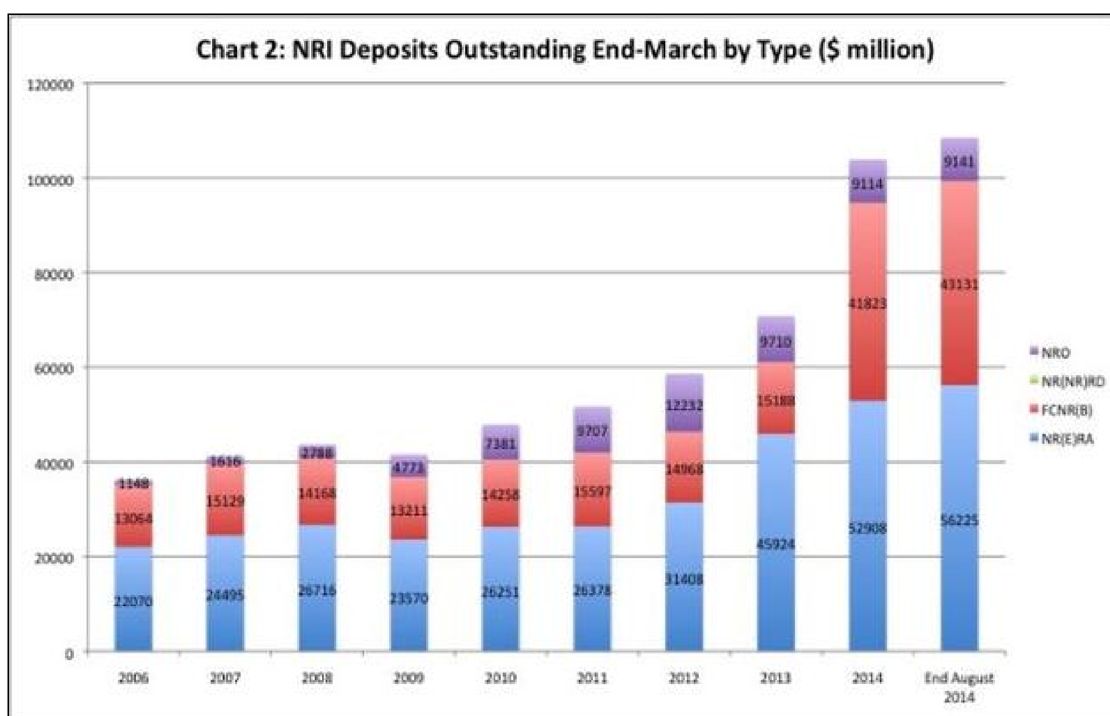


As Chart 1 indicates inflows into NRI deposits have spiked post-2011. Over the period 2000-2011, the maximum inflow into NRI deposits in any financial year was $4,321 million in 2006-07. However, inflows into NRI deposits rose to $11,920 million in 2011-12, or by 3.6 times relative to the previous year. It then rose further to $14,486 million in 2012-13 and a huge $38,406 in 2013-14. It is relative to that high figure that we are witnessing a decline this financial year.

There have also been some recent changes in the composition of inflows. Between end-March 2006 and end-March 2013 (see Chart 2), the volume of deposits in FCNR

accounts had been relatively stable in the $13 billion to $15.5 billion range. On the other hand, that in NRER accounts had risen from $22 billion to $26.4 billion between end-March 2006 to end-March 2011, and then to $31.4 billion in 2012 and $45.9 billion in 2013. The year 2013-14 was the most remarkable. Deposits in NRER accounts continued to rise from $45.9 billion at the end of March 2013 to $52.9 billion at the end of March 2014. In addition, in that year, FCNR(B) deposits registered a huge increase from $15.2 billion to a huge $41.8 billion.

Two questions arise. Why were NRI deposits (driven by NRER accounts) buoyant after 2011? And, why did deposits in FCNR accounts spike dramatically in 2013-14, despite the fact that banks which have to carry the currency risk would not be too eager to canvas deposits in such accounts? The answer to both these questions is the same: central bank policy, even if different ones. Since 1997 the RBI has allowed banks to set the interest rate they offer on NRI deposits of different maturities. However, since 2003 these rates were subject to a ceiling linked to the London Inter-bank Offer Rate (LIBOR) and the prevailing rate for rupee to dollar swaps. Initially the ceiling was set at 250 basis points above the LIBOR/Swap rate, but was brought down and equated to the LIBOR/Swap rate in April 2007.



A ceiling on the interest payable on these deposits is required to prevent deposits motivated by returns from arbitrage, or profits to be made from excessive interest rate differentials between borrowing abroad and in India. If interest rates in India are much higher than abroad, speculators would borrow abroad to make large investments that would be volatile given likely changes in interest rate differentials.

The understanding implicit in the benchmark used is partly that the LIBOR provides an indicator of the interest rate Non-resident Indians could get from investing in deposits abroad. They are unlikely to come to India if they do not get at least that much. In addition, as noted earlier, when dollars are invested in India in deposits of different maturities either the bank or the depositor carries the exchange rate risk. The

swap rate measures the premium that must be paid to hedge against such risk. So this rate is added on to the LIBOR to arrive at a rate that would cover the return that must be offered to make deposits in India attractive, which determines the benchmark adopted by the Reserve Bank of India to set a ceiling on interest rates.

The policy issue that the RBI has addressed differently at different points in time is whether the benchmark ceiling should be set so as to equate the estimated maximum, effective interest rate payable in India with those received abroad, or whether it should be kept above or below that level to either incentivise or discourage inflows into NRI deposits. That decision does affect the volume of inflows. Thus, it was the decision to continuously raise the ceiling on the interest rate payable on NRI deposits that explains the more recent changes in inflows into such deposits. In 2008 the government decided to change its policy of setting the ceiling on interest rates paid on NRI deposits equal to the LIBOR/Swap rate. Clearly the intention was to incentivise NRI deposits. In September and October 2008, through directives issued in quick succession, the RBI hiked the ceiling rates. The rate on fresh Non-Resident (External) Rupee (NRE) Term Deposits for one to three years maturity was set at LIBOR / SWAP rates plus 50 basis points effective from the close of business on September 16, 2008 and then raised to LIBOR / SWAP rates plus 100 basis points at the end of September. The ceiling on interest rate on FCNR (B) deposits of all maturities contracted effective October 15, 2008 was set at LIBOR / SWAP rates plus 25 basis points for the respective currency / corresponding maturities as against LIBOR / SWAP rates minus 25 basis points earlier. The two rates were further raised to LIBOR/SWAP rates plus 175 basis points and LIBOR / SWAP rates plus 100 basis points, respectively, a month later on 15 November 2008.

This was immediately after the crisis when India was experiencing an exodus of foreign portfolio investment, which explained the decision. So the policy being adopted was one of incentivising NRI depositors so as to try and mobilise debt as a counter to the loss of portfolio investment. The strength of these incentives was probably also influenced by the fact that flows into NRI deposits in 2007-08 were at a low of just $179 million. Soon, however, as a result of the huge infusion of liquidity into international markets by the Federal Reserve and other central banks, portfolio flows to India (and many other emerging markets) recovered smartly to $32.4 billion in 2009-10. This should have led to a reduction in the special arbitrage rates being offered to foreign portfolio investors, even if the original decision was correct.

But that was not to happen. Rather, after some lag, the ceiling rates were hiked further in November 2011 to LIBOR/SWAP rates plus 275 basis points and LIBOR/SWAP rates plus 125 basis points for NRER and FCNR deposits respectively. It was this added incentive that tipped the barrel leading to the huge flow of deposits into India noted earlier. But as stated earlier, these flows were largely into NRER accounts in which the NRI depositor carried the exchange rate risk. A change occurred in mid-2013, when the Federal Reserve announced its decision to "taper" or exit from the policy of buying bonds to enhance liquidity. This resulted in a short-run outflow of portfolio capital from India and a depreciation of the rupee. In response, the RBI chose once again to rely on the NRI depositor to compensate for the "loss". On 14 August, 2013 the ceiling interest rate on FCNR (B) deposits of 1-3 year maturity was raised to LIBOR / SWAP rates plus 300 basis points and that for maturity of 3-5 year was raised to 400 basis points above LIBOR / SWAP. Moreover, to ensure that banks

would utilise this opportunity, increments to these deposits were exempted from reserve requirements (CRR and SLR) and NRER interest rates were completely freed.

On top of this, the RBI announced a special swap scheme valid for a three-month period (September to November 2013). Under the scheme the RBI promised to swap dollars received by banks in FCNR deposits against rupees for the period of the deposit at an interest rate of 3.5 per cent a year. This essentially meant that banks were paying a forward premium for the dollar of 3.5 per cent a year, which was much lower than the market SWAP rate that determined the ceiling rate on the deposits. The RBI was in essence subsidising the banks allowing them to mobilise FCNR deposits at lower rates. Not surprisingly, the banks went all out to mobilise such deposits during the September-November 2013 period. Outstanding FCNR(B) deposits, which stood at $15.2 billion at the end of August 2013 rose dramatically to $40.4 billion by the end of December 2013.

These policy shifts explain the spike in outstanding NRI deposits in 2013-14, with much of the increase occurring during September to December 2013. The moment the special concession ended in December 2013, inflows into FCNR deposits began to fall, explaining the government's current predicament.

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