Demonetization: Bank Profitability and Dividends on Commercial Deposits

Impact of Demonetization on the profitability of commercial banks and RBI; in the short, medium and long run.

Abstract

Estimation is mostly qualitative, owing to the inherent speculative nature of the exercise. Possible proofs would come from the balance sheet of commercial banks in the next quarter and YoY 2016-17. The motivation is to explore the possibility of declaring a dividend on common bank deposits (the so-called CASA[[1]](#footnote-2) deposits); keeping in view a. the possible *artificial* increase in banking profitability; b. compensating for potential loss of income to common account holders. The methodology of declaring the dividend will also be explored.

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# Is Demonetisation Profitable for Banks?

Rating agency Moody’s feels that the banking sector will be a key beneficiary (Global Credit Research, 2016) of the demonetisation drive, especially in the short term. The reasons are discussed below.

## Improved availability of cheaper liquidity to banks

Banks make profits on the frictional rate of operation, i.e. difference between lending and deposit interest rates. Usually, banks pay higher interest rates on term deposits (e.g. FD) as they are guaranteed to stay longer in the banking system, allowing banks a security on supply of funds. However, given a) the controlled liquidity flow owing to demonetisation, b) increased CASA deposits in the banking system with their increased presence within the commercial banking system, the need for term deposits to maintain cash reserves within the commercial banking sector has reduced significantly. Additionally, there is no need to attract deposits with market-competitive interest rates. Therefore, both private and public sector interest rates on CASA and term deposits have fallen. **Interest rates on CASA deposits have fallen by .5-1% whereas maturity rates on term deposits have fallen by .15-.25%** (PTI, 2016)**.**

**According to estimates, the banking sector has received over 4 lac crores of fresh deposits since demonetisation; with gross increase of 10 lac crores expected. The banking sector is looking at an average 1-2% increase in bank deposits after the completion of the demonetisation drive** (Global Credit Research, 2016)**.**

## Impact on Lending Activity of the Banking Sector

In the short to medium run, the credit side investment[[2]](#footnote-3) of the banking sector will be slow. This is due to reduced consumption demand in the economy as the Indian economy is highly cash intensive. With there being no guarantees on when the restriction on liquidity flow will be eased, banks are investing in highly liquid bonds in the financial market; logically many of these investments would be in short term international bond markets. Even with rising prices of these bonds, the unexpected flow of liquidity make these investments highly lucrative for banks.

Additionally, banking sector does not have to depend on their SLR-portfolio[[3]](#footnote-4) and funds from RBI (which are costly) to maintain their cash reserve requirements. This means, that overall banks would make significant profits in the third and fourth quarter, especially the public-sector banks which will receive a windfall though deposits in *Jan Dhan Bank Accounts.*

However, in the medium-term banks would make losses on loan defaults that could come from consumers and SME enterprises who face losses due to slowdown in business activities (Nair, 2016). CSLA analyst Aashish Agarwal feels that the loan defaults would start appearing after 6 – 8 months unless some constructive measures are taken to ease liquidity flow to the SME sector. Compensating SMEs for loss of revenues would also be important.

## Impact of increased digital transactions

Commercial banks are the biggest players in the e-payment markets. The drive towards cashless transactions could potentially boost banking sector revenues in the medium to long term. This will happen due to a psychological shift towards digital banking and commercial banking in general as marketing research from Moody’s shows that people are likely to keep using banking services that they have been exposed to at least once.

The short-term impact is not going to be significant as transaction costs have been reduced or waived off (IANS, 2016).

# Dividends on Fresh Bank Deposits

It seems highly likely that bank will profit from the demonetisation drive in a manner which would have otherwise not been possible. These profits would have two components: a short-term component until the normal flow of liquidity through cash is restored and a long-term component due to greater utilisation of banking services in the economy. It therefore makes sense to separately ascertain these two streams of profits and declare a general dividend for bank account holders through increased retrospective interest payments on bank deposits; in order to benefit the end citizen whose money would be responsible for the banks’ profits. These payments should apply on deposits from November 10, 2016 to until the date of announcement of these dividends.

Additionally, SME and consumer loan holders on fixed interest terms should be given interest payment relief of 1-2 quarters to compensate for the loss of income. This would also prevent loan holders on defaulting on their borrowing which would negatively impact the banking system’s stability and profits.

**With net banking deposits expected to increase by 1-2%, a dividend equivalent to increased net liquidity, i.e. 1-2% could be given on CASA accounts under favourable circumstances.**

# References

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1. Current Account/Savings Account [↑](#footnote-ref-2)
2. Loans in the local market; demand comes mainly from consumer loans and enterprise loans for business activity. [↑](#footnote-ref-3)
3. SLR: Statutory Liquidity Ratio – the amount of cash reserves that must be maintained by banks in gold and bond of the Indian Government. [↑](#footnote-ref-4)