A Shift in Household Savings and Investment

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India's savings patterns are likely to see a tectonic shift, with far-reaching implications for the economy and financial system. We expect Indian savers (households) to diversify away from real estate, gold, bank deposits and cash into longer-term investment such as mutual funds and pension products. This, in turn, will provide productive capital to fund infrastructure and business investment in India. It will also provide the domestic liquidity to both debt and equity market going ahead and may keep the valuations rich for an extended period of time.

India's high savings rate has been a crucial driver of its economic boom, providing productive capital and helping to fuel a virtuous cycle of higher growth, higher income and higher savings. Domestic Savings in India has shown an uneven uptrend up until FY08-09, led by the rising private savings. Between FY57-58 to FY08-09 (~50 years), Savings as a percentage of GDP rose from 10% to 40% of GDP. From the peak of FY09, domestic savings fell to 30% of GDP in FY17 (29% estimated for FY18). Both household (from 23% of GDP to 19%) and corporate savings (from 17% to 14% of GDP) fell during the period. Weak corporate earnings (from 2014 to 2016), near double-digit inflation (2008 to 2014) leading to negative real rates, high fiscal deficit and issues of policy paralysis explain the fall in savings. Nevertheless, the rate still compares very favourably with other emerging economies. Further, looking ahead, it appears that savings rate has bottomed out.

Households account for majority of savings in India

Domestic savings have been dominated by household savings (60-70% share) and particularly physical household savings. Saving in physical assets, which had a whopping share of almost 90% of total household saving in 1950s, came down to around 40% in late 1990's. It has risen since then and hovered around 55-62% in the last five years. Consequently, the last five year period (FY12 to FY15) has seen the lowest financial savings by the household (average of 38% of total household savings).

In the present scenario when Indian Government is likely to stay in deficit mode, private sector and particularly household savings continue to remain crucial to sustaining a strong savings rate.

Demography and weak social security system warrants higher savings in India

64% of the Indian population falls in working age group (15-64 years) and the ratio is likely to stay favourable for next few decades, implying larger pool of savers than dis-savers in India. Additionally, India is one of those few economies with declining age-dependency ratio. Falling age-dependency increases the proportion of income available to save. However, weak job-prospects dent the demography impact. As of census survey 2011, 40% of the Indian population is employed. This means that while the working age population is 64%, only 40% people are employed

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(either willingly or unwillingly) implying the higher dependency and implying that demography factors will take longer to play out (as economy grows and per-capita income improve).

On the other hand, the woeful inadequacy of India's social security systems dictates that personal savings remain vital to meet long-term needs such as home buying, children's education, retirement and healthcare. Lastly, while the retail loans are rising fast and need to be watched, many Indians still remain averse to taking loans (household debt is 28-30% of GDP, 37% of household income). All these factors put an automatic floor to the savings rate in India.

India Households typically save in the form of cash and bank deposits; that is changing

Historically, households in India have traditionally preferred to invest in low risk assets with bank deposits and currency accounting for 50-60% of gross financial savings. This also explains why bank credit is the key source of funding business investment in India, leading to gross asset-liability mismatch and hence the current situation of NPAs. Investment in equities, both direct and via Mutual Fund (MF), gained traction for a short period between FY86-96 and then in FY06-08 but owing to couple of instances of stock market scams, retail investors have typically shied away from equities. Investments in other long-term financial products (particularly insurance and pension funds) have also been low (around 30% of gross financial savings and 4-5% of GDP) suggesting a weak penetration of these products in India.

These trends have been changing since last four-to-five years (since FY15). Bank deposits are gradually losing their sheen. Between FY15-FY18, households have put 45% of their financial savings in bank deposits. In parallel, savings in long term financial products (MF+ insurance+ pension funds) has risen from 34% of financial savings in FY14 to 44% by FY18.

Cyclical Factors too, favour higher financial savings - particularly the longer term products

Real-rates have turned positive for four years now. Analysis suggests that financial savings are positively correlated with real rates.

Further, banks' term-deposit returns presently hover around 7% (depending on tenor) compared to the historical trend of double digit returns (FD rates were as high as 20% in 1990's). Given the view of contained inflation, term-deposits will gradually loose traction and households will be forced to search for higher yields. We expect the long-term financial products to be a structural beneficiary here as already evidenced in rising SIPs, premium collection and pension fund deposits. The financial literacy initiatives being adopted by the financial regulators and measures to enhance the regulatory guidelines for the financial investments are also helping to lure the households to channelize their money away from the traditional products.

For instance, Mutual Fund AUM has depicted 21% CAGR in last four years with the Assets Under Management (AUM) size doubling from ₹10 trillion at the start of 2015 to ₹23 trillion as of 2018 end.

Insurance sector premium collection is posting a CAGR of 13% in last three years (FY16-FY18) compared to 6% CAGR during FY12-FY15.

Inflows are also coming through the National Pension Scheme (NPS, very similar to 401k in US) and The Employee Provident Fund Organisation (EPFO)- the two key pension fund schemes in India. In FY16, EPFO had flows of ₹1.02 trillion and an AUM of ₹6.34 trillion. While in early 2018, EPFO's AUM had nearly doubled to ₹11 trillion.

Mutual Fund Industry to be the biggest beneficiary

We estimate that domestic mutual funds will be the largest beneficiary to a coming boom in financial

savings. As discussed previously, Mutual Fund AUM has grown by ₹13 trillion in the last 4 years (21% CAGR) with retail + HNI investors accounting for 63% of the incremental contribution. The key driver here is a focus on systematic investment plans (SIPs). Flows via SIPs have grown at a 50% CAGR over 2014-2018.

These developments are favourable from the point of funding the business investment and long-term infrastructure investments in India, particularly when the country is keen to contain its current account deficit to 2% of GDP and below. As an aside, the improving domestic liquidity explains the rising valuation premium in India. The financial savings ascent can keep India's relative multiples higher for long and equity market less vulnerable to FII flows, thus reducing the Indian equity correlations with the other emerging markets. **A caveat here is that, rising economic growth and healthy market returns are absolutely critical for equity ascent of household financial savings as households respond very quickly to unfavourable returns.** Retail investors are typically fast fleeting. Any deep market turmoil will drive them back to the safety of bank deposits, reducing the amount of capital available to mutual funds and other longer-term financial products and possibly risk the growth of the financial-services industry as a whole.

To sum up, the household savings and particularly the financial savings are crucial to sustaining a strong growth in India. We see that the tide has turned in favour of growth and the financial savings are getting increasingly channelized towards longer-term financial products. We expect Mutual Funds to be one of the significant beneficiaries of this turn of tide. This would not only deepen and stabilise the financial markets, but also, help fund India's infrastructure needs.

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Regulatory Framework for Government-Owned NBFCs

There are currently 42 government-owned NBFCs registered with the Reserve Bank. Of these, 16 are owned by the central government and 26 by the state governments. Of these government NBFCs, 23 NBFCs are classified as non-deposit taking systematically important NBFCs (NBFC-ND-SI), 12 are non-deposit taking NBFCs (NBFC-ND) and 7 are deposit taking NBFCs (NBFC-D).

Government owned NBFCs have been, till now, exempted from various provisions of the RBI Act, 1934 as well as prudential norms since they cater to various social obligations. However, it is recognised that their high exposure to certain sectors may have adverse financial stability implications, especially where the scale of operations is large. Further, as entities raising public funds, they have high level of interconnectedness with the formal financial sector. Accordingly, deposit taking and systemically important government-owned NBFCs were advised in 2006 to submit a roadmap for complying with the prudential regulations applicable to other NBFCs. Although all central government NBFCs and 12 state government NBFCs submitted their road map, their implementation has been disparate. Hence, it was decided to require government-owned NBFCs *vide* notification dated May 31, 2018 to adhere to the Bank's prudential regulations, and instructions on acceptance of public deposits, corporate governance, conduct of business regulations and statutory provisions, in a phased manner. A phase-in period till 2022 has been prescribed to ensure that the withdrawal of exemptions takes place in a non-disruptive manner.

Source : Reserve Bank of India, Annual Report 2017-18.