Has the time come to do away with CRR funds with central bank?

By *Madan Sabnavis*, ET Bureau | Dec 05, 2018, 09.47 AM IST

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In recent times, the repo window and OMO are being used to inject liquidity rather than CRR cuts.

The cash reserve ratio (CRR) concept came into the RBI Act of 1934 and has remained since then. This reserve ratio was to be maintained by banks to ensure the solvency of the system. In case a bank failed, then there would be cash reserves available to make payments before help could arrive. Given the evolution of the system and the safeguards introduced over the years, has the CRR lost its relevance?

A global comparison is always compelling though it should be pointed out that there are always cases where the CRR exists and does not depending on whether or not countries follow a fractional reserve system. Even in terms of level, one can always argue for different numbers depending on the country and its banking system.

India had a CRR of 15 per cent at one time and, at the present rate of 4 per cent, looks modest. The US has it at 3 per cent, while Argentina 44 per cent. For China, it is 14.5 per cent and 1 per cent for EU and 8 per cent in Turkey. Japan does not find it relevant given the well-developed money market. Therefore, there is nothing right or wrong about having or not having a CRR. There is, however, room for debate on whether we need to have CRR or not in India given that we have travelled quite a distance.

Company Summary NSE BSE

Indian Bank	-4.55 (-2.05%)

The banking system has evolved a lot over the years with various levels of regulation coming in making it more resilient. We have SLR, which is quite high at 19.5 per cent. This is deployment of bank funds in government securities, which are 100 per cent safe and earn a return which is lower than lending but subject to MTM risk. There are Basel III standards too, which puts a check on the solvency of banks. With RBI being even more aggressive than BIS in the implementation of the agenda, the banking system, notwithstanding all the problems that are being confronted like NPAs and capital shortage, is not lacking in solvency.

Anecdotally, no Indian bank NSE -2.12 % has failed and deposit holders suffered as the RBI has been quick to act and ensure that the stakeholders have been protected. If we can extrapolate the same to the future, we can confidently say that there will not be such a failure and even if there is an extreme situation, the 4 per cent will not matter especially so if the holdings of 19.5 per cent in GSecs turn out to be insufficient. This means a strong case for dispensing with CRR.

Now why is CRR irksome? Banks have to put 4 per cent of their NDTL in idle cash. With NDTL being close to Rs 127 lakh crore, around Rs 5 lakh crore is set aside in cash. Banks pay at least 4 per cent as interest on these deposits, which has a direct cost of Rs 20,000 crore. The same could have earned at least the GSecs rate of say 7-7.5 per cent and, hence, there is a lost opportunity cost of another 3-3.5 per cent. While banks are allowed to factor this cost when calculating their base rates and MCLRs, the fact remains that idle funds do not make sense when liquidity conditions tend to be volatile due to various

NEXT STORY

RBI proposes expert panel to study MSME distress

ET Bureau | Dec 06, 2018, 10.24 AM IST

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"In order to enable the MSMEs tide over the impact of demonetisation and GST, RBI undertook regulatory forbearance in prudential norms," said M K Jain, RBI deputy governor

MUMBAI: The Reserve Bank of India (RBI) expressed concerns over the increasing stress in the micro, small and medium enterprises industry, seeking a comprehensive approach to assess the problems faced by businesses that employ thousands of people in the unorganised sector across the country.

To identify causes and propose longterm solutions for the economic and financial sustainability of the MSME sector, RBI will constitute an expert committee. The composition of the committee and its terms of reference will be finalised by the end of December, and the report will be submitted by the end of June 2019.

Company Summary NSE BSE

Bank Of India	-2.40 (-2.88%)
Shriram Tran...	-6.40 (-0.57%)

"In order to enable the MSMEs tide over the impact of demonetisation and GST, RBI undertook regulatory forbearance in prudential norms," said M K Jain, RBI deputy governor, after Wednesday's bimonthly monetary policy announcement. "The increasing stress in the sector is a matter of concern. A comprehensive approach needs to be adopted to understand the problems of the MSMEs and the challenges faced by them for a holistic development of the sector."

The MSME sector contributes to nearly a third of the gross domestic product and employs 111 million people, accounting for about 45 per cent of manufacturing output and 40 per cent of total exports, data from RBI showed. RBI said that many MSMEs exist outside of the formal space and face difficulty in accessing credit.

RBI has taken several steps, such as setting up a trades receivables discounting system and allowing banks to co-originate loans with non-banking finance companies, to facilitate the flow of credit to the sector. With the liquidity squeeze in the NBFC sector, credit flow to MSMEs is understood to have taken a hit. MSMEs have relied on NBFCs in the past two decades to finance their expansion. On Nov 19, the RBI board had advised the central bank management to consider a scheme for the restructuring of stressed standard assets of MSME borrowers with aggregate credit facilities of up to ?25 crore, subject to conditions that would ensure financial stability.

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