Standing Deposit Facility Scheme

RBI uses array of instruments such as Cash Reserve Ratio, Open Market Operation, Market Stabilisation Scheme to absorb excess liquidity in the economy. These measures are considered as Liquidity Adjustment Facility (LAF) to bring the liquidity gap under control. However, these tools were not proven to be useful when the money market liquidity is in excess to deal with. Eg. Post demonetization scenario.

During post demonetization, RBI ran out of government securities to offer as collateral and had to temporarily hike its CRR. Now, there is a proposal to introduce Standing Deposit Facility Scheme (SDFS) which was already recommended by Urjit Patel Committee in 2014. It is to empower RBI with an additional instrument for liquidity management.

SDFS is a toolkit of monetary policy for absorption of surplus liquidity from the system but without the need for providing collateral in exchange.

Elaboration

The Standing Deposit Facility, proposed to be introduced by the RBI, is a collateral free liquidity absorption mechanism that aims to absorb liquidity from the commercial banking system into the RBI. Government in the Budget’s (2018) Finance Act included a provision for the introduction of the Standing Deposit Facility (SDF).

What is Standing Deposit Facility (SDF)?

Standing Deposit Facility allows the RBI to absorb liquidity (deposit) from commercial banks without giving government securities in return to the banks. In the present situation, the main arrangement for the RBI to absorb excess money with the banking system is the famous reverse repo mechanism. Under reverse repo (which is a part of the Liquidity Adjustment Facility), banks will get government securities in return when they give excess cash to the RBI. An interest rate of reverse repo rate is also provided to banks.

The inconvenience with this arrangement is that the RBI has to provide securities every time when banks provides funds.

As per the stand of the RBI, when the central bank has to absorb tremendous amount of money from the banking system through the reverse repo window, it will become difficult for the RBI to provide such volume of government securities in return. This situation was occurred during the time of demonetisation.

In this sense, the Standing Deposit Facility (SDF) is a collateral free arrangement meaning that RBI need not give collateral for liquidity absorption. The SDF will allow the RBI to suck out liquidity without offering government securities as collateral.

Significance of Standing Deposit Facility

Importance of the SDF is that it is designed to enable the Reserve Bank to deal with extraordinary situations in which it has to absorb massive amounts of liquidity. In the past
situations like global financial crisis and demonetisation caused liquidity absorption problems for the RBI.

Under the existing liquidity framework, liquidity absorption through reverse repos, open market operations and the cash reserve ratio (CRR) are at the discretion of the Reserve Bank. But SDF will enable banks to park excess liquidity with the Reserve Bank at their discretion.

As a standing facility, the SDF supplements Marginal Standing Facility or the MSF (SDF for liquidity absorption whereas MSF for liquidity injection).

Difference between Standing Deposit Facility, Reverse Repo and MSF

Within the existing liquidity management framework, liquidity absorption through reverse repos, open market operations and the cash reserve ratio (CRR) are at the discretion of the Reserve Bank. On the other hand, the use of standing facilities (MSF, SDF) would be at the discretion of banks.

The difference between the Standing Deposit Facility and Reverse Repo is that there is no need for collateral under the SDF.

According to the Finance Act that made the launch of SDF, a separate clause shall be inserted in the RBI Act: “The accepting of money as deposits, repayable with interest, from banks or any other person under the Standing Deposit Facility Scheme, as approved by the Central Board, from time to time, for the purposes of liquidity management...”

The proposal was first suggested by the Urjit Patel Committee in its recommendation of the Monetary Policy Framework in 2014.