

ICRA COMMENTS ON RBI'S SEVENTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2019-20

MPC cuts Repo rate by unexpected 75 bps, while maintaining policy stance as 'Accommodative'; RBI announces liquidity infusion and forbearance

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HIGHLIGHTS

- In an out-of-cycle policy meeting, the Monetary Policy Committee (MPC) voted for an unexpectedly sharp cut of 75 bps in the policy Repo rate under the Liquidity Adjustment Facility (LAF) to 4.40% from 5.15%. While the decision to cut the Repo rate was unanimous, four members voted for a cut of 75 bps, whereas two members voted for a 50 bps cut. Moreover, the monetary stance was unanimously retained at 'accommodative' for as long as necessary to revive growth and alleviate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target, in the Seventh Bi-monthly monetary policy statement for FY2020.
- With a cut in the Repo rate, the Marginal standing facility (MSF) rate and bank rate were also revised lower by 75 bps to 4.65% each, from 5.40%, whereas the Reverse repo rate was cut by a larger 90 bps to 4.00% from 4.90%, resulting in a wider and asymmetric policy corridor of 65 bps.
- The RBI undertook several measures to expand liquidity in the system, such as conducting Targeted Long Term Repo Operations, to be deployed by banks in corporate bonds, commercial paper, and non-convertible debenture, increasing the borrowing limit under MSF to 3% of SLR from 2% of SLR, and widening the monetary policy corridor. Moreover, the Cash Reserve Ratio (CRR) had been reduced by 100 bps to 3.0% from 4.0%.
- The RBI also undertook various measures to ease the burden of debt servicing, such as permitting commercial banks to allow a three month moratorium on payments of instalments for term loans, deferring the interest payments of working capital facilities by three months, increasing working capital facilities through cash credit or overdraft, and deferring the implementation of net stable funding ratio and the last tranche of capital conservation buffer by six months.
- In addition, the RBI permitted banks to participate in the offshore non-deliverable rupee market to improve the price discovery in the forex market, by reducing the arbitrage between onshore and offshore markets

Outlook: The comprehensive announcements made by the RBI prior to the scheduled policy review are a welcome step, in light of the degenerating economic and credit conditions. The combination of moratoriums, liquidity enhancing measures and the sharper-than-hoped-for repo rate cut will help to assuage the markets in these increasingly unsettled times, and offer some protection against widespread defaults, even though the actual impact on boosting economic activity may be limited.

Regardless of the measures announced now by the RBI, we are lowering our base case scenario for GDP to a contraction of 4.5% for Q1 FY2021 and a subdued growth of 2.0% for FY2021, in light of the rapidly growing uncertainties over the duration of the impact of the coronavirus on economic activity in India and the rest of the world.

MPC cuts repo rate by a substantial 75 bps, maintains monetary policy stance at 'accommodative'

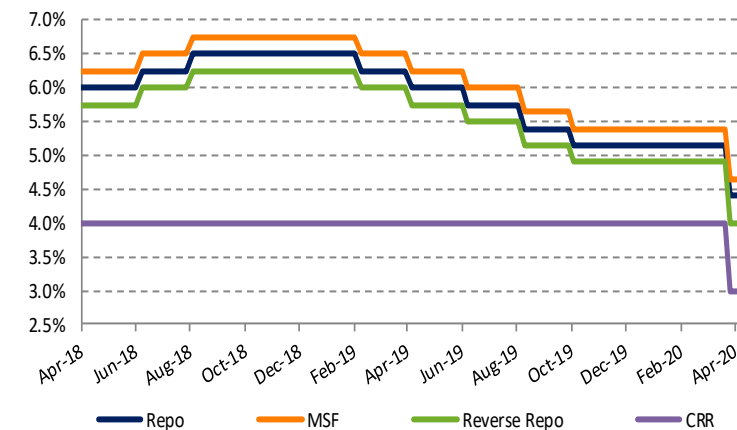
The six-member MPC voted for an unexpectedly large cut of 75 bps in the Repo rate to 4.40% from 5.15%. While the decision to cut the Repo rate was unanimous, four members voted for a cut of 75 bps, whereas two members voted for a 50 bps cut. Moreover, the monetary stance was unanimously retained at 'accommodative' for as long as necessary to revive growth and alleviate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target.

The CPI inflation had declined to 6.6% in February 2020 from the 68-month high 7.6% in January 2020, driven by a softening in inflation for food and miscellaneous items, while breaching the upper threshold of the MPC's medium-term inflation target of 4%+/-2% for the third consecutive month. The MPC noted that the correction in onion prices brought down the food inflation to single digits in February 2020 from double digits in the preceding two months. While the price pressures related to protein-rich items, such as edible oils and pulses, remained sticky, they are likely to eventually weaken following the demand shock related to the Covid-19 outbreak. The inflation related to fuels increased sharply in February 2020, on account of the deferred domestic adjustment to international LPG prices, according to the MPC. As a consequence of the Covid-19 outbreak, the plunge in the international crude oil prices in the ongoing month may result in some easing of both the fuel and core-CPI inflation, going forward. Moreover, the inflation expectations survey conducted by the RBI, displayed a moderation of 20 bps in one-year-ahead households' inflation expectations in March 2020. The MPC noted that the heightened volatility in financial markets could also have a bearing on inflation.

The CSO had released its 2nd advance estimates of GDP in February 2020, which implicitly pegged the GDP growth for Q4 FY2020 at 4.7%, within the FY2020 forecast of 5.0%. However, the MPC noted that the Covid-19 pandemic poses a key risk to this estimate. In ICRA's view, GDP growth would ease to 2.4% in Q4 FY2020, with the full year FY2020 growth now expected at 4.4%.

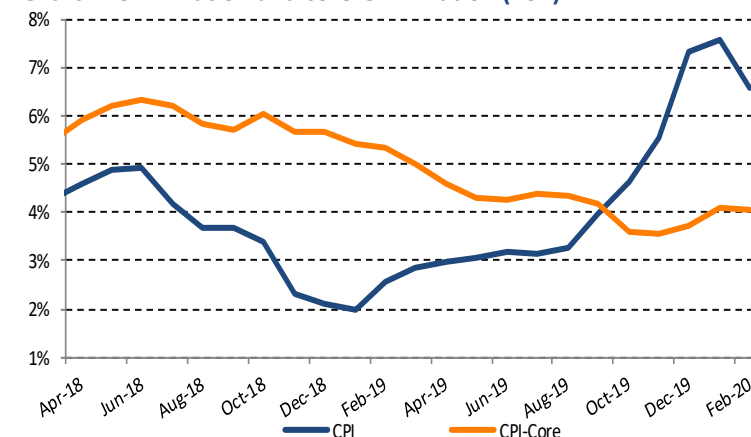
The MPC highlighted that private final consumption expenditure has been adversely impacted due to the lockdowns, even as gross fixed capital formation has already displayed a contraction since Q2 FY2020. Moreover, discretionary and labour-intensive activities such as trade, tourism, hospitality, air travel and construction sector have been severely impacted by the pandemic. According to the MPC, the favourable outlook for agricultural and allied activities appears to be a singular bright spot. Going forward, the global economic slowdown could deepen if the Covid-19 is prolonged and disruptions related to supply chains get intensified, which would impart a downside risk to growth. While highlighting that the Govt has already announced a fiscal package of Rs. 1.7 trillion, covering cash transfers and food security for vulnerable sections of society, the MPC's statement highlighted that strong fiscal measures are critical to deal with the ongoing situation.

Chart 1: Movement in Key Rates



Source: RBI; CEIC; ICRA Research

Chart 2: CPI Inflation and core-CPI inflation (YoY)



Source: CSO; CEIC; ICRA Research

The MPC highlighted its commitment to keep the financial markets liquid, stable and functioning normally, amidst the adversity and the prevailing risk-off sentiment. The RBI undertook several measures to expand liquidity in the system, ease the burden of debt servicing and improve the price discovery in the forex markets to contain the impact of Covid-19 on the financial markets. These measures are discussed in detail below.

1) Targeted Long-Term Repo Operations (TLTROs) of Rs 1.0 Trillion

The recent sell-off in the equity markets was felt in the corporate bond markets as well, with the increase in the yields of corporate bonds since the first week of March 2020, which got accelerated with the onset of Covid-19 crisis. To address the flow of funds and improve liquidity conditions in the debt capital markets, the RBI has announced TLTROs of Rs 1.0 trillion, whereby banks can use this funding to specifically purchase bonds and commercial paper. The key highlights of the facility are:

1. The duration of the TLTROs will be upto three years
2. The funding will carry a floating rate linked to the repo rate, and the allocation will be determined based on pro-rata basis in case of oversubscription.
3. The banks will have to utilize the funds within 15 working days of availing the facility
4. Funding has to be deployed in investment grade commercial paper, bonds and NCDs over and above the level of investments in these investments as on March 27, 2020.
5. Of the incremental investments, upto 50% to be through primary market issuance and the balance through secondary purchase from markets (including mutual funds and NBFCs)
6. Investments so acquired won't be constrained by the large exposure framework and will be classified under held to maturity, thereby insulating them from mark to market risk

In our view, the targeted TLTROs would provide a much-needed relief in cooling down the corporate bond yields. While there is no deferment of borrowings from the debt capital markets, the measures announced by the RBI will make it easier for most companies to raise funding through fresh issuances. The TLTROs can aid stronger and well managed companies as they raise fresh funding at finer rates. The measures are expected to improve the trading volumes in the debt markets compared to the previous week, as secondary market liquidity risks are alleviated to an extent. With ~60% of debt market issuance volume attributable to financial sector entities, we expect a sizeable portion of TLTRO funds to flow to NBFCs. With this, NBFCs may be better placed to rollover their debt maturities as no moratorium is currently available for debt capital instruments.

2) Cut in cash reserve ratio by 100 bps and increase in MSF by 1%

Despite an overall surplus liquidity of ~Rs 2.5-3.0 trillion, RBI has proposed a CRR cut of 100 bps to 3.0% of NDTL, to improve the system-wide liquidity across the banking system. Additionally, the individual banks can now avail up to 3.0% of their NDTL (up from 2.0%) from the RBI under the MSF to meet their liquidity requirements. The CRR cut is applicable for one year till March 26, 2021, and the enhanced MSF is available till June 30, 2020. Both the above measures can improve the liquidity of banking system by Rs 1.37 trillion each or Rs 2.74 trillion together.

In our view, Private banks generally don't have much of excess securities eligible for meeting SLR requirements to meet any unanticipated liquidity requirements. Amid concerns on liquidity of private banks and some pick-up in deposit withdrawals, both these measures shall aid in improving the liquidity position of banks. With reduced CRR requirements, the negative carry for the banks on their CRR balances will also decline, as such balances will now be deployed in interest earning assets.

The liquidity infusion measures along-with a higher cut in reverse repo rate will nudge banks to push credit growth as the negative carry on their funds will increase, thereby impacting their profitability. We also expect a sharp cut of 50-60 bps in 1-year deposit rates in the near term given the surplus liquidity in the banking system.

3) Moratorium on term loans and deferment of interest on working capital facilities to mitigate the burden of debt servicing amid the disruption on account of Covid-19

With the approval of their respective boards, all commercial banks (including regional rural banks, small finance banks and local area banks), co-operative banks, All-India Financial Institutions, and NBFCs (including housing finance companies and micro-finance institutions) are being permitted to:

- 1) Allow a moratorium of three months on payment of instalments in respect of all term loans outstanding as on March 1, 2020. Accordingly, the repayment schedule and all subsequent due dates, as also the tenor for such loans, has been shifted across the board by three months.
- 2) In respect of working capital facilities sanctioned in the form of cash credit/overdraft, the above intuitions are being permitted to allow a deferment of three months on payment of interest in respect of all such facilities outstanding as on March 1, 2020. The accumulated interest for the period will be paid after the expiry of the deferment period.

The above moratorium will not result in asset classification downgrade.

In our view, given the genuine hardship faced by the borrowers given a serious disruption in their cash flows, we believe the above measures are positive for borrowers as well as banks in the near-term. We expect most of the banks will be willing to extend such moratorium to their customers, if the customers were to ask for the same. However, the revival of the economic conditions after the lifting up of lockdown conditions will be critical for the asset quality of the lending institutions. In case the economic conditions continue to remain weak, there will be a pressure on the asset quality of the institutions thereafter.

4) Deferment of implementation of net stable funding ratio by six months to October 1, 2020

Net Stable Funding Ratio (NSFR) requires the bank to fund their long-term assets (over a time horizon of a year) with long-term sources of liabilities in order to mitigate the funding stress. Banks were required to maintain NSFR of 100% from April 1, 2020, however given the recent instability in funding environment, it has been deferred to October 1, 2020.

5) Deferment of hike in last tranche of capital conservation buffer (CCB) for banks by six months

As per the RBI's Basel-III capital requirements for banks, the CCB was to be implemented in tranches of 0.625% every year and the transition to full CCB of 2.5% was to be completed by March 31, 2020 (earlier in December 2018 the implementation was deferred by one year from March 31, 2019 to March 31, 2020). Considering the potential stress because of Covid-19, RBI has proposed to defer the implementation of the last tranche of 0.625% of the CCB by six months to September 30, 2020.

In our view, the above deferment shall aid banks' ability to support credit requirements in the short term. It also gives them more time to raise new capital given the sharp correction in the stock prices and current market environment. The said deferment will imply that the regulatory capital requirements for the sector is lower by around Rs. 560 billion.



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