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Commercial paper borrowing costs increase sharply

NBFCs shift to shorter maturities, while PSUs shift to longer maturities

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Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Anil Gupta
+91 124 4545314
anilg@icraindia.com

Aashay Choksey
+91 22 6114 3430
aashay.choksey@icraindia.co

Aayush Behal
+91 124 4545386
aayush.behal@icraindia.com

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Lower yields and risk aversion towards the commercial papers (CPs) issued by non-banking financial companies (NBFCs) kept investor appetite and the overall CP outstanding muted over the last two years. The short-term rates started firming up from H2 FY2022 on the back of the increased liquidity absorption under the variable rate reverse repo followed by the off-cycle policy hike on May 4, 2022. The tightening monetary policy together with the expectations of policy rate hikes in the foreseeable future have resulted in an increase in the weighted average cost of CP. As the yield on CPs have improved, inflows into the short-term debt schemes of Mutual Funds (MF) could increase. This could drive the demand for CPs, although the growth in issuances will also depend on the issuers' appetite for short-term funding.

Furthermore, the overall issuances by the NBFCs, which are key issuers (excluding CPs issued for initial public offering (IPO) financing and by public financial institutions), witnessed a strong month-on-month growth in April-May 2022, partly driven by one-two large NBFCs. However, the share of issuances over the 90-days maturity bucket witnessed a declining trend. Conversely, the share of longer-tenor issuances by public sector undertakings (PSUs) has increased as their spreads remain closer to the yields on the 91-day T-Bill rates.

While CP volumes were muted over the last two years, ICRA expects overall volumes to revive, subject to growth in mutual fund AUM and issuer appetite for short-term funding

Growth in CP volume outstanding remained muted in last few years; however, revival could be expected in coming quarters: During the last two years, the growth in commercial paper (CP) volumes outstanding was weighed down by the risk aversion of investors towards CPs issued by non-banking financial companies (NBFCs) after the NBFC crisis in FY2019. This apart, lower yields on these instruments and the consequently lower growth in the assets under management (AUM) of various money market and liquid mutual fund schemes could be another reason. Mutual funds are typically the largest investors in CPs with over 70-75% of the total holding of outstanding CPs as on March 31, 2022. The CP outstanding level was lower by 3% at Rs. 3.5 lakh crore on March 31, 2022 (Rs. 3.6 lakh crore on March 31, 2021). These levels were considerably lower than Rs. 4.8 lakh crore in March 2019 and the peak outstanding level of Rs. 6.4 lakh crore in July 2018.

With rising short-term rates, the yield on CPs has improved, which could boost inflows in the short-term debt schemes of mutual funds and possibly lead to a rise in demand for this instrument. Moreover, in a rising rate environment, when bond issuances take a temporary hit, the reliance on bank funding and short-term instruments increases till the yields stabilise at higher levels and bond issuances improve. The actual growth in CP volumes outstanding will, however, be driven by the growth in AUM of the mutual funds as well as the issuers' appetite for short-term funding, given the lessons learned from the liquidity crisis in FY2019.

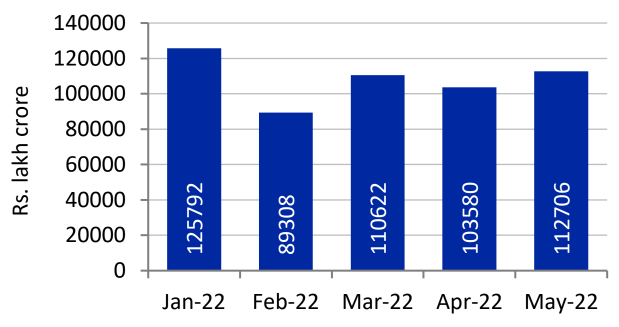
Rising policy rates drive hardening of short-term borrowing costs for CPs; a relatively steep rise in policy rates will transmit to borrowing costs as well in the near term

Short-term borrowing costs continue to harden, in sync with rising policy rates and moderating liquidity levels: Short-term rates began to harden gradually in H2 FY2022, in sync with the increased liquidity absorption from the banking system (~80% of the surplus liquidity) under the variable rate reverse repo (VRRR) conducted by the Reserve Bank of India (RBI). Subsequently, the replacement of the reverse repo rate with the Standard Deposit Facility (SDF) at a higher rate of 3.75% in April 2022 as a liquidity absorption tool also led to an increase in the short-term rates. The SDF rate was hiked to 4.15% shortly thereafter in an off-cycle policy meeting held on May 4, 2022. This, along with high inflation levels, which are likely to sustain, raised expectations of accelerated monetary tightening. The expectations of policy rate hikes and reduction in liquidity surpluses have resulted in an increase in the weighted average cost of CP issuance to 5.29% in May 2022 from 4.39% in April 2022. We expect the Monetary Policy Committee (MPC) to hike the repo rate by 40 basis points (bps) at the upcoming meeting in June 2022, followed by 35 bps each in the subsequent two policy reviews in August and September 2022, which is likely to further harden the CP rates/borrowing costs.

Maturity tenor of CP issuances by NBFCs has declined in last three months: The weighted average tenor of CP issuances (excluding CPs issued for initial public offering (IPO) financing) by NBFCs steadily declined to 116 days in May 2022 from 131 days in April 2022 and 181 days in March 2022. Given the uncertainty regarding the quantum of rate hikes and the terminal policy rate for this cycle, investors are also seeking a higher yield on long-tenor CP issuances (>90 days) to incorporate higher repricing risk. They also seek higher spreads for investments in the papers issued by NBFCs, given the sectoral cap on investment limits. This, coupled with the expectation of higher yields, has prompted NBFCs to gravitate towards lower-tenor issuances. Public sector undertakings (PSUs) have conversely increased the share of longer-tenor issuances even as their spreads remain closer to the yields on the 91-day treasury bill (T-Bill) rates.

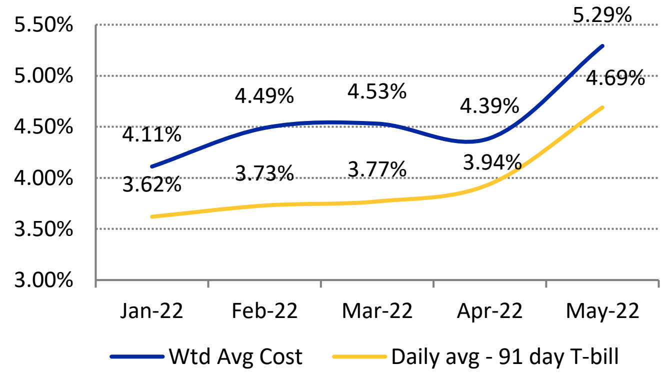
POLICY RATE HIKE AND UNCERTAINTY REGARDING QUANTUM OF FUTURE RATE HIKES DRIVING A SHARP INCREASE IN SHORT-TERM YIELDS

EXHIBIT 1: Monthly CP Issuance Volume



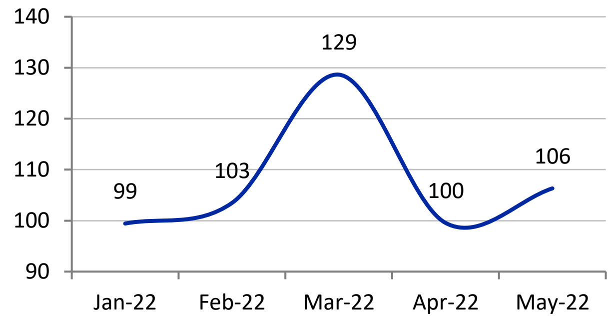
Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

EXHIBIT 2: Weighted Average Borrowing Cost



Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

EXHIBIT 3: Weighted Average Maturity (days)



Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

Short-term rates spiked in May 2022 on the heel of an off-cycle rate hike by RBI; extent of short-term rates hardening in the near term to be guided by timing of future hikes

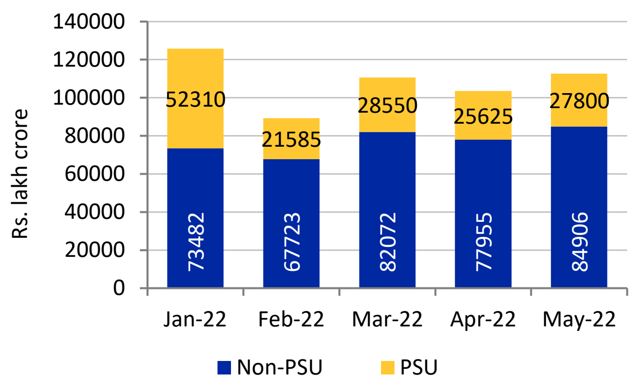
Short-term yields spike after off-cycle rate hike by RBI: Market expectations, post the monetary policy of April 2022, were of a relatively modest rate hike starting from August 2022 with possibly a 50-75-bps hike in the policy rates in FY2023. However, the sharp rise in inflation levels, which are likely to sustain, and the off-cycle rate hike of 40 bps in May 2022 resulted in heightened uncertainty regarding the quantum of rate hike in policy rates in the near term. As a result, as seen in Exhibit 2, the 91-day T-Bill rate, which was lower than the policy rate in April 2022, rose above the policy rate of 4.4% in May 2022. The CP rates, which were 39 bps above the policy rate in April 2022, rose to 89 bps above the policy rate. The relatively higher increase in these short-term rates compared to the policy rates reflects investor expectations of a further hike of 40-50 bps in the policy rate in the near term.

Short-term rate trend to be driven by guidance on timing of future hikes by RBI: While the current short-term rates are building in a 40-50-bps hike in the policy rates in the near term, the guidance from the RBI in the upcoming policy statement on June 8, 2022 will be the key driver of the short-term rate trends. Even with a 40-50-bps hike in the policy rates to 4.8-4.9%, the repo rate is likely to be lower than the pre-Covid level of 5.15%. The guidance on the pace at which the future rate decision will be taken will drive the trend in short-term rates.

Weighted average maturity not expected to rise in the near term: Given the uncertainty surrounding the extent of policy rate increase in the coming quarters, investors are likely to remain more circumspect while investing in longer CP tenors. This, in turn, is expected to drive flows/volumes in the shorter maturity. As a result, we do not expect the weighted average maturity to rise meaningfully in the near term.

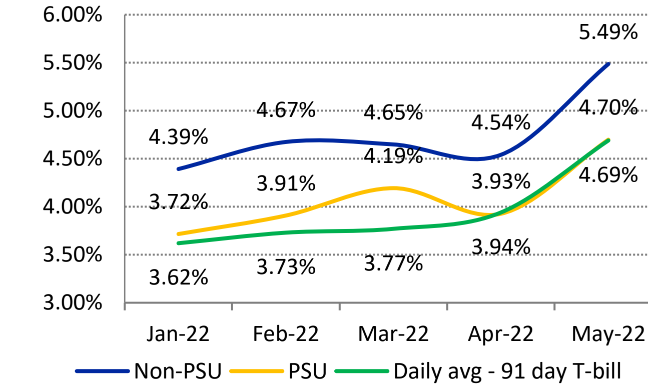
BORROWING COSTS FOR NON-PSUS INCREASE SHARPLY; PSUS TAKE ADVANTAGE OF LOWER SPREADS OVER T-BILL RATES

EXHIBIT 4: Monthly CP issuance Volume



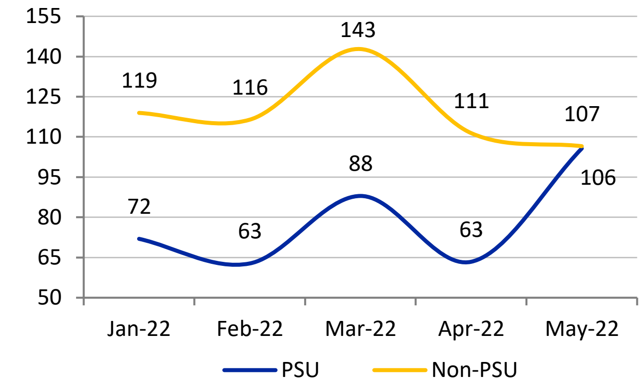
Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

EXHIBIT 5: Weighted Average Borrowing Cost



Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

EXHIBIT 6: Weighted Average Maturity (days)



Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

CP volumes witnessing a steady rise, excluding an occasional surge in issuances by PSUs

91-day T-Bill expected to reach 6%, while non-PSU borrowing costs for CPs to rise to 6.5% based on anticipated policy rate hikes in the upcoming reviews till September 2022

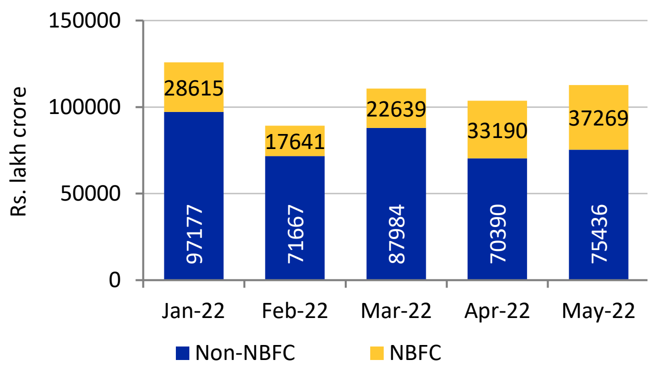
PSU volumes remain stable: The surge in CP volumes witnessed in January 2022 was largely contributed by public financial institutions {PFIs; EXIM Bank, Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD)} and oil marketing companies (OMCs). However, issuances by PFIs and OMCs moderated in subsequent months and issuances by PSUs normalised to Rs. 25,000-28,000 crore in subsequent months.

Borrowing cost for non-PSUs witnesses relatively sharper rise: Compared to a 75-bps increase in the 91-day T-Bill rate, the average borrowing cost via CP for non-PSUs hardened by 95 bps and 77 bps for PSUs in May 2022. Moreover, ICRA anticipates a policy rate hike of 110 bps in the upcoming reviews with the terminal rate at 5.5% by September 2022. With a 40-50-bps premium, the 91-day T-Bill could eventually peak at 6.0% and non-PSUs could see borrowing costs for CPs rising further to 6.5% based on current expectations or policy rate hikes.

PSUs seen to have shifted to longer maturities: Issuances by PSUs witnessed a marked shift to longer maturities in May 2022. With bank borrowings having a spread over the T-Bill rate and given the limited premium over the 91-day T-Bill, there is a likelihood that PSUs preferred to borrow from the CP market with a longer tenor.

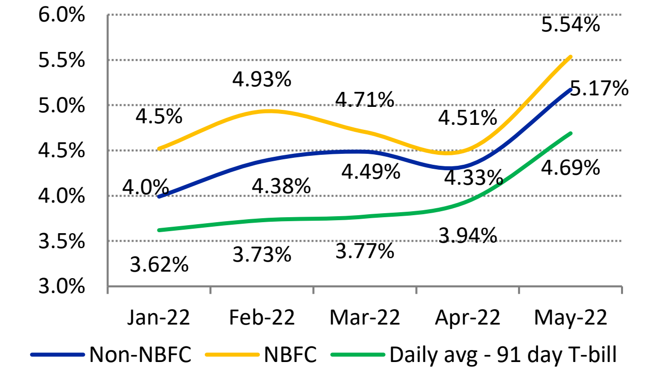
NBFCs Shifting To Lower Maturity Issuances; Have To Be Mindful Of Asset-Liability Gaps

EXHIBIT 7: Monthly CP Issuance Volume



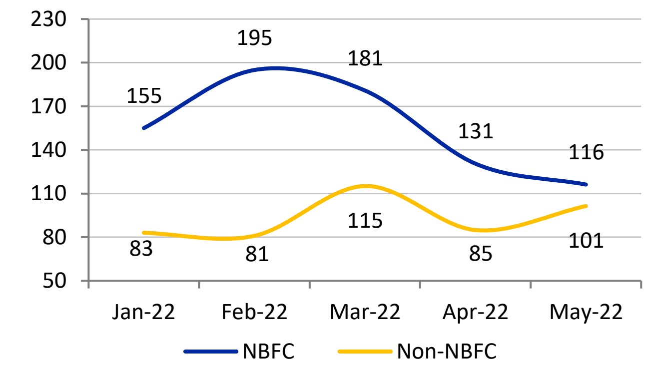
Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

EXHIBIT 8: Weighted Average Borrowing Cost



Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

EXHIBIT 9: Weighted Average Maturity (days)



Source: aimin.co, ICRA Research (excludes CPs issued for IPO financing)

While short-term borrowing costs for NBFCs and non-NBFCs have risen, the increase remains relatively higher for NBFCs

Issuances by NBFCs pivoting towards shorter tenor as investor appetite for longer-tenor CPs appears to be low

Issuances by NBFCs increase in the last two months: CP volumes of NBFCs witnessed a strong month-on-month growth during April-May 2022. NBFCs are also large issuers in bond markets, accounting for ~50-60% of the total issuances. Amid rising rates, issuers as well as investors continue to adopt a wait-and-watch approach for the rates trajectory to stabilise, driving down the corporate bond issuances in April and May 2022. The higher issuances in April and May 2022 were also driven by the relatively large issuances by HDFC Limited.

Borrowing costs for NBFCs witness higher increase over non-NBFCs: While the daily average T-Bill rates rose sharply by 75 bps in May 2022 over April 2022, the average CP borrowing costs for NBFCs witnessed a sharper increase of 103 bps in May 2022 to 5.5% whereas non-NBFCs witnessed a lower increase at 84 bps. Given the sectoral investment caps for certain investors, the CP rates are typically higher for the NBFC segment.

Weighted average maturity of issuances by NBFCs decreases: CP issuances by NBFCs witnessed a steady shift to shorter maturities, with a relatively declining share of issuances over the 90 days maturity bucket. Given the near-term uncertainty regarding the quantum/timing of rate hikes, investor appetite for longer-maturity CPs appears to be low as of now. Once the rates stabilise, the tenor of issuances could improve. In the interim, as the share of short-term CPs increases in the overall borrowing mix for NBFCs, they need to be mindful of the associated asset-liability gaps.

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- Provide intermediaries with a tool to improve efficiency in the funds raising process.

ICRA

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
+91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: Jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: Communications@icraindia.com
Tel: +91 124 4545 860

Registered Office

B-710, Statesman House 148,
Barakhamba Road
New Delhi-110001
Tel: +91 11 23357940-45

Corporate Office

Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,
Gurgaon - 122 002
Tel: +91-124-4545300

Ahmedabad

1809-1811, Shapath V,
Opp: Karnavati Club,
S.G.Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/501

Bengaluru 1

'The Millenia', Tower B Unit No. 1004,
10th Floor, 1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

4th Floor, 'Shoban'
6-3-927/A&B. Somajiguda
Raj Bhavan Road,
Hyderabad - 500 082
Tel: +91 40 4067 6500

Hyderabad 2

No. 7-1-58, 301, 3rd Floor, 'Concourse',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road,
Shivajinagar, Pune - 411 020
Tel: +91 20 2556 1194

Email: Info@icraindia.com
Helpdesk: 9354738909
Website: www.icra.in/ www.Icraresearch.in