SBI RESEARCH

ECOWRAP

EXCESS LIQUIDITY AND PRICING OF CREDIT RISK: ARE WE DOING ENOUGH?

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In the aftermath of the pandemic, the RBI has been in the forefront of stabilising the financial system in terms of keeping liquidity in surplus mode. The average net durable liquidity injected into banking system since Apr'21 is at Rs 9.3 lakh crore. The conundrum of weak credit demand and excess liquidity is evident from the average reverse repo at Rs 7 lakh crore since April and Government of India cash balances with RBI at Rs 3.4 lakh crore. Not surprisingly, the SBI Financial Stability Index reflecting all the surplus liquidity and credit spreads was at the highest level in Aug'21 since Apr'20.

However, against this background, it is now pertinent to ask whether the credit risk is getting adequately reflected in pricing? **A back of envelope estimate suggests that the core funding cost of the banking system that includes cost of deposits, negative carry on SLR and CRR and Return on Assets is currently at 6%, while the reverse repo rate is at 3.35%. Additionally, if we add cost of provisions to the core funding cost, the total cost comes to around 12%**. Clearly, banks are facing significant margin pressures.

This apart, market sources point out that risk premia over and above core funding cost are not fairly acknowledging the inherent credit risk. For example, 15 years loans are being priced at even lower than 6%, linking with Repo / T-Bill rates. It is to be noted that 10-Yr G Sec is currently trading at 6.2% and by the current pricing trends this could even gravitate towards 6.0% again. This anomaly not only negates the concept of Tenor Premium but may create a material risk with regards to sustainability of such rates in long term, on which borrowers and banks are basing their financial calculations. The only good thing is that such pricing war is mostly restricted to AAA borrowers. 3 year term loans are being quoted at close to 4% repo rate and 7 year term loans for borrowers below AAA are also quoting a risk premium of 15-20 basis points over the 10 year rates. Working Capital Loans (WCL) are currently being quoted at a notch above reverse repo rate at 3.35%.

Interestingly, RBI had proposed the concept of **normally permitted lending limit** (NPLL) for specified borrower, meant to nudge the borrowers to move towards corporate bonds market, which may lose its importance. In the current situation, corporate bond rate and bank lending rate are showing huge differential.

The CP market is also witnessing significant churn with banks now almost absent. Non-Banking participants like Mutual Funds who do not have access to RBI Reverse Repo window are creating pricing pressure in CP market as they are sometimes quoting below RBI reverse repo rate. In fact, the CP market reflects the huge pricing gap between better and lower rated borrowers.

It is noteworthy that the industry is replacing its long-term debts by very low-priced CP / WCDL and this will obviously act as an enabler once the investment cycle revives. However there is the risk of an Asset Liability mismatch if the liquidity is withdrawn quickly. As of now, the inflation numbers may not warrant such a decision from RBI, but if core inflation persists in the current range of 6% or above, that might act as a hindrance to continued liquidity abundance. **As of now, low interest rate regime and low corporate taxes for corporates (taxes were cut in FY20) apart from expenditure reduction also contributed to large share buy-backs, with the 5 year period ended Aug'21 showing such buybacks at Rs 1.73 lakh crore. In the last 3 years, the share buybacks have been around Rs 65,421 crore.**

The RBI has been navigating through the pandemic with delicate balance. However, as we have pointed out the period of extended surplus liquidity is already witnessing fierce pricing wars across banks, some of which may not reflect credit risk adequately. Perhaps the balancing act is most prominent when it comes in understanding the depositors' and lenders' interest. We estimate that the total number of depositors in the banking system is around 207 crore, the number of creditors is at 27 crore. The total bank deposits at Rs 151 lakh crore constitute Rs 102 lakh crore of retail deposits, including that of senior citizens. Clearly, real rate of return on bank deposits has been negative for a sizeable period of time and with RBI making it abundantly clear that supporting growth is the primary goal, the low banking rate of interest is unlikely to make a north bound movement anytime soon as liquidity continues to be plentiful. **This implies that the current bull run in financial markets is possibly a break from the past as households may have got into the bandwagon of self fulfilling prophecy of a decent return on their investment.**

We thus believe, it is now the opportune time to revisit the taxation of interest on bank deposits, or at least increasing the threshold of exemption for senior citizens. The RBI can also relook at the regulation that does not allow interest rates of bank to be determined as per age-wise demographics. Additionally, while there is no restriction by RBI on benchmarking of loans (as against earlier MCLR) and Banks are free to use any benchmark published by FBIL, continued restrictions on not allowing negative spread on MCLR may also be removed. This will help Banks to be nimble, optimally manage and book quality business without having to expose the entire book to external benchmarks.

- In the aftermath of the pandemic, the RBI has been in the forefront of stabilising the financial system in terms of keeping liquidity in surplus mode. The average net durable liquidity injected into banking system since Apr'21 is at Rs 9.3 lakh crores. RBI has been absorbing liquidity through LAF operations. Meanwhile Government cash balances are at Rs 3.4 lakh crore (Apr'21-Sep'17, average). With the Government spending not picking up enough pace to mop a sizeable amount of excess liquidity being generated by RBI forex purchases and liquidity measures announced previously, the liquidity overhang is significant.
- Against this background, it is now pertinent to ask whether the credit risk is getting adequately reflected in pricing? **A back of envelope estimate suggests that the core funding cost of the banking system that includes cost of deposits, negative carry on SLR and CRR and Return on Assets is currently at 6%, while the reverse repo rate is at 3.35%. Additionally, if we add cost of provisions to the core funding cost, the total cost comes to around 12%**. Clearly, banks are facing significant margin pressures.
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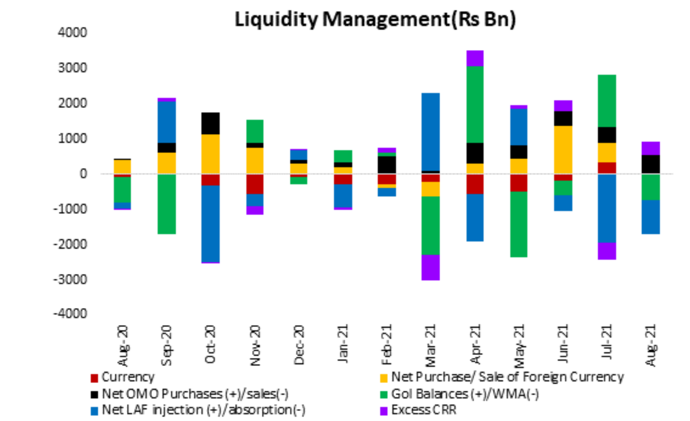
CPs– the changing face of credit delivery

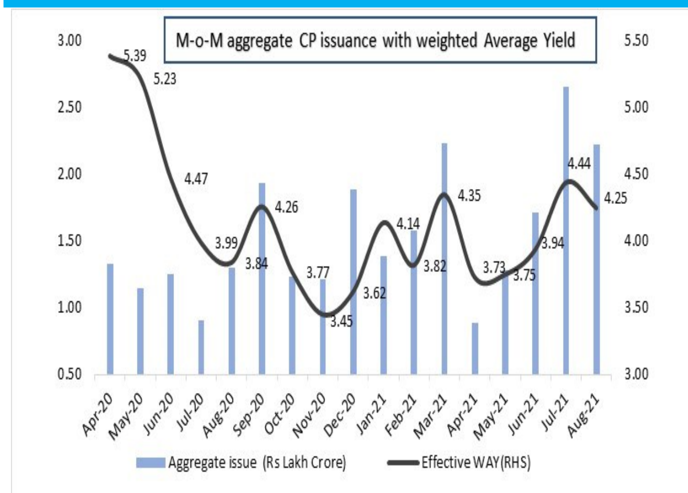
- Since the onset of pandemic, there has been an increasing flurry of activities in the money market, with corporates tilting towards raising major slice of working capital requirements through CPs, taking advantage of significant drop in coupon. As markets got crowded by mutual funds flush with unebbing inflows, Banks are staying away. CP rate declined from 5.4% in April 20 to sub 4% level during April-May'21 and are now around 4.25% in Aug'21.
- Non-Banking participants like Mutual Funds who do not have access to RBI Reverse Repo window are creating pricing pressure in CP market as they are sometimes quoting below RBI RR rate.

Liquidity Management by RBI



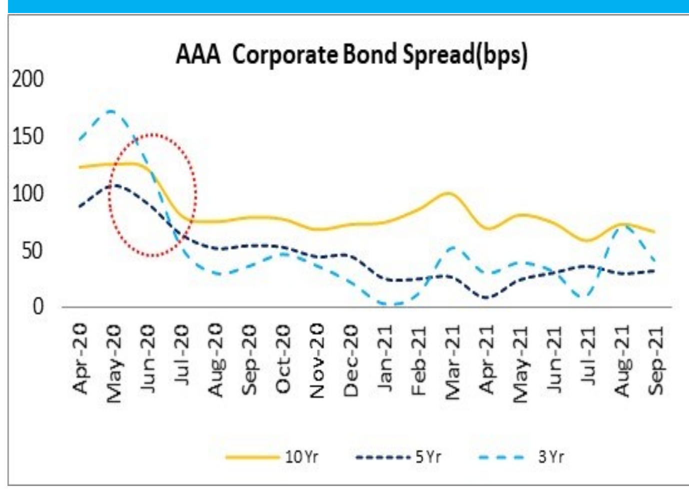
Source: SBI Research

CP Issuance



Source: SBI Research

Bond spread



Source: SBI Research

Share Buy-back

- Flush with cheap and easily available funds, India's corporates have found the time opportune to buy back shares. In an increasingly galloping market, the strategy has yielded dividends.

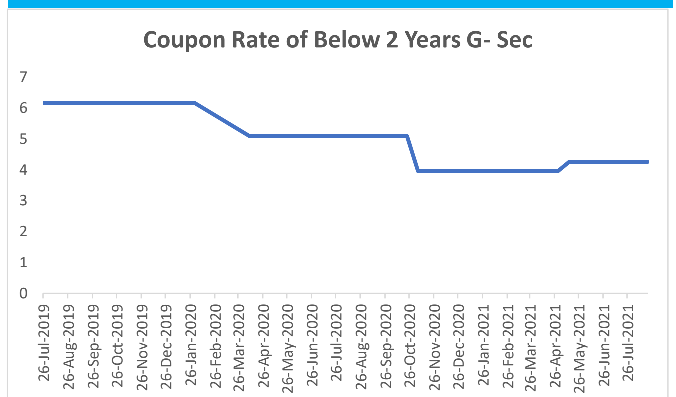
Buy Back of Shares		
Year	No of issues	Acquired Amount Rs Crore
FY18	59	53012
FY19	63	55295
FY20	52	17843
FY21	61	37378
FY22	15	10200

Source: Primedatabase; FY22 up to Aug

Increased investments in Floater Funds

- If we look at the investments in mutual funds, investors have been increasingly investing in floating rate mutual funds anticipating increase in interest rate. Floating rate funds invest in either floating rate instruments or in fixed coupon instruments which are converted to floating rate by using swaps/overnight index swap.
- Such instruments can provide support to the fixed income portfolio in a rising interest rate scenario, thereby leading to its increased demand. These funds have received a net inflow of Rs 33,000 crore in the first eight months of the year, with Rs 23,733 crore in the last 3 months. The category has received the second largest amount amongst the all debt mutual funds.

CP Issuance



Source: SBI Research

Cost of Funds

- Approximately 44% of bank deposits, across banking sector, with somewhat little tolerance on either side for major Banks, is constituted of CASA with Current accounts contributing around a fifth of this bucket. In Banking sector's total term deposits, contribution by 40 -million plus senior citizens, who remain much dependent on accrued interest income for meeting most of their fixed expenditure needs, hovers around 20%.
- Despite some Banks offering incremental rate of 25-50 basis points to this vulnerable class, the pressure to keep deposit rates south bound to accommodate loan pricing may create a further squeeze on their return in particular. Also, most of banking sector's deposits are short-term/ payable-on-demand, with even term deposits having a larger slice comprising of deposits up to one year bucket. As such, financing long term projects with such deposits, without factoring in the right/ optimal pricing, may be cumbersome going forward.

The Asset Liability position of Indian Banks (Estimated)				
Type of Deposits		No of A/Cs (in crores)*	FY21^	FY20^
Agg. Deposits	A (=B+C+D)	207	151.1	139.7
Current	B	10	14.9	13.4
Saving	C	172	47.9	43.0
Term	D (E+G)	25	88.4	83.4
Individuals	E	23	84.8	80.0
Sr Citizen	F	5	17.7	16.0
Others	G	1	3.5	3.4
Bank Credit		27	109.5	103.7

Source: RBI, SBI Research *2020 ^ Rs lakh crore

Refinancing

- In the absence of any firm commitment to fresh investments, in part aggravated by the uncertainty engulfing business environment, corporates have used the low interest rate structure for refinancing the existing liabilities, apart from deleveraging.

- Banks, as an anchor to other industries/ sectors are quite different when pitted against other verticals. They may find the going tough, to retain the deposits with them going forward, especially in the wake of outflows to the galloping equities markets and opening of bonds to general public, both guaranteeing better returns.

Way Forward

- We thus believe that it is now the opportune time to revisit the taxation of interest on bank deposits, or at least increasing the threshold of exemption for senior citizens. The RBI can also relook at the regulation that does not allow interest rates of bank to be determined as per age-wise demographics.
- Additionally, while there is no restriction by RBI on benchmarking of loans (as against earlier MCLR) and Banks are free to use any benchmark published by FBIL, continued restrictions on not allowing negative spread on MCLR may also be removed. This will help Banks to be nimble, optimally manage and book quality business without having to expose the entire book to external benchmarks.

Impact of Excess Liquidity on Banks

A	Deposits Cost			3.9%
			Rate/Cost	
		SB	2.8%	
		CA	0.0%	
		TD	5.0%	
B	Provisions			6.0%
C	ROA			1.0%
D	Negative Carry	CRR		0.4%
E		SLR		0.7%
Total Cost				12.0%

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