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RBI ANNOUNCES MORE MEASURES: RESEMBLANCE TO FED IN PROVIDING SECOND GENERATION SIGNALS

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In a short span of 21 days (first announced regulatory package to provide relief against COVID-19 on 27 Mar), RBI once again unleashed a plethora of liquidity and regulatory measures to support the banks and economy in the current uncertain environment. RBI reduced the fixed rate reverse Repo rate by 25 basis points to 3.75% with immediate effect, keeping the policy Repo rate ate 4.40%. With this the LAF corridor has widened to 90 bps (upper bound spread: 25 bps and lower bound: 65 bps). The widening of the LAF corridor and a surplus liquidity regime effectively implies reverse repo rate could be the effective policy rate.

Long Term Operations (TLTRO) 2.0 are to be conducted for an aggregate amount of Rs 50,000 crore, to begin with, in tranches of appropriate sizes to be invested in investment grade bonds, commercial paper and non-convertible debentures of NBFCs. At least 50% of the total amount availed is mandated to go to small and midsized NBFCs and MFIs. As on date around 380 NBFCs including Housing finance and Micro Finance Institutions are in investment grade i.e. having external rating of BBB and above (all rating agencies) and potentially can benefit from this. Normally large NBFCs, are having a share of 80-85% in raising NCDs. With 50% total amount availed now mandated to go to small and midsized NBFCs and MFIs, this will also benefit the former. The RBI has also incentivized the banks by allowing them the benefit of HTM while investing in such debt instruments and not applying the provisions of Large Exposure Framework.

RBI has excluded the accounts availing moratorium from the 90-day NPA norm, thus providing a breather to banks as well as customers. However, given the working capital challenges it is advisable for the RBI now to relook at the 90-day norm. The classic demand-supply shock that a pandemic creates can have serious economic disruption. The fact that China's Gross domestic product shrank 6.8% in the first quarter from a year ago, the worst performance since 1992, is a case in point. When resources are scarce, an accelerated recognition of assets will take a heavy toll not only on the economy but also on requirement of core capital by the bank under the current situation. Further, it would be pertinent to mention here that once an account is classified NPA, the borrower won't be able to raise funds from any other lender. **Hence, in the current circumstances the only way to save the economy and the financial system seems to be a relaxation of the IRAC norms i.e extending the 90-day schedule to 180 days. Further this relaxation should be given along with a well laid out calendar of returning to the current norm of 90 days in the next two years by which time, hopefully, the current pandemic crisis would have subsided completely.**

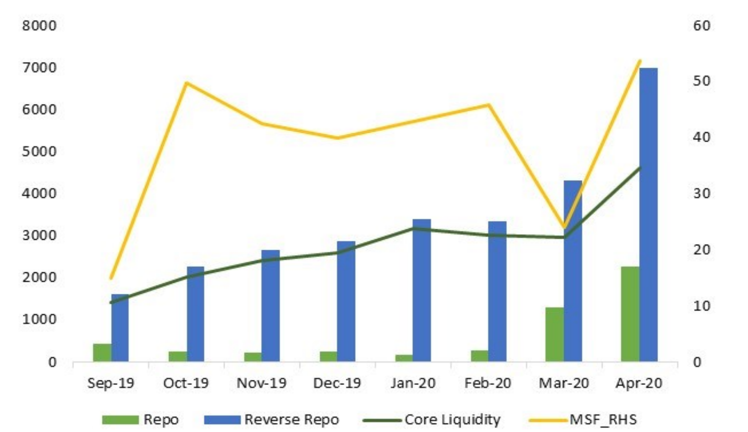
Although the relaxation in WMA limits for States is appreciated, the time has come now to reconsider the additional borrowing conditions stipulated by FRBM Committee so that states can fulfil their funding needs in such difficult scenario.

Meanwhile refer the RBI policy statement "In the period ahead, inflation could recede even further, barring supply disruption shocks and may even settle well below the target of 4 per cent by the second half of 2020-21. Such an outlook would make policy space available to address the intensification of risks to growth and financial stability brought on by COVID-19" **Drawing yet again from the US experience during the crisis, such policy statement bears remarkable resemblance of second generation signals as Fed provided during global financial crisis**! **Clearly this RBI is different in terms of communication and policy responses!**

RBI JUMPS IN TO REVIVE MARKET SENTIMENTS

- In a short span of 21 days (first announced regulatory package to provide relief against COVID-19 on 27 Mar), RBI Governor has again announced plethora of liquidity and regulatory measures to support the banks and economy in the COVID breakthrough.
- In the wake of stupendous rise in surplus liquidity and in order to nudge banks to deploy this surplus liquidity in investments and loans in productive sectors of the economy, RBI reduced the fixed rate reverse Repo rate by 25 basis points to 3.75% with immediate effect, keeping the policy Repo rate ate 4.40%. With this the LAF corridor changed to 90 bps (upper bound spread: 25 bps and lower bound: 65 bps). The widening of the LAF corridor and a surplus liquidity regime effectively implies reverse repo rate is the effective policy rate.
- Many researchers and analysts are confused whether RBI is empowered to change the reverse repo rate without MPC meeting. To clarify the same, under the RBI Act, 1934 section 45ZB (3) it is clearly mentioned that, "*The Monetary Policy Committee shall determine the Policy Rate required to achieve the inflation target" and in the act the policy rate is defined as "Policy Rate means the rate for repo-transactions under sub-section (12AB) of section 17*". Hence, it is incorrect to say that change in reverse Repo without MPC consent is unlawful.
- Due to various reasons, the system liquidity is in surplus mode since Jun'19 and banks have been parking a monthly average of Rs 2888 billion under the reverse repo window of RBI, which has been increasing after RBI's 27 Mar measures. So, we believe the reduction of reverse repo is an excellent step and will disincentives banks to park their surplus funds under reverse Repo. Further, this will also reduce the interest cost of RBI.

System Liquidity Position (Rs bn)



Source: SBI Research

IMPACT OF LIQUIDITY & REGULATORY MEASURES

- **Targeted Long Term Operations (TLTRO) 2.0:** An aggregate amount of Rs 50,000 crore, to begin with, in tranches of appropriate sizes are to be invested in investment grade bonds, commercial paper, and non-convertible debentures of NBFCs. The RBI is open to increasing this amount beyond Rs 50,000 going forward. At least 50% of the total amount availed must go to small and midsized NBFCs and MFIs. These investments have to be made within one month of the availing of liquidity from the RBI. As in the case of TLTRO auctions conducted hitherto, investments made by banks under this facility will be classified as Held to Maturity (HTM) even in excess of 25% of total investment permitted to be included in the HTM portfolio. Exposures under this facility will also not be reckoned under the large exposure framework.
- Generally NBFCs fund their resources around 40% through NCDs, 33-35% from Banks, 7-8% from CPs, 4-5% from deposits and remaining through capital and other sources. NBFCs were the largest net borrowers of funds from the financial system with gross payables of around Rs 8,29,468 crore as of September 2019.
- Though the guidelines will spell out the details, as on date around 380 NBFCs including Housing Finance and Micro Finance Institutions are investment grade i.e. having external rating of BBB and above (all rating agencies) and can benefit from this. Normally large NBFCs, considering loan book greater than Rs 30000 crore have share of 80-85% in raising NCDs. With 50% total amount availed going to small and midsized NBFCs and MFIs, small ones also will be benefited.
- **Ways and Means Advances for States:** For FY19 net borrowing of the States is around Rs 6.40 lakh crore. With redemption of Rs 1.47 lakh crore, the total gross borrowing comes to Rs 7.88 lakh crore. Together with the Centre's borrowing of Rs 7.8 lakh crore the total borrowing comes to a whopping Rs 15.6 lakh crore, that could now touch Rs 20 lakh crores in current fiscal. Thus, to provide greater flexibility to states to spend on COVID-19 related efforts and efficiently plan their borrowing, RBI has enhanced the Ways and Means Advances (WMA) limit of States further to 60% over and above the level as on 31 Mar'20 from the earlier increase by 30% announced at the beginning of the year. The increased limit will be available till September 30, 2020. **The existing WMA limit from RBI by States amounted to Rs 32,225 crore in FY20, thereby implying an enhanced limit of Rs 51,560 crore for all states.** However, we need to now seriously reconsider the 14th Finance Commission recommendations for the States to have access to additional borrowing limits. The 15th Finance Commission has not given any extra guideline for borrowings and states are expected to adhere to their specific rules. If we evaluate the 19 states on these criteria, for FY21 only Assam and Odisha qualify for additional 0.5% borrowing. Meanwhile, Goa, Gujarat, Jharkhand, Karnataka, Telengana, Uttar Pradesh and Uttarakhand can raise 0.25% of their respective GSDP with Jharkhand and Uttar Pradesh not qualifying the debt criteria while the others not qualifying the interest payments to revenue receipts ratio criteria. Thus, this WMA limit will help the states who do not fulfil the criteria for additional borrowing.
- **Asset Classification:** RBI has excluded the accounts availing moratorium from the 90-day NPA norm, thus providing a breather to banks as well as customers. Although the NPA classification norms have been relaxed for all the accounts availing moratorium or deferment, RBI, adhering to the vision of financial stability of banks in the long-term, has stipulated higher provision of 10% on all such accounts under the standstill, spread over two quarters, i.e., March, 2020 and June, 2020. This will help the banks in maintaining their health, should the financial conditions deteriorate further for these accounts and the economy. Disciplined growth is very important in these times, and this RBI measure will help the banks to maintain sufficient buffers and remain adequately provisioned to meet future challenges. However, given the working capital challenges it is advisable to relook at the 90-day norm under the exceptional circumstances created by COVID pandemic and the same be extended.

Top 3 lenders group in NBFCs gross payable to the financial system (% share)

Institutions	Mar'19	June'19	Sept'19
SCBs	49.9	49.3	48.4
AMC-MFs	28.3	27.8	25.9
Insurance Cos	17.5	18.3	21.3

Source: RBI; SBI Research

Top 3 instruments in NBFCs gross payable to the financial system (% share)

Instruments	Mar'19	June'19	Sept'19
LT Debts	40	39.1	40.3
LT Loans	33.8	36.1	35.8
CPs	10	9.5	7

Source: RBI; SBI Research

Additional Borrowing (Rs crore)

Sr. No.	States	Existing WMA Limit	Enhanced WMA Limit	Availability of Enhanced Borrowing limit over 3% Fiscal Deficit
1	Andhra Pradesh	1,510	2,416	
2	Arunachal Pradesh	195	312	
3	Assam	940	1,504	Yes (0.5% of GSDP)
4	Bihar	1,420	2,272	
5	Chhattisgarh	660	1,056	
6	Goa	170	272	Yes (0.25% of GSDP)
7	Gujarat	1,915	3,064	Yes (0.25% of GSDP)
8	Haryana	915	1,464	
9	Himachal Pradesh	550	880	
10	Jammu and Kashmir	880	1,408	
11	Jharkhand	720	1,152	Yes (0.25% of GSDP)
12	Karnataka	1,985	3,176	Yes (0.25% of GSDP)
13	Kerala	1,215	1,944	
14	Madhya Pradesh	1,600	2,560	
15	Maharashtra	3,385	5,416	
16	Manipur	195	312	
17	Meghalaya	175	280	
18	Mizoram	160	256	
19	Nagaland	205	328	
20	Odisha	985	1,576	Yes (0.5% of GSDP)
21	Punjab	925	1,480	
22	Rajasthan	1,630	2,608	
23	Tamil Nadu	2,475	3,960	
24	Telangana	1,080	1,728	Yes (0.25% of GSDP)
25	Tripura	255	408	
26	Uttar Pradesh	3,550	5,680	Yes (0.25% of GSDP)
27	Uttarakhand	505	808	Yes (0.25% of GSDP)
28	West Bengal	1,895	3,032	
29	Puducherry	130	208	
Total (All States)		32,225	51,560	

Source: SBI Research

- **Refinancing Facilities for All India Financial Institutions (AIFIs):** NABARD refinances (short and long-term credit) and direct finance business, keeping in view the resource position, ground level credit demand, need for maintaining regional and inter-sectoral balance, objectives of national programmes and missions, health status of the rural financial institutions, etc. For production and working capital requirements of farmers, weavers, artisans, etc, NABARD refinances the State Cooperative Banks (StCBs) and Regional Rural Banks (RRBs) for lending under Short-term Seasonal Agricultural Operations (ST–SAO). While, the long-term (LT) refinance support for asset creation and capital formation in rural areas is provided to all banks, including SCBs, RRBs, etc. RBI line of credit support of Rs 25,000 crore at repo rate will help NABARD to refinance during this Kharif Seasons at a lower cost. During 2018–19, an amount of Rs 90,088 crore was disbursed to StCBs (Rs 73,142 crore) and RRBs (Rs 16,946 crore) to meet the seasonal credit demand for rural economic activities.
- Along similar lines, line credit facility has extended to SIDBI (Rs 15,000 crore) for on-lending/refinancing; and Rs 10,000 crore to NHB for supporting housing finance companies (HFCs). This is a welcome step to meet the liquidity crisis of the AIFIs.
- **Distribution of Dividend:** To maintain financial health of the banks, RBI provided exemption to banks from making dividend payment for FY20 in the light of financial difficulties posed by COVID-19 pandemic. However, it will be reviewed on the basis of the basis of the financial position of banks for the quarter ending September 30, 2020. The net profit of the SCBs was negative in FY18 & FY19 (-Rs 32,438 crore in FY18 and - Rs 23,397 crore in FY19). Though their financial position has improved in H1FY20 but may deteriorate due to the crisis. So, RBI's step will definitely help banks to meet their growth capital.
- **Liquidity Coverage Ratio**: RBI has brought down the LCR of SCBs to 80% from the existing 100% with immediate effect and will be gradually restored back in two phases; 90% by 01 Oct'20 and 100% by 01 Apri'21. As LCR provides short-term resilience of banks to potential liquidity disruptions by ensuring that they have sufficient high-quality liquid ssets (HQLAs) to survive an acute stress scenario lasting for 30 days. This will help small and weak banks.
- **Extension of Resolution Timeline**: Going by the same logic of easing the pressure on corporates and banks in the times of social distancing and lockdown, it has been decided that the period for resolution plan shall be extended by 90 days to 300 days from the current 210 days.

Progress of Disbursements under Short-Term Credit to StCBs and RRBs

Rs crore	StCBs			RRBs		
	2016-17	2017-18	2018-19	2016-17	2017-18	2018-19
ST–SAO	62,881	45,000	45,000	10,002	10,000	10,000
Additional ST–SAO	7,465	15,308	23,770	3,116	4,828	5,694
ST–Others including Weavers	1,055	3,150	4,373	455	1,418	1,252
Total	**71,401**	**63,458**	**73,143**	**13,573**	**16,246**	**16,946**

Source: NABARD, SBI Research

RBI COMMUNICATION OF FURTHER RATE CUTS ARE EMULATING BEST PRACTICES AND ARE NOW SECOND GENERATION SIGNALS

- Globally, over the last two decades, central banks have moved towards clearer communication and greater transparency. Central banks have realised that open and transparent communication enhances policy effectiveness. This shift reflects a shift in the theory of monetary policy and the most eloquent illustration of this shift is the change in the communication strategy of the US Fed. Prior to 1994, the US Fed didn't even announce the target Fed Funds Rate; the market was expected to infer the rate from the timing, sequencing and magnitude of its open market operations. In contrast, today, the Fed not only announces the rate but also gives a clear indication of future policy trajectory.
- In the Indian context, till now the RBI provided first generation signals in its policy statement. But now we believe that RBI is providing signals that reduce the disconnect with market expectations at the time when economy and financial markets/sectors are battling for growth due to COVID-19. Consider this statement in policy—*"In the period ahead, inflation could recede even further, barring supply disruption shocks and may even settle well below the target of 4 per cent by the second half of 2020-21. Such an outlook would make policy space available to address the intensification of risks to growth and financial stability brought on by COVID-19. This space needs to be used effectively and in time*." **Such communication, instead of being a vehicle for policy, can be the policy itself and is a perfect example of second generation signals.**
- Drawing yet again from the US experience during the crisis, such policy statement bears remarkable resemblance of second generation signals as Fed provided during global financial crisis. In August 2011, the Fed had enhanced its guidance, which until then had stated that the Fed would likely stay at exceptionally low levels "for an extended period", by replacing the latter with "at least through mid-2013".

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