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"GIVE ME GROWTH AND I (RBI) WILL GIVE YOU (POLICY) FREEDOM"

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As widely expected, RBI's Monetary Policy Committee unanimously decided to keep policy repo rate unchanged and decided to continue with the accommodative stance as long as necessary (to revive growth on a durable basis). Such explicit forward guidance by RBI in October and December is akin to Fed guidance post 2008 that had significantly anchored market expectations and we believe it is the best part of RBI policy announcement. Eminent monetary theorist Michael Woodford has described monetary policy as "the art of managing expectations" as little else matters in a modern financial system. RBI revised its FY21 real GDP growth from a decline of 9.5% to a decline of 7.5%; CPI inflation is projected at 6.8% for Q3, and 5.8% for Q4 FY21.

The global outlook continues to be exceptionally uncertain, with both upside and downside risks. In this backdrop, RBI assesses that outlook for Q4 (October-December) of 2020 is overcast with a surge in COVID-19 infections in a second wave across Europe, the US and major emerging market economies (EMEs), with accompanying lockdowns. World growth is likely to slow down in Q4 as pent-up demand is exhausted, inventory restocking is completed, and trade-related uncertainty is rising with the second wave. Worryingly, in October private and foreign banks have increased their lending rate on fresh loans (WALR) by 36 and 28 bps respectively, while PSBs have reduced 14 bps in October, compared to September.

The regulatory and development policies cover a large turf. Within liquidity measures, RBI has permitted RRBs to participate in money markets as post COVID-19 there has seen surplus liquidity generation in banking system. RRBs have also seen surplus cash and lending money markets/LAF can give necessary flexibility to manage daily liquidity. The TLTRO facility has been extended to the 26 stressed sectors identified by the Kamath Committee and encouraging banks to synergise funds from RBI under on tap TLTRO and guarantee under ECLGS 2.0 to provide credit support to stressed sectors is good policy innovation.

The policy has placed considerable emphasis on behavioural aspect of conduct of financial transaction. It has been decided to harmonise guidelines on appointment of Statutory Auditors for commercial banks, UCBs and NBFCs. Risk Based Internal Audit (RBIA) was mandated by RBI for commercial banks in 2002. RBI has now decided to include UCBs and NBFCs in the preview of RBIA. RBI decided that SCBs and cooperative banks shall not required to make any dividend pay-out for FY20. The payments systems are hub of financial innovation and digital technology and the policy has proposed to issue Reserve Bank of India (Digital Payment Security Controls) Directions, 2020 for regulated entities to set up a robust governance structure for such systems and implement common minimum standards of security controls for channels like internet, mobile banking, card payments etc. RBI has also taken a slew of measures to push further digital transaction with a better security management & controls.

Given the linkages that NBFCs have with banks and other segments of financial market, NBFC regulation needs to be fine-tuned. Accordingly the RBI will formulate a dividend distribution policy framework keeping in view the increasing significance of NBFCs in the financial system and their interlinkages with different segments. Different categories of NBFCs would be allowed to declare dividend as per a matrix of parameters, subject to a set of generic conditions.

The ease of doing measure on trade financing is also good. The removal of limit on dispatch of Shipping Documents, allowing write-off to the AD banks, without limits in specified circumstances and allowing Indian companies to set-off their export receivables against import payables in respect of goods and services with their overseas group/associate companies either on net basis or gross basis through a centralised treasury arrangement are welcome move.

The policy continues to be in wait and watch mode. There is very limited scope on what monetary policy can achieve given GDP in contraction mode and inflation risk on upside. It was in regulatory and development policy where the policy has covered considerable ground. With Union Budget in February, probably April is the best time to take stock of situation.

Finally, a word on liquidity in the banking system. Liquidity could be Structural, (driven by deposits) and Cyclical, that is policy induced. It is a good thing that Cyclical liquidity has still not outpaced Structural liquidity. RBI has been utilising liquidity management as a strategic tool for financial stability and is not focusing just on inflation. Linking liquidity management to inflation outcomes, in itself, is a complex exercise requiring the incorporation of the feedback-loop. Through cyclical liquidity management, RBI has been able to influence the borrowing rates and achieved its objective and this has been possible due to the credibility it has built about its "open mouth operations"/ explicit forward guidance! Three cheers for such guidance.

RBI HOLDS THE RATES; GDP CONTRACTION PROJECTED AT 7.5% FOR FY21

- As widely expected, RBI's Monetary Policy Committee unanimously decided to keep policy Repo rate unchanged at 4% and decided to continue with the accommodative stance as long as necessary (to revive growth on a durable basis). Reverse repo rate remains unchanged at 3.35% and MSF and the Bank Rate remain at 4.25%.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q2 FY21	Q3 FY21	Q4 FY21	FY21	Q1 FY22	Q2 FY22
Dec'20(4th Bi-monthly)	6.9*	6.8	5.8	6.5	5.2	4.6
Oct'20(3rd Bi-monthly)	6.8	5.4	4.5	5.8	4.3	-
Real GDP Growth (%)	**Q2 FY21**	**Q3 FY21**	**Q4 FY21**	**FY21**	**Q1 FY22**	**Q2 FY22**
Dec'20(4th Bi-monthly)	-7.5*	0.1	0.7	-7.5	21.9	6.5
Oct'20(3rd Bi-monthly)	-9.8	-5.6	0.5	-9.5	20.6	-

Source:RBI, SBI Research,*Actual

- RBI has revised its FY21 real GDP growth from a decline of 9.5% to a decline of 7.5% and also revises estimates for Q3 and Q4 FY21. Q3 growth revised from –5.6% to +0.7% and Q4 growth revised to +0.7% from +0.5% estimated in the last policy. For H1 FY22, RBI projected growth rate in the range of 21.9% to 6.5% with risks broadly balanced. We also believe that FY21 real GDP decline will be in the range of 7-8% though we are still apprehensive about positive growth in Q3 FY21. Q4 GDP growth will definitely be in positive zone in the range of 1-2%.
- Coming to CPI inflation projections, RBI has projected Q3 inflation at 6.8% and 5.8% for Q4 FY21. For H1 FY22 RBI provided a range of 4.6-5.2% with balanced risks. Supply-side bottlenecks, large margins being charged to the consumers and cost-push pressures are some of the major risks for CPI, going forward.
- The outlook on global economic growth has improved with GDP projected to rise by around 4¼ per cent in 2021 and a further 3¾ per cent in 2022. However the recovery will be uneven across countries, potentially leading to lasting changes in the world economy. The outlook continues to be exceptionally uncertain, with both upside and downside risks.
- In this backdrop, RBI assesses that outlook for Q4 (October-December) of 2020 is overcast with a surge in COVID-19 infections in a second wave across Europe, the US and major emerging market economies (EMEs), with accompanying lockdowns. World is likely to slow in Q4 as pent-up demand is exhausted, inventory restocking is completed, and trade-related uncertainty is rising with the second wave.

IMPACT OF DEVELOPMENTAL & REGULATORY MEASURES

- **Liquidity Management for RRBs:** RRBs had limited avenues (Bank fixed deposits, Government securities and Non-SLR securities including mutual funds with cap of 5%) to deploy their surplus funds. While liquid mutual funds are a good option for short term overnight deployment of excess funds, other non-SLR securities are of little longer duration. Thus the current decision of extending the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) to RRBs in addition to permitting the RRBs to participate in the Call/Notice money market, both as borrowers and lenders is a welcome move which will help the RRBs to manage liquidity efficiently. Government securities held by RRBs account for around 29.5% of their total deposits, implying excess securities of 11.5% of their deposits or around Rs 50,000 crore.
- **Dividend Distribution by Banks:** RBI has decided that SCBs and cooperative banks shall not required to make any dividend pay-out for FY20. In Union Budget FY21, total dividend from the RBI, nationalised banks and financial institutions is estimated at Rs 89,648 crore. Of this, RBI has already provided dividend of Rs 57,128 to the Government. Now owing to this decision, we believe that there will be shortfall of around Rs 25,000-30,000 crore to the Government's budget estimate. However, this will surely augment the Tier I capital through internal plough back. Further RBI expanding the scope of dividend distribution direction to NBFC given the interlinkages through a formal rule-based guideline on dividend distribution by NBFCs is also a good move.
- **Strengthening Audit Systems of Supervised Entities (UCBs and NBFCs):** Risk Based Internal Audit (RBIA) was mandated by RBI for commercial banks in 2002. RBI has now decided to include UCBs and NBFCs in the preview of RBIA. The primary focus of RBIA is to provide reasonable assurance to the Board and top management about the adequacy and effectiveness of the risk management and control framework in the banks' operations. This is an expected (as UCBs are now under RBI regulation) and excellent step and will aid the ongoing risk management system by providing necessary checks and balances. However, since RBIA will be a fairly new exercise for UCBs and NBFCs, a gradual but effective approach would be necessary for its implementation. Further, the new guidelines will enable UCBs and NBFCs to appoint the audit firms as per their needs in a timely, transparent and effective manner. This is expected to improve the quality of financial reporting of UCBs and NBFCs.
- **Pushing Digital Payments:** With the increasing digital economy, RBI has taken a slew of measures to push further digital transaction with a better security management & controls. Some of them are: (i) Limits on contactless transactions has increased to Rs 5000 from Rs 2000, which will enhance customer convenience in general while benefitting from increased use of technology; (ii) Enabling Posting of Settlement Files of Payment Systems on all days, which will help banks to manage funds most efficiently; (iii) RBI will bring a detailed guidelines on digital payments security controls to bring security controls in the internet channels.
- **Measures on NBFC regulation & supervision:** Given the linkages that NBFCs have with banks and other segments of financial market, NBFC regulation needs to be fine-tuned. Accordingly the RBI will formulate a dividend distribution policy framework keeping in view the increasing significance of NBFCs in the financial system and their interlinkages with different segments. Different categories of NBFCs would be allowed to declare dividend as per a matrix of parameters, subject to a set of generic conditions. A draft circular in this regard will be issued shortly for public comments.
- Further a scale-based regulatory approach linked to the systemic risk contribution of NBFCs will be devised keeping in mind the interconnectedness of the NBFCs with rest of the financial system. To strengthen the corporate governance, Risk Based Internal Audit (RBIA) was mandated by RBI for commercial banks in 2002 will now be extended to NBFCs.
- **Export Trade Facilitation:** With a view to liberalising the export-import procedures, RBI has eased the process and allowed: (i) Removed the monetary ceiling for AD-I banks in dispatch of shipping documents directly to consignee or his agents; (ii) Delegate the power of allowing write-off to the AD banks, without limits in specified circumstances; and (iii) Set-off of Export Receivables against Import Payables. All this will give a boost trade activities and export credit consequently.

BANKING BUSINESS IMPROVING

- In the current FY so far, banking business is improving with renewed demand from corporates and retail segments. ASCBs incremental credit growth has turned positive in Nov'20 and grew by 0.3% (YTD) as on 06 Nov'20, compared to 0.8% growth during the corresponding period of last year. Aggregate deposits are also increasing continuously and touched 6.0% YTD growth compared to last year YTD growth of 3.4%.
- Demand for credit demand is coming back to traction in all sub-segments like housing, vehicle loans & other personal loans, it will push the growth to above last year number. We believe Emergency Credit Line Guarantee Scheme (ECLGS) would continue to play a major role in the sequential improvement in the bank credit. Banks have sanctioned Rs 2.03 lakh crore, out of which Rs 1.48 lakh crore has been disbursed till Oct'20 under the scheme.
- However, still we may not see much credit offtake for new facilities i.e. term loans, this year. However, in sectors facing stress i.e. real estate, construction, textile etc. with elongated working capital cycle, we may see higher utilisation in working capital limits. Further, we may also see enhancement in working capital limits under the ECGLS scheme as the scheme is since extended to entities in 26 stressed sectors identified by the Kamath Committee of RBI with health care sector with credit outstanding of above ₹50 crore and up to ₹500 crore as on 29.2.2020.
- Hopefully, many sectors are coming back to normalcy and once the normalcy is stabilised, further growth in credit may be expected. Further, we believe top rated corporates would re-finance their high cost debt with low cost loans offered by Banks, which are flush with funds with limited avenues for investments. It is pertinent to mention that, as per outstanding bank credit, as on March'20, still more than 37% of bank credit outstanding is above 10% interest rate.
- The good thing is that while analysing data of listed entities, it is observed that share of loanable funds of companies with interest coverage of less than one declined to around 20% in Sept'20 quarter as compared to 26% and 37% in Sept'19 and March'20 quarter.
- Weighted average yield (WAY) in Commercial Paper has also declined from more than 5% in April 2020 to sub 4% level because of various liquidity windows/schemes announced by Govt. of India and RBI. WAY further declined to 3.45% in Nov'20 from 3.77% in previous month.

PVT & FBs HAVE INCREASED LENDING RATES IN OCTOBER

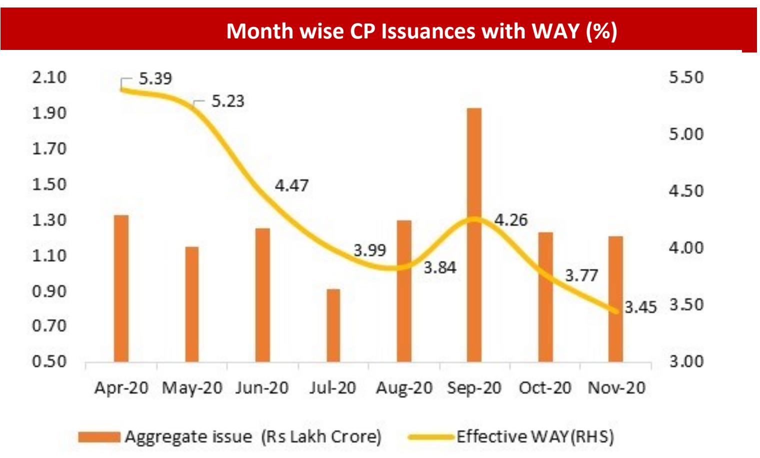
- In 2020, RBI has reduced the policy rate 115 bps and banks (across the groups) have also reduced their deposits and advances rates accordingly, for a better transmission. However, in October private and foreign banks have increased their lending rate on fresh loans (WALR) by 36 and 28 bps respectively, while PSBs have reduced 14 bps in October, compared to September.

Interest coverage and loan fund in listed space

Qtr ending	Total		Interest Coverage (IC) < 1			
	No. of Companies	Loan Funds Rs Crore	No. of Companies	Loan Funds Rs Crore	% Share in Loan Fund	% Share in no. of Companies
Q2FY21	2884	2117435	577	415615	20%	20%
Q4FY20	2884	2191204	718	802192	37%	25%
Q2FY20	2884	1856755	522	476268	26%	18%

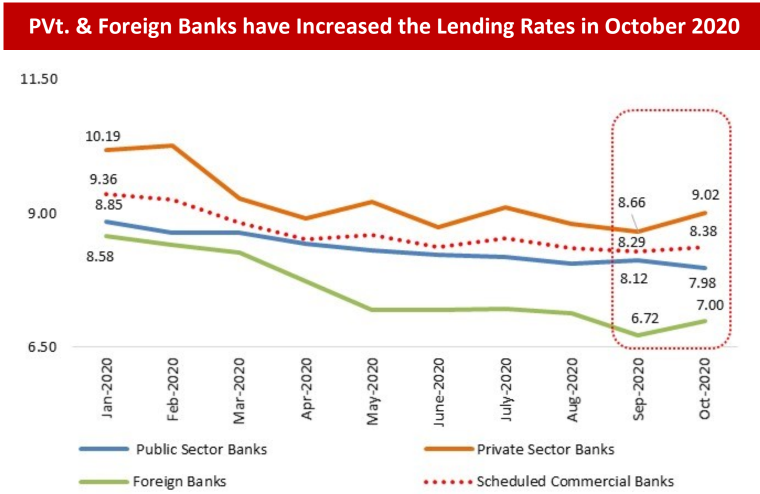
Source: Cline; listed entities ex BFSI; IC = PBIDT/Interest

Month wise CP Issuances with WAY (%)



Source: SBI Research

PVt. & Foreign Banks have Increased the Lending Rates in October 2020



Source: SBI Research

LIQUIDITY MANAGEMENT BY RBI

- The problem is however with liquidity in the banking system. Such Liquidity is composed of 2 parts. Structural and Cyclical. Structural liquidity refers to the level of reserves in the banking system created from deposits prior to market operations by the central bank to supply or drain reserves from the banking system. If we look at the structural liquidity in the system it has increased quite a bit and RBI has been conducting LAF operations to manage the same. However, RBI has also created cyclical liquidity, which is due to the policy measures and the intervention done by central bank to manage financial stability, through TLTRO, Forex purchases and OMO.
- BOP estimates show that overall BOP could cross $85 billion this fiscal leading to increased reserve accumulation by RBI. In the current fiscal RBI has already accumulated $100 billion in forex reserves so far. Past data indicates it was only in FY08 that RBI had accumulated forex reserves more than this amount. In FY08, forex reserves increased from $200 billion to $309 billion, an accretion of $110 billion. With the external sector metrics showing such upward movement, if RBI continues with its scheme of dollar purchase more cyclical liquidity will be created in the system. Our estimates show that overall net cyclical liquidity surplus will be around Rs 5.5-6.0 lakh crore by Mar'21.
- However, it is a good thing that cyclical liquidity has still not outpaced structural liquidity. RBI has been utilising liquidity management as a strategic tool for financial stability and is not focusing just on inflation. Linking liquidity management to inflation outcomes, in itself, is a complex exercise requiring the incorporation of the feedback-loop. Through cyclical liquidity management RBI has been able to influence the bond interest rate structure and borrowing rates and achieved its objective and this has been possible due to the credibility it has built about its "open mouth operations" / explicit forward guidance.

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