

TAKING A BOTTOM UP APPROACH TO FINANCIAL STABILITY

RBI Monetary Policy Committee today unanimously decided to keep policy Repo rate unchanged at 4% with accommodative stance. RBI's monetary policy statement draws a fine balance between the challenges posed due to COVID-19 pandemic shock and the need to support growth and financial stability. On the macroeconomic front, the outlook to growth continues to be negative with RBI refraining to give any number to the extent of the GDP contraction on account of COVID-19. The asymmetric recovery across rural and urban areas poses challenges in policy formulation. RBI today indicated that real GDP is expected to be in negative territory in H1 FY21 and FY21 overall.

The outlook on domestic inflation is equally uncertain as supply shock has limited the scope of monetary policy in containing the risk. RBI expects CPI inflation to remain elevated in Q2 FY21 but remain under control in Q3 FY21. Internationally benign fuel prices and soft aggregate demand have kept inflation subdued. However depreciation in dollar has fueled inflation in commodities which may compound inflation in emerging markets. On the balance demand shock as of now appears to net out the supply shock on price levels.

On the regulatory and development policy front the RBI has carefully addressed the concerns emanating from the wider market participants and has taken a bottom up approach to addressing financial stability. For a central bank, regulating and supervising the banks is an ongoing process and not a one-off event. It is akin to one's cleaning and setting one's house in order. Such tasks, however, are not taken up on rainy days when the outlook is gloomy and conditions are overcast. Instead, such activities are taken up on sunny days when the mood is cheerful and prospects are bright. This has been the motto of this RBI under the current dispensation and served the purpose meaningfully. Asphyxiation of credit had choked off the growth potential of the economy snowballing into a major slowdown of economic activity much before the COVID-induced lockdown. This was the result of banks earlier being caught in a pincer movement of intense regulatory monitoring and mounting non-performing assets that we need to avoid!

Notably, RBI has addressed the appeal to offer some form of restructuring facility for standard accounts that are facing difficulty in debt restructuring. For the first four months of FY21 (April to July), we have seen huge rating downgrades across sectors. Overall rating agencies have reported 4979 downgrades against only 395 upgrades during the period. The Resolution Framework for COVID-19-related Stress facility has been extended to large corporates, MSME and personal loans which were functioning well prior to COVID with safeguards in each segment. In particular, the provision to also engage the existing promoter and incentivize the Inter Creditor Agreement are low hanging fruits that will hasten the resolution.

To broaden the scope of Priority Sector Lending (PSL), RBI has announced to include start-ups, enhanced borrowing limits for renewable energy sectors and also increased the targets for lending to 'small and marginal farmers' and 'weaker sections'. Additionally, to address the regional disparities in the flow of PSL credit, RBI has put in place an incentive framework for banks, in which higher weight will be assigned for incremental PSL credit in the identified districts where credit flow is comparatively lower and a lower weight would be assigned to incremental PSL credit in identified districts where the credit flow is comparatively higher. LTV on gold loans for non-agri purpose is increased from 75% to 90% tracking the pro-cyclical trend in price of collateral and is likely to benefit those banks and NBFCs which have large gold loan business.

The announcement on CRR, mechanism to check and track multiple operating accounts by large borrowers will benefit the industry at large. Harmonizing the capital charge for market risk for debt and equity mutual funds is also a good move towards capital conservation given the volatility has increased after COVID-19 pandemic.

In conclusion, the decision to hold the policy rate was correct as trajectory of economic growth, inflation and external demand continues to be uncertain. The calibrated approach is in consonance with evolving situation while keeping enough headroom for future.

RBI HOLDS THE RATES, AS EXPECTED

- ◆ As widely expected, RBI's Monetary Policy Committee today unanimously decided to keep policy Repo rate unchanged at 4% with accommodative stance. Reverse repo rate remains unchanged at 3.35% and MSF and the Bank Rate remain at 4.25%.
- ◆ RBI further indicated that real GDP is expected to be in negative territory in H1 FY21 and FY21 overall. However, we believe that all the four quarters of FY21 will exhibit decline in real GDP growth with overall decline in the range in double digits. The Q1 FY21 real GDP growth will be the steepest decline though not as deep as -40% as was anticipated in some quarters.
- ◆ RBI expects CPI inflation to remain elevated in Q2 FY21 but remain under control in Q3. Though the MPC is conscious that its primary mandate is to achieve the medium-term target for CPI inflation of 4% (+/- 2%), the inflation objective itself is further obscured by (a) the spike in food prices because of floods in eastern India and ongoing lockdown related disruptions, and (b) cost-push pressures in the form of high taxes on petroleum products, hikes in telecom charges, rising raw material costs reflected in upward revisions in steel prices and rise in gold prices on safe haven demand. Our preliminary assessment of inflation trajectory indicates that inflation may be highly uncertain and will tilt in any direction from the current level.
- ◆ Transmission of interest rates has happened with ease due to ample liquidity injection by RBI.

GLOBAL ECONOMY

- ◆ Global economic activity has remained fragile and uneven in several geographies. While the uneasy and differently-paced withdrawal of COVID-19 lockdown restrictions in some countries enabled a sequential improvement in high frequency indicators during May-July, a renewed surge in COVID-19 infections in major economies and threats of a second wave of infections appear to have weakened these early signs of revival. Contractions in economic activity have been more severe in Q2:2020 than in Q1, and the near-term outlook points to a slow, uneven recovery with risks steeply slanted to the downside.

INFLATION TRAJECTORY HAS A CLEAR BREAK

- ◆ MPC in its resolution document indicated that since NSO has not provided inflation rates for April and May, the CPI prints for April and May can be regarded as a break in the CPI series and now the inflation trajectory will start from June. MPC also recognizes that the headline CPI prints of April-May, 2020 require more clarity. This indicates that the imputed numbers provided by NSO has no value for MPC in deciding the policy rates. We have already highlighted this issue in our **Ecowrap dated 16 July** and reported that, *"With lockdowns, the fixed basket on which inflation is calculated is totally irrelevant as many of those typical items, particularly services are no longer available / disappearing product problem.....extrapolating price trends of overall CPI basket (which were largely driven by food and fuel sub groups) to key Core components such as Clothing, Footwear, etc. by NSO is puzzling and incorrect. This has resulted in a paradoxical problem of significant jump in prices in commodities like Clothing and Footwear and even intoxicants in April when the country was in the midst of the strictest lockdown and these commodities were not even consumed"*.

- Further, following the methodology that Cavallo (NBER, June 2020) has employed to estimate headline CPI in India, our computed headline inflation is much higher than the imputed NSO inflation, with Jun'20 inflation almost 90 basis points higher than the imputed inflation of NSO at 6.1%. Consumers are now spending minimal amount on services like hotels, restaurants, and recreation, which are experiencing significant declines in inflation, while expenditures on food and other groceries have increased in both absolute and relative terms, which are witnessing rapid inflation because of supply bottlenecks and are hence imparting an even further upward bias to headline CPI.
- However, there is another twist in the story. Currently, the NSO measures CPI based on the Consumer Expenditure Survey (CES) of 2011-12. The next round of the survey will be carried out in 2021. The CES survey shows a clear downward trend in expenditure on food but the data is not available beyond 2012 and thus the CPI weights based on the CES survey are largely overstated and misleading. There is a stark difference between the weightage of food based on the CES at 46% and that published by the National Account Statistics at 30% — this can have a significant downward impact on CPI even in the baseline scenario.
- Take for example the rising prices of milk in headline CPI that is utterly perplexing in the current circumstances. Paradoxically, headline CPI does not capture the products made from milk. This non-inclusion of sweets is giving a completely distorted picture of milk prices in the current as institutional buyers such as hotels, sweet shops, private dairies have sharply reduced their procurement which should have resulted in lower milk prices.

IMPACT OF DEVELOPMENTAL & REGULATORY MEASURES

- Resolution of COVID-19 related stress:** RBI, keeping mind the hardships generated by COVID has come up with the steps aimed to support businesses which were functioning well prior to COVID and has announced restructuring of accounts.
- Subsequently, RBI has now allowed accounts to be restructured by the lenders to implement a resolution plan in respect of eligible corporate exposures even without change in ownership. For lending institutions this is a positive development as it could be used both as a carrot and stick to get promoters onto the resolution table and also save time as buyers in the current uncertain environment and given that NCLT is now in suspended animation. Furthermore, only genuinely stressed borrowers, whose accounts were in trouble after 1 March 2020, will be able to avail this scheme.
- The implementation of the scheme also entails higher of the provisions held as per the extant IRAC norms immediately before implementation, or 10% of the total debt, including the debt securities issued in terms of clause 30, held by the ICA signatories post-implementation of the plan (residual debt). This will ensure that unanimity of decisions is reached quickly across borrowers that will only hasten the resolution process.
- An expert committee** under RBI shall recommend a list of financial parameters which, in their opinion would be required to be factored into the assumptions that will go into each resolution plan, and the sector specific benchmark ranges for such parameters. The Expert Committee shall also have the responsibility of vetting the resolution plans to be implemented under this window in respect of all accounts where the aggregate exposure of the lending institutions at the time of invocation of the resolution process is ₹1500 crore and above.

- What could be the stressed sectors?** Major sectors that have opted for relief under moratorium on loan servicing includes Metal, Power, Real Estate Textile, Construction etc. (see table). However, all may not be under stress and some of the entities in the sectors such as Pharma, FMCG might have opted due to uncertainty and prefer to conserve cash during these times. For the first four months of FY21 (April to July), we have seen huge rating downgrades across sectors. Overall rating agencies have reported 4979 downgrades against only 395 upgrades during the period. Sector wise credit ratio depicts, no sector is untouched from the pandemic and rating agencies has reported huge rating downgrades across sectors (see table).

Major sectors opted for moratorium on loan servicing			
Sector	Rated Amount (Rs in cr)	Debt Equity Ratio (D/E)	Cash and Bank to Loan fund
Metal & Metal Products	116412	1.32	0.08
Petrochemicals	62209	0.21	0.41
Power	53019	1.76	0.04
NBFC	31584	-	-
Real Estate	31525	0.55	0.26
Pharmaceuticals	28798	0.39	0.35
Textile	6163	1.12	0.07
Hotel & Restaurants	4093	1.05	0.09
FMCG	3215	0.33	0.58
Constructions	2992	1.86	0.09
Auto & Auto Ancillary	2632	0.57	0.23
Infrastructure	1726	1.76	0.17
Hospital	1500	-	-
Consumer Durable	940	0.18	0.92
Gems & Jewellers	436	0.37	1.52

Source: SBI Research; ICRA moratorium list; Cline listed entities March'20

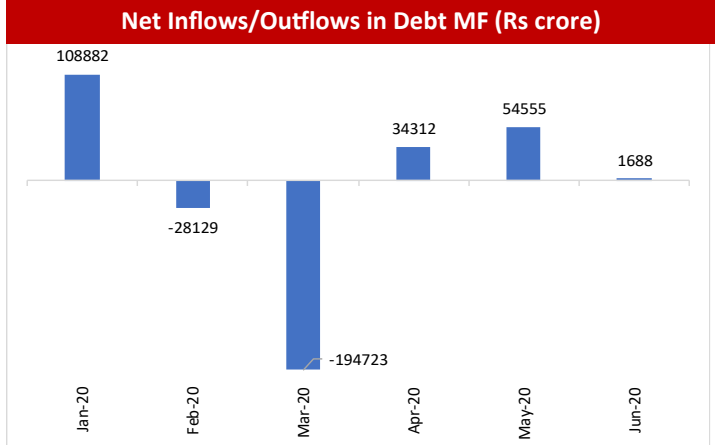
- We expect, borrowers from sectors such as Constructions, Metal, Real Estate, Textile, Hotels & Restaurants, Power, Capital Goods etc. are going to approach their lenders for a resolution under the new framework.

Sectorwise Credit Ratios during Q1 FY2021			
Sectors	April to June 2020		
	Upgrades	Downgrades	Credit Ratio
Steel	8	140	0.06
Construction	23	364	0.06
Capital Goods - Electrical Equipment	5	100	0.05
Hotels & Restaurants	-	57	-
Automobile	-	6	-
Capital Goods-Non Electrical Equipment	45	770	0.06
Auto Ancillaries	5	95	0.05
IT - Software	3	62	0.05
Cement	-	5	-
Pharmaceuticals	12	51	0.24
Diamond, Gems and Jewellery	-	79	-
Gas Distribution	1	-	-
Healthcare	22	109	0.20
Non Ferrous Metals	1	30	0.03
Consumer Durables	1	71	0.01
FMCG	29	481	0.06
Fertilizers	4	22	0.18
Telecomm-Service	-	3	-
Textiles	12	365	0.03
Realty	6	160	0.04

Source: CRISIL - numbers for all rating agencies; SBI Research

- MSME accounts also to get the benefit of restructuring:** Keeping in line with these guidelines, for MSMEs whose aggregate exposure, including non-fund based facilities, does not exceed ₹25 crore as on March 1, 2020 and whose account was a 'standard asset' as on March 1, 2020, their existing loans classified as 'standard' may be restructured without a downgrade in the asset classification. Asset classification of borrowers classified as standard may be retained as such, whereas the accounts which may have slipped into NPA category between March 2, 2020 and date of implementation may be upgraded as 'standard asset', as on the date of implementation of the restructuring plan.

- ◆ Farm credit , Loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi- Purpose Societies (LAMPS) for on-lending to agriculture, Government agencies, certain housing finance companies and personal loans can also be restructured under this resolution plan.
- ◆ **Revisiting PSL Lending:** To broaden the scope of Priority Sector Lending (PSL), RBI has announced to include start-ups, enhanced borrowing limits for renewable energy sectors and also increased the targets for lending to 'small and marginal farmers' and 'weaker sections'.
- ◆ Additionally, to address the regional disparities in the flow of PSL credit, RBI put in place an incentive framework for banks, in which higher weight will be assigned for incremental PSL credit in the identified districts where credit flow is comparatively lower and a lower weight would be assigned to incremental PSL credit in identified districts where the credit flow is comparatively higher.
- ◆ With the change in definition in 2015, banks will be able to achieve the overall PS lending targets. However, shortfalls were found in certain sub-targets: PSBs in micro enterprises; PVBs in small and marginal farmers; and both PVBs and FBs in non-corporate individual farmers. With the change in definition, this will help banks to achieve the targets and credit would be available to desired sectors. There are 360 districts in India where CD ration is below 50%. So, with this move the credit distribution would be more uniform.
- ◆ In India, we have around 4.2 lakh Start-ups, of which 34,569 DPIIT recognised. Generally, initially start-ups funded by venture capital funds, and foreign funds. There are also some state government funds to promote start-ups. However, there was a need for permanent source of funds for the growth of the start-ups. . With the inclusion in PSL, now banks will be able to fund good start-ups, which will boost employment in the economy.
- ◆ **Removal of differential capital requirement for banks investments in Debt instruments through MF/ETF:** This measure is positive for banking sector as there will be no need for banks to withdraw money at quarter end period to save on capital charge.
- ◆ As debt MF/ETF also has equity like features, general market risk of 9% will continue to hold. Furthermore, specific risk charge will be applicable as per Basel norms and in case of debt mutual fund/ETF which contains a mix of the debt instruments, the specific risk capital charge of the lowest rated debt instrument/ instrument attracting the highest specific risk capital charge in the fund will be applied.
- ◆ This in turn will be clearly beneficial for the mutual fund industry as well since they will not have to sell in quarter end to meet banks' redemption needs. Also, some banks may simply shift their debt portfolio management to MFs/ETFs so it could lead to increased flows into mutual fund industry. This could well arrest the lower pace of net inflows into debt mutual funds which witnessed decline in net inflows to Rs 1688 crore in Jun'20 compared to Rs 54,555 crore in May. Also, this move is expected to stabilise bond yields, thereby positive for bond markets.



Source: SBI Research

- ◆ **LTV on gold loans for non-agri purpose increased from 75% to 90%:** The move is aimed at helping the borrowers having temporary liquidity shortages and will also likely benefit those banks which have large gold loan business.
- ◆ **Flexible Automated Option in e-Kuber for managing CRR Balances:** This is another major initiative which will give operational convenience to banks in managing liquidity and reduce compliance burden on treasury.
- ◆ Other Measures, including additional liquidity of Rs 5000 crore for NABARD and NHB, Streamlining the use of multiple operating accounts by large borrowers, encouragement of offline payment solutions, online dispute resolution of digital payments, Positive Pay mechanism for cheques and creation of Reserve Bank Innovation Hub are all welcome moves in the right direction.

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Contact Details:

Dr. Soumya Kanti Ghosh
 Group Chief Economic Adviser
 State Bank of India, Corporate Centre
 Nariman Point, Mumbai - 400021
 Email: soumya.ghosh@sbi.co.in
 gcea.erd@sbi.co.in
 Phone:022-22742440
 :@kantisoumya