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RBI PROCLIVITY FOR GROWTH: REPO RATE LIKELY TO DECLINE TO LOWEST EVER IN CURRENT CYCLE

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For the second time in succession, the RBI frontloaded its rate action and regulatory measures. While the market was expecting regulatory action from RBI regarding the clarification of moratorium, the cut in rates reflects the RBIs anxiety in keeping pace with the cycle. In a span of just 2 months MPC has now reduced policy rate by 115 bps. We expect the terminal repo rate to be cut by 100 basis points in the current cycle even after today's rate cut. An aggressive cut in repo rate is the effective policy response to adjust the real interest rate as inflation is set to collapse in FY21. This will have a significant sobering impact on asset quality of banks as RBI research shows. The RBI has now admitted that GDP is likely to contract in FY21.

Even as the economic impact caused by the epidemic looks likely to be of gigantic proportions, the long run effects on the economy can only be less severe as long as the Government and RBI act quickly and decisively to contain the fallout. Once the epidemic is over, there will be some catch-up growth as businesses restock inventories and consumers make up for forgone spending. But there will be a difference between the shape of the post-epidemic recovery in manufacturing, which will probably experience a sharp rebound, and the services sector, which may struggle for a longer period of time. **As of now, the RBI has done much of the heavy lifting and it is certain that the Government will have to support the sectors ravaged by economic slowdown at some point of time.**

The RBI has taken several regulatory measures.

First, RBI has extended the moratorium on term loan instalments by another three months, i.e., from June 1, 2020 to August 31, 2020. Accordingly, tenor for such loans, may be shifted across the board by another three months. We believe for the majority of retail borrowers who fall in such category, this extension will only elongate the repayment by an equal period and may not see any stress in the portfolio. As regards to corporate, as around 75% of the corporate credit is rated A and above they should not face any repayment issue post moratorium. Furthermore, RBI has also deferred Interest on Working Capital Facilities. Banks are now permitted to convert the accumulated interest on working capital facilities over the deferment period into a funded interest term loan (FITL) which shall be repayable within the current financial year (i.e., March 31, 2021). We feel majority of MSMEs have opted for the same and possibly around half of corporates have opted for it. Further, with around 75% of such Debt is A and above rated, we expect them to be able to pay the accumulated interest as scheduled or to the FITL..

Second, in the light of the Covid-19 pandemic and the consequent stress on State Government finances, the RBI has reviewed the Consolidated Sinking Fund Scheme to ease the redemption pressure on SDL during the financial year. Such relaxations to states will release an additional amount of about Rs. 13,300 crore. Together with the normally permissible withdrawal, this measure will enable the states to meet about 45% of their redemptions due in 2020-21 through withdrawal from CSF.

Third, the ease in exposure limit for large corporates by 5%, will give additional headroom to the banking system, to lend to the large corporate groups, which have Tier 1 capital of approx Rs 12 lakh crore.

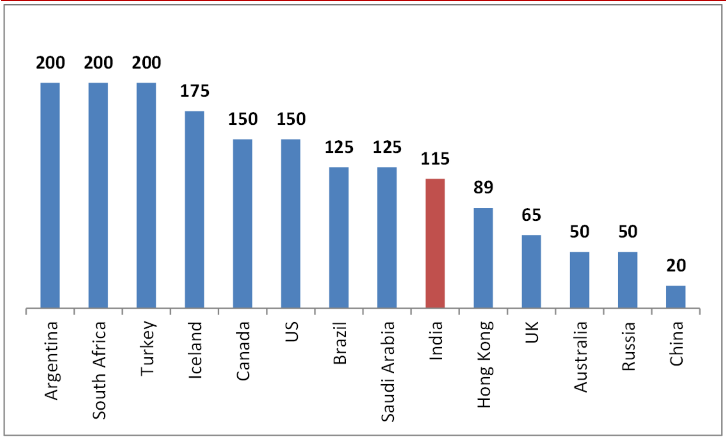
Fourth, the extension of duration of loans for exporters will help the former by ensuring that they manage their working capital cycle effectively. Furthermore, efforts have been taken to provide relief to importers by extending the time period for completion of remittances against normal imports into India from six months to twelve months. This will provide greater flexibility to importers in managing their operating cycles and avoid unavoidable delays in movement of goods and documents in a COVID-19 environment.

Meanwhile, given that the current approach to asset recognition and restructuring are quite stringent in light of stress created by the pandemic, going forward, we expect a one time restructuring by RBI and a change in asset quality norm from 90 days to 180 days. Further this relaxation should be given along with a well laid out calendar of returning to the current norm of 180 days in the next two years!

RBI CUTS RATES BY 40 BPS

- As widely expected, RBI's Monetary Policy Committee today reduced Repo rate by another 40 bps to 4.0%. Earlier in March MPC had reduced Repo rate by 75 bps. Hence in just a span of 2 months MPC reduced policy rate by 115 bps. In May, 16 countries including India have reduced their policy rates. With the reduction of repo rate all other linked rates has also reduced by 40 bps. Country-wise data also indicate that most of the major economies have reduced their policy rates by more than 100 bps during Mar-May period.
- RBI today hinted that India's GDP growth for FY21 would be in negative territory. Our latest estimates indicate that India real GDP growth would decline by as much as 6.8% in FY21 as lockdown has disrupted almost 50% economic activity in Q1.
- RBI has indicated that inflation outlook will remain highly uncertain as supply lines are still get to restored in the coming months with gradual relaxations in the lockdown. The unusual spike in food inflation in April is expected to moderate in the coming months due to expectation of normal monsoon and restoration of supply.
- In the current downward rate cycle, which started in Feb'19, RBI has reduced the policy repo rate by 250 bps, transmission in the bank lending channel has happened substantially. The transmission in the 1 Yr Median MCLR is 80 bps till Apr'20, on WALR on fresh rupee loans has declined by 114 bps till Mar'20, while the WALR on outstanding rupee loans declined by 27 bps in Jan'19-Mar'20.

Country-wise Reduction in Policy Rate during Mar-May (in bps)



Source: BIS; SBI Research

- The Weighted Average Domestic Term Deposit Rates (WADTDR) on O/S term deposits declined by 53 bps only between Jan'19-Mar'20. So, to pass on the decline in policy rate benefits, banks have also reprised the saving banks rate significantly. In the banking space, we see that the PSBs, while transmitting the repo rate cut, have tried to minimize the cut in term deposit rates to have minimal impact on the depositor. Meanwhile, for pvt banks the deposit rate cuts have been more aggressive than the MCLR cuts. Foreign banks have aggressively cut both the MCLR and term deposit rates.

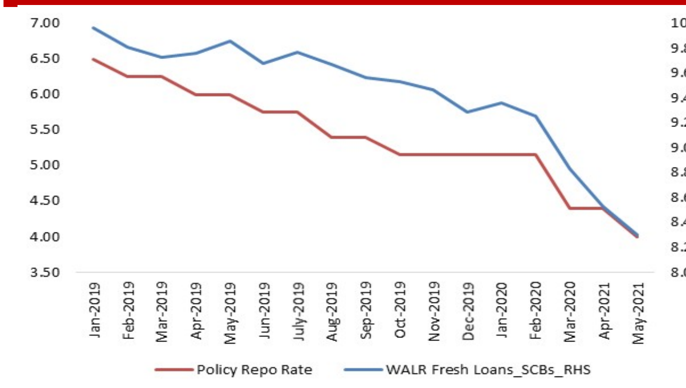
GLOBAL ECONOMY

- Since the last monetary policy meeting the global economic outlook has only deteriorated. Global economic activity has remained in standstill under COVID-19 related lockdowns and social distancing. Among the key advanced economies (AEs), economic activity contracted in the US, Euro area, Japan and the UK in Q1:2020. Among emerging market economies (EMEs), the Chinese economy went into a pronounced decline.
- ADB estimates that the world could suffer between $5.8 trillion and $8.8 trillion in losses—equivalent to 6.4% to 9.7% of global gross domestic product (GDP)—as a result of the COVID-19 pandemic. Economic losses in Asia and the Pacific could range from $1.7 trillion under a short containment scenario of 3 months to $2.5 trillion under a long containment scenario of 6 months, with the region accounting for about 30% of the overall decline in global output.

IMPACT OF DEVELOPMENTAL & REGULATORY MEASURES

- **Consolidated Sinking Fund (CSF) of State Governments:** In the light of the Covid-19 pandemic and the consequent stress on State Government finances, the RBI has reviewed the CSF Scheme to ease the redemption pressure on SDL during the financial year.
- State Governments maintain CSF and Guarantee Redemption Fund (GRF) with the Reserve Bank as buffer for repayment of their liabilities. States can avail of the Special Drawing Facility (SDF) at a discounted rate from the Reserve Bank against incremental funds invested in CSF and GRF as collateral. The rate of interest on SDF is currently 200 bps below the repo rate with effect from June 2018. Taking into account the announcements today this translates into 2% rates of interest for states to borrow from SDF using CSF fund.
- These relaxations to states will release an additional amount of about Rs. 13,300 crore. Together with the normally permissible withdrawal, this measure will enable the states to meet about 45 per cent of their redemptions due in 2020-21 through withdrawal from CSF.
- **Relief to Exporters:** In case of exports, the increase in maximum period of pre-shipment and post- shipment export credit sanctioned by banks from the existing one year to 15 months, for disbursements made up to July 31, 2020 is commendable. ASCB export credit has been on a declining trend with outstanding credit at around Rs 1.8 lakh crore as on Apr'20, registering negative growth of -15% to 20% yoy during the month. The extension of duration of loans will provide relief to exporters who are suffering from delayed or postponement of orders/ payment owing to Covid-19 pandemic by increasing their working capital cycle.
- **Line of Credit to EXIM bank:** In addition, extension of line of credit of ₹15000 crore to the EXIM bank for a period of 90 days from the date of availment with rollover up to a maximum period of one year so as to enable it to avail a US dollar swap facility to meet its foreign exchange requirements is a welcome move. Exim Bank's resource base inter-alia includes rupee bonds, certificates of deposit, commercial papers, term deposits, FC bonds, FC loans and long-term swaps.
- During FY19, the Bank raised borrowings of varying maturities (excluding raised and repaid during the year) aggregating ₹152.50 billion, comprising Rupee Resources of ₹81.96 billion and foreign currency resources of US$ 1.02 billion equivalents, net of amounts raised and repaid. This extension of line of credit will provide substantial liquidity relief to Exim Bank as it is facing issues in raising funds from international debt capital markets.

Transmission of Policy Rate



Source: SBI Research, RBI

Investments in CSF/GRF by States

State/UT	CSF	GRF	CSF as per cent of Outstanding Liabilities
Andhra Pradesh	7,459.0	735.0	3.0
Arunachal Pradesh	1,027.0	1.0	13.4
Assam	3,732.0	47.0	5.6
Bihar	6,371.0	-	3.9
Chhattisgarh	3,743.0	-	5.9
Goa	539.0	270.0	2.8
Gujarat	12,346.0	428.0	4.3
Haryana	1,879.0	1,074.0	1.0
Karnataka	3,466.0	-	1.3
Kerala	1,942.0	-	0.8
Madhya Pradesh	-	832.0	0.0
Maharashtra	33,388.0	267.0	6.7
Manipur	339.0	90.0	3.3
Meghalaya	551.0	27.0	5.1
Mizoram	497.0	29.0	6.3
Nagaland	1,336.0	29.0	12.8
Odisha	12,053.0	1,301.0	12.0
Punjab	-	-	0.0
Rajasthan	-	-	0.0
Tamil Nadu	5,973.0	-	1.6
Telangana	4,831.0	828.0	2.6
Tripura	295.0	4.0	1.9
Uttar Pradesh	-	-	0.0
Uttarakhand	2,709.0	71.0	4.8
West Bengal	9,938.0	479.0	2.5
Puducherry	289.0	-	1.7
Total	**1,14,701.0**	**6,514.0**	**2.6**

Source: Report on State Finances

- **Relief for Importers:** Furthermore, efforts have been taken to provide relief to importers by extending the time period for completion of remittances against normal imports into India (except in cases where amounts are withheld towards guarantee of performance) from six months to twelve months from the date of shipment for such imports made on or before July 31, 2020. The measure will provide greater flexibility to importers in managing their operating cycles and avoid unavoidable delays in movement of goods and documents in a COVID-19 environment.

- **Rollover of refinance facility to SIDBI:** Another measure to help the AIFIs in India is the rollover of refinance facility of ₹15,000 crore to SIDBI for on-lending/refinancing at policy repo rate, for another period of 90 days. SIDBI's institutional finance portfolio was around ₹125000 crore in FY19, with finance provided for 26 banks and 24 NBFCs. The assistance has benefitted more than 6 lakh MSE units in FY19. With the Government focus on small and medium enterprises, this refinance facility will help SIDBI in re-energizing the MSE lending in the country.
- Besides the above, the RBI has decided to extend Voluntary Retention Route (VRR) for FPI by another 3 months to smoothen the functioning of markets.
- **Moratorium on Term Loan Instalments:** On March 27, 2020, the RBI permitted all commercial banks, co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies and micro-finance institutions) to allow a moratorium of three months on payment of instalments in respect of all term loans outstanding as on March 1, 2020. Now, in view of the extension of the lockdown and continuing disruptions on account of COVID-19, RBI has permitted to extend the moratorium on term loan instalments by another three months, i.e., from June 1, 2020 to August 31, 2020. Accordingly, tenor for such loans, may be shifted across the board by another three months.
- **Deferment of Interest on Working Capital Facilities:** Further, in view of the above, in respect of working capital also banks are being permitted to allow a deferment on interest payment for another three months i.e. from June 1, 2020 to August 31, 2020 in respect of all such facilities outstanding as on March 1, 2020.
- **Payment of Interest on Working Capital Facilities for the Deferment Period:** In order to ameliorate the difficulties faced by borrowers in repaying the accumulated interest at one go, lending institutions will be permitted to convert the accumulated interest on working capital facilities over the deferment period into a funded interest term loan (FITL) which shall be repayable within the current financial year (i.e., March 31, 2021). This is a much-required step, as it would have been practically difficult for borrowers particularly MSMEs to pay the entire accumulated interest at one go.
- For **Working capital deferment,** we feel majority of MSMEs have opted for the same and possibly around half of corporates have opted for it. Further, with around 75% of such Debt is A and above rated, we expect them to be able to pay the accumulated interest as scheduled or to the FITL. Though, majority of MSMEs will opt for FITL, it is important to see their repaying capacity/cash flows as the same needs to be paid within this financial year itself. **As the MSME book from banking system stands at around Rs 14 lakh crore, assuming 2/3rd have opted for moratorium and 70% of it is working capital, interest on around Rs 6-7 lakh crore loan which is required to be funded through FITL works to around Rs 30000 – 35000 crore.**
- **Limit on Group Exposures under the Large Exposures Framework :** In view of the Covid-19 pandemic and uncertainties in financial markets, many corporates are finding it difficult to raise funds from the capital market and are dependent primarily on Banks funding. In order to facilitate the flow of resources to corporates, RBI, as a one-time measure, increased bank's exposure to group from current 25 per cent to 30 per cent of the eligible capital base of the bank. The increased limit will be applicable up to June 30, 2021. This will facilitate large groups to raise funds from banks and also boost credit growth. **This ease in exposure limit by 5%, will give additional headroom to the banking system, to lend to the large corporate groups, which have Tier 1 capital of approx Rs 12 lakh crore**. For example, Bank with an eligible capital base of say Rs 2 lakh crore can get additional headroom of Rs 5000 crore to a group.
- **Restructuring and change in NPA norms:** The current approach to asset recognition and restructuring are quite stringent in light of stress created by the pandemic. Since many of the services such as hotels and restaurants will not be able to operate at full capacity, there is need to allow one time restructuring of exposures to ensure that these business survive in the long run.
- Additionally, the income recognition and asset classification (IRAC) norms as it has evolved in India shows that there is no direct linkage between IRAC norm used by banks and economic growth. The best period of economic growth 1994-2004 was achieved when RBI followed 180-day norm. The growth rates after 2004 have also been good when 90-day norm was in force.
- The 90-day norm is not suited to Indian conditions as the liability side of the Indian banking system has very little market-based funding. Thus 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 banks under the current situation.

Rating wise share in Corporate Credit	
Rating	Share %
AAA (20%)	19.39
AA (30%)	31.65
A (50%)	23.4
A and above	**74.44**
BBB (100%)	14.68
BB & below (150%)	10.88
Source: SBI research, FSR Sep'19	

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