Monetary Policy Review – RBI ties up the missing piece: a credible restructuring plan that won’t lead to moral hazard

RBI kept its key policy rates unchanged through a unanimous vote of the Monetary Policy Committee (MPC). Thus Repo, Repo rate & MSF rate stands at 4.00%, 3.35% and 4.25%. The MPC decided to continue with the accommodative stance of monetary policy as long as it is necessary to revive growth and mitigate the impact of coronavirus (COVID-19) on the economy. MPC refrained from releasing a projection for 2000-21 in its second bi-monthly policy review for the year. It, however, did mention in its statement, that it expected the growth to be negative for 2020-21. expects inflation, both food and non-food to remain elevated in the first half of 2020-21 as supply chain disruptions on account of Covid-19 persist. It expects inflation to moderate in the second half mainly on account of favourable base effect and probable softening of food prices owing to bumper kharif output and moderate increase in marginal support prices for the season. RBI’s survey on business confidence showed a major drop while consumer confidence plummeted to all time low even as capacity utilization levels showed an improvement to 69.9% in March 2020 quarter.

The following regulatory and supportive measures were announced too.

- RBI allowed banks onetime restructuring of loans of borrowers who are in financial difficulty on account of Covid-19 impact and are unable to repay them. The resolution of stressed loans will be available only to those borrowers who were repaying their loans regularly as on 1 March 2020. Borrower will have to get a resolution plan sanctioned before 31 December 2020 and the bank will need to implement it within 180 days from the date of invocation. The restructured loan will continue to be considered as standard assets till the borrower sticks to the resolution plan. The lenders, however, will have to keep and additional provisions of 10 per cent on the post-resolution debt. Banks can reschedule the payments, convert interest into another credit facility, and provide moratorium of up to two years. This would cover both corporate and personal loans.

- Increased the permissible loan to value ratio (LTV) for bank loans against pledge of gold ornaments and jewellery for non-agricultural purposes from 75 per cent to 90 per cent. This relaxation will be available till 31 March 2021.

- Computation of total capital charge of nine per cent for market risk shall now incorporate elements of both debt and equity instruments. This will result in substantial capital savings for banks and give a boost to the bond market.

- Additional liquidity facility (ASLF) of Rs.50 billion for National Housing Bank to be extended at the repo rate for a period of one year. This is over and above Rs.100 billion already provided. Additional liquidity support of Rs.50 billion to NABARD for a period of one year at the repo rate for refinancing NBFC-MFIs and other smaller NBFCs of asset size of Rs.5 billion and less, to support agriculture and allied activities and the rural non-farm sector. This is over and above the Rs.250 billion liquidity support extended in April 2020.

- RBI has decided to introduce an optional facility to provide banks more flexibility/discretion to manage their day end cash reserve ratio (CRR) balances.

- Awarded priority sector lending status to loans provided to start-ups.

- RBI will soon introduce a scheme of retail payments in offline mode using cards and mobile devices, and a system of online dispute resolution (ODR) mechanism for digital payments.

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RBI keeps rates unchanged closer to historic lows

Exhibit 1: RBI keeps policy rates unchanged

![Graph showing RBI's policy rates from 2002 to 2020, with rates at 4.75% and 4.25% highlighted.](source: RBI, ASKWA Research)

Real rates stay negative in sync with negative real growth, liquidity support continues

Exhibit 3: Real rates negative since Nov-19

![Graph showing real rates from 2012 to 2020, with rates at 4.5% and 6.1% highlighted.](source: CMIE, RBI, ASKWA Research)

Exhibit 4: Huge liquidity support continues

![Graph showing huge liquidity support from Sep-18 to Jul-20, with Net LAF deficit at -2500 INR bn.](source: CMIE, RBI, ASKWA Research)

The transmission is happening even in the more difficult credit market, credit spreads have eased too

Exhibit 3: Rate transmission effective in credit market

![Graph showing rate transmission in credit market from Apr-15 to Apr-20, with WALR at 100 and AAA spreads at 200 highlighted.](source: CMIE, RBI, ASKWA Research)

Exhibit 4: Credit spreads have moderated too

![Graph showing credit spreads from Apr-15 to Apr-20, with AAA spreads at 500 highlighted.](source: CMIE, RBI, ASKWA Research)
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Implication and outlook:

RBI took a calculated pause while maintaining the accommodative stance without any indication of its expiry date. While the cumulative reduction in policy rates is still sipping through the financial market and especially through the difficult credit market – it undoubtedly had a salutary effect already in ensuring financial stability coming on the heels of some institutional failures and the aftermath of Covid-19 crisis. As a result, credit spreads even for lower rated corporate bond papers have shown signs of easing.

RBI has also sequenced its rate cuts well. As the baseline expectations suggest, inflation would start easing from Sep-20 onwards by when a good part of borrowing programme would also be completed. Rate cuts then would be far more effective and positions us well to save some ammunition for any likely adverse global or domestic development from a second upsurge of virus cases. In the interim an arrangement was needed to keep the deserving households and corporates financially afloat and provide some regulatory dispensation to the banks too to make this workable. The restructuring plan has addressed just that.

First, the ambit of the restructuring plan, unlike previous such instances, have been extended to retail loans too. Also, the LTV for gold loans has been enhanced allowing households to dip into their past savings to withstand the difficult period and help in financialization of static gold assets. Second, a clear entry barrier has been put by making only performing loans of pre-Covid-19 period eligible for this. Third, sufficient filters have been put in place to discriminate the good borrowers from the bad (the discretion of which would still lie with the bank) within the broad framework already laid out by RBI and also to be fine tuned later by the KV Kamath Committee. Fourth, a detailed accountability framework too has been put in place with responsibilities demarcated and ongoing monitoring mechanism. Fifth, an incentive schemes has been put in place with graded provisioning for the banks to come on board while both the banks and borrowers enjoy a two year period back to viability. Sixth, the scheme is intended to be well targeted by specifically addressing the deserving sector keeping NBFCs, govt. cos. etc. outside its scope. The restructuring scheme therefore has all the ingredients of being a game changer in dealing with Covid-19 situation.

There is however, some concern that for these two years’ banks’ accounts wont reflect the true picture of its credit quality as at present banks are not required to disclose the extent of restructuring and likely loss there. This however, may change and as seen even with moratorium bank-wise information started becoming available after a while. Information disclosure standards are likely to be put in place with specifics of the regulation in place allowing financial markets to continuously price such information.

While there may not be anything immediate for the bond market resulting in 10yr benchmark yield hovering back to near 6% level, there are many comfort lines to look forward to during H2FY21. Besides the likely ease of inflation, as per our calculation borrowing programme of this year is likely to have a smooth sail even without any extraordinary measure by RBI including any additional OMO for the remaining part of the year. Low credit growth, stable INR, a more tolerant view by rating agencies, ultra-loose monetary policy by global central banks – all are likely to have a moderating impact. If however, push comes to shove, as mentioned on earlier occasions, RBI has enough and more in its armory to see yields down including the following.

Tools available for RBI/Govt. to impact yields

1) Cut rates further substantially (50-75 bps)
2) Ensuring smoother transmission by benchmarking a greater segment of loan book
3) OMOs (with a pre-announced calendar) and forex swaps (if necessary)
4) Continued Operation Twist
5) Hiking FIs debt sovereign limits and easing restrictions and various caps
6) Nudge to banks to reduce Reverse Repo balance (by fixing limits either individual or aggregate)
7) Reduce (increasing) the SLR/LCR norms to facilitate OMOs (banks/NBFCs holding)
8) Separate issuance of Covid-19 bonds with identical character as SLR
9) Direct monetization of debt

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Our fixed income strategy stays the same as the policy was on expected line. Higher term spreads offer value in longer tenure papers which provides an interesting opportunity to continue to benefit from the higher end of the curve instead of its deployment at the shorter end. The intermittent volatility provides good entry points in the volatile market. We however, expect the volatility to reduce too as the year pass by as seen in the easing of credit spreads. Thus, fixed income portfolios should continue to be geared towards benefiting from duration strategies focused on government securities and AAA papers and focused on in the 4-5 year average maturity bucket and locking in yields across highest rated instruments at the short end of the curve.

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