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RBI GOOGLY FOR MARKETS: PLEASE READ THE FINE PRINT CAREFULLY!

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The RBI decision to maintain status quo has taken the market by complete surprise. However, this should not be construed as an unanticipated policy surprise and the markets must read through the fine print carefully. The markets does not like unexpected news and to that extent yields have jumped. However, markets must interpret it as a temporary pause and akin to **biological osmosis** (defined as the process of gradual or unconscious assimilation of ideas, knowledge, etc.). In a similar vein, the current pause with an accommodative stance could just be an attempt to allow the impact of surplus liquidity and transmission to permeate through the system. But in the same vein, given that inflation will stay elevated in the next couple of months at close to at least 5.3%-5.4%, a February cut is ruled out (December inflation numbers will be available only) at least logically. By the same logic, an April cut looks difficult. **Thus, it might be a longer pause.** Experience in Australia and elsewhere has shown that inflation is difficult to fine-tune within a narrow band. Thus, RBI can take a cue from Australian central bank, which aims at maintaining the inflation target over the business cycle.

Interestingly, credit market transmission is happening and will pick up much faster pace as rates are reset from next quarter. The 1-year median MCLR has declined by 49 bps while the WALR on fresh rupee loans sanctioned by banks declined by 44 bps.

We believe that the Government in conjunction with RBI should consider a similar step like TARP to address the problems in NBFC sector. Government can sponsor a fund or liquidity facility to buy out stressed real estate projects at fair valuation and ensure their completion. The fund will have the potential to make significant profits and even at present, ready properties are housed at locations where there is enough demand. There is now a significant risk that if too much time elapses, NBFCs will further reduce their assets, thus continuing a credit crunch. What is needed is a credible backstop for the NBFC sector which can be used quickly to absorb potential losses, if they materialise. **We can't wait any further!**

We believe the market fascination with "Operation Twist" is unjust. Currently, in FY20 so far RBI has purchased 67% of securities with more than 5 years tenure through OMO. Clearly, the RBI is already doing enough of "Operation Twist" to manage the yield curve expectations. Furthermore, the RBI does switches from short term to long term that is exactly the opposite of "Operation Twist" whereby yields on long term securities are expected to rise.

Separately, the steps taken in the policy for UCBs are most welcome. Specifically, the extension of the Central Repository of Information on Large Credits (CRILC) umbrella for the UCBs with assets of Rs 500 crores will go a long way in strengthening the offsite supervision and early recognition of the probable financial stress of such institutions in future, resulting in a new regime of lending discipline therein. RBI has also prescribed a new comprehensive cyber security framework for the UCBs. In order to give a fillip to the Peer to Peer (P2P) lending sector where NBFCs carries their business, RBI has increased the lending cap for each individual lender from the current Rs 10 lakh to Rs 50 lakh.

RBI MAINTAINS *STATUS QUO*

- Contrary to market expectations, MPC has decided to keep the Repo rate unchanged at 5.15%. All the members voted for *status quo*.
- For FY20, RBI has again cut its GDP growth forecast by whopping 110 bps to 5.0% [H2: 4.9-5.5% (earlier 6.6-7.2%)] owing to weakening of both domestic and external demand conditions. In the last five policies (including this) RBI has cut its growth forecast by 240 bps. GDP growth for H1 FY21 is estimated at 5.9-6.3%.
- CPI inflation projection is revised upwards to 5.1-4.7% for H2:FY20 (earlier: 3.5-3.7%) and 4.0-3.8% for H1:FY21. The upsurge in vegetable prices and other food items such as milk, pulses, coupled with volatility in financial markets are the upside risks to the inflation.

TRANSMISSION OF POLICY RATE IS EVOLVING

- **In conjunction with 75bps rate hike followed by 135 bps rate cut in 2 years, banks' monetary transmission is not that bad**. Monetary transmission has been full and reasonably swift across various money market segments and the private corporate bond market. During Feb-Oct' 2019, RBI has reduced 135 bps cumulative, while transmission to various money and corporate debt market segments ranged from 137 bps (overnight call money market) to 218 bps (3-month CPs of NBFCs). Transmission to the g-sec market, however, has been partial at 113 bps (5-year g-secs) and 89 bps (10-yr g-secs).
- Credit market transmission remains delayed but is picking up. The 1-year median MCLR has declined by 49 bps, WALR on fresh rupee loans sanctioned by banks declined by 44 bps, while the WALR on outstanding rupee loans increased by 4 bps during this period.
- However, transmission is expected to improve going forward as (i) the share of base rate loans, interest rates on which have remained sticky, declines; and (ii) MCLR-based floating rate loans, which typically have annual resets, become due for renewal.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
Dec'19 (5th Bi-monthly)	5.1	4.7	4.0	3.8
Oct'19 (4th Bi-monthly)	3.5	3.7	3.6	-
Aug'19 (3rd Bi-monthly)	3.5	3.7	3.6	-
Jun'19 (2nd Bi-monthly)	3.4	3.7	-	-
Apr'19 (1st Bi-monthly)	3.4	3.8	-	-
Real GDP Growth (%)	**Q3 FY20**	**Q4 FY20**	**Q1 FY21**	**Q2 FY21**
Dec'19 (5th Bi-monthly)	4.9	5.5	5.9	6.3
Oct'19 (4th Bi-monthly)	6.8	7.3	7.2	-
Aug'19 (3rd Bi-monthly)	7.4	7.6	7.4	-
Jun'19 (2nd Bi-monthly)	7.3	7.4	-	-
Apr'19 (1st Bi-monthly)	7.3	7.5	-	-

Source: RBI, SBI Research

Transmission of Policy Repo Rate to ASCBs Lending Rate

	Feb'19	Oct'19	Change in bps
1Yr Median MCLR	8.8	8.31	-49
WALR O/S Loans	10.36	10.40	+4
WALR Fresh Loans	9.97	9.53	-44
Memo			
Repo Rate	6.50	5.15	-135

Source: RBI, SBI Research

NO RATE CHANGE IS AN UNANTICIPATED SURPRISE TO MARKET

- Over the last two decades, central banks have moved towards clearer communication and greater transparency. This has been driven by several motivations. First, central banks have realised that open and transparent communication enhances policy effectiveness. This shift reflects a shift in the theory of monetary policy. Until the early 1990s, monetary policy was strongly influenced by Robert Lucas' argument that monetary policy affected real variables only if the policy changes were unanticipated. This encouraged obscurity over openness and clarity. Lost in the message was the fact that monetary policy always affected nominal variables like inflation even if fully anticipated.
- In the 1980s, Finn Kydland and Ed Prescott argued that fully transparent rules rather than discretionary policy changes were more efficient and credible. This was the beginning of the push towards rules over discretion and greater central bank transparency.
- **Against this background, the latest RBI policy inaction should however be properly interpreted by the market. The markets does not like unexpected news and to that extent yields have jumped. However, markets must interpret it as a temporary pause and akin to osmosis, defined as the process of gradual or unconscious assimilation of ideas, knowledge, etc. In a similar vein, the current pause with an accommodative stance could just be an attempt to allow the impact of surplus liquidity and transmission to permeate through the system.**
- While it may be difficult to vouch for either a rule-based approach or a discretion- based approach to policy making, empirical research does suggest (Greg Mankiw) that a discretion-based approach also serves the desired purpose if the regulator has credibility.

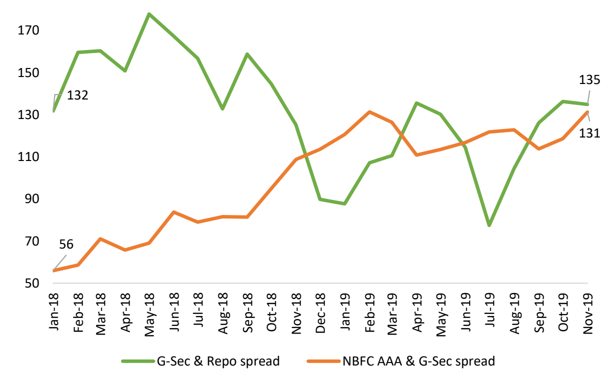
"OPERATION TWIST" UNLIKELY TO WORK IN CURRENT SCENARIO OF UNCERTAINTY

- Market is expecting RBI to go for "Operation Twist". Operation Twist implies that RBI is expected to buy long term securities and simultaneously sell short term securities so that the long ends of the yield curve and short end is more aligned.
- However, we believe such a measure through aggressive OMO is unlikely to result in the desired outcome. **First, there might be a demand supply mismatch in terms of enough buyers of short term securities.** Second, it is foolhardy for the markets to believe that OMO will pull down the yields when the spread between 10-year G-Sec is 135 bps above repo, nearly identical to NBFC AAA 10 year & 10 year G-Sec spread is 131 bps in Nov'19. thus, unless NBFC issue is settled, it is unlikely for the yield differential to narrow as it merely a reflection of economic uncertainty.
- In fact, given the low demand for credit, the growth in base money (M0) and Broad money (M3) will continue to be conflicting and any incremental OMO purchase will only reduce money multiplier further. The creation of money supply is largely endogenous in Indian context, catering purely to low money demand.
- Furthermore, If we look at the money market rates, the situation of liquidity surplus has indeed led to short term Treasury yields trading at par or below the repo rate. The yield on 91-day Treasury bill is currently at 4.98% while 182-days Treasury bill is around 5.12%. Even the CP and CD rates have moved down. The 3-month CD (traded) rates have moved down from an average of 7.14% in April to 5.28% in Nov'19 and further down to 5.06% in Dec'19. The traded 3-month CP rates have also declined to 5.1% in Dec'19 from 7.6% in Apr'19.
- Separately, if we look at security wise OMO data purchases by RBI shows that papers with maturity of more than 5 years accounted for around 85% in FY17, which reduced to 59% and 52% in the subsequent two years. Currently, in FY20 so far RBI has purchased 67% of securities with more than 5 years tenure through OMO. **Clearly, the RBI is already doing enough of "Operation Twist" to manage the yield curve expectations.**
- Finally, RBI also does switches whereby it pushes short term securities to long term securities to smoothen out Government repayment obligations. **As an example, the RBI has issued more long dated securities when compared with such securities accepted (cut off to switch ratio is more than one). Such switches is exactly the opposite of "Operation Twist" whereby yields on long term securities are expected to rise.**

GLOBAL ECONOMY IMPROVING

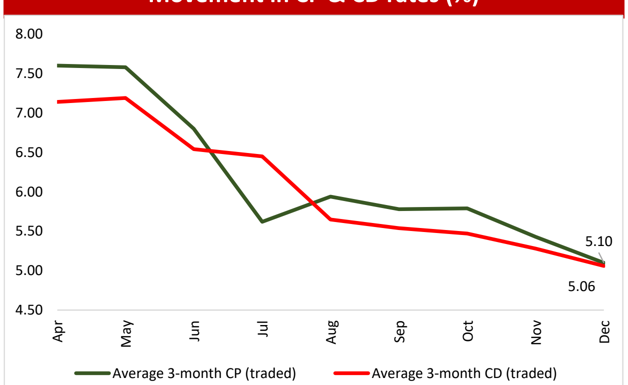
- Global economy since October 2019 did show any improvement and factors that have constrained its growth has more or less remained intact. In the EME however the growth in China has been impacted adversely due to trade wars and the internal adjustment towards consumption and events in Hong Kong. However, the rapid transition to digital economy in China may accelerate the internal adjustment process. The structural slowdown in China will impact EME economy that export commodities to China and will include India.

Spread of 10 yr G-Sec yield & Repo rate and NBFC AAA & G-Sec 10-yr yield (bps)



Source: SBI Research

Movement in CP & CD rates (%)



Source: SBI Research

- In this period of uncertainty, the energy prices which remain the mainstay of inflation will fluctuate with limited upside. Thus, inflation will breach the target in in 2020 on the lower side in India. Thus, there may be some role of monetary policy in 2020 but with policy rates close to lower bound the potential impact will limited.
- The financial markets will mirror the real economy and sequential impulses of data. The unrest in Hong Kong and Brexit are two most important events that will have bearing on the mood of financial markets. The yields are expected to be on the lower side.

DOMESTIC CONDITIONS REMAIN UNCERTAIN: RATING UPGRADE TO DOWNGRADES RATIO DECLINED SHARPLY FOR NBFCS

- Rating upgrade to downgrade ratio has deteriorated sharply in FY20 (Apr-Nov) in almost all types of NBFCs compared to FY19 (Apr-Nov). The U/D ratio of Housing Finance Companies has declined to 0.57% in FY20 from 2.40% in FY19. The pace of downgrades has been increasing and hence explains the sharp fall in U/D ratio in Apr-Nov FY20 versus Apr-Nov FY19. It may be possible that same company is being rated by more than one rating agencies. However, the trend is the same across rating agencies, as can be seen from table.

RESOLUTION OF STRESSED NBFCS ARE IMPORTANT: DOES INDIA NEED TARP LIKE FUND?

- The Troubled Asset Relief Program (TARP) was a US economic program designed to ward off the nation's mortgage and financial crisis. Signed on Oct 3, 2008, TARP allowed the Department of the Treasury to pump money into failing banks and other businesses by purchasing assets and equity. The idea was to stabilize the market, relieve consumer debt and bolster the auto industry. The program was originally authorized to spend $700 billion, but that amount was reduced to $475 billion when another bill, the Dodd-Frank Act, was signed into law in 2010. TARP effectively expired on Oct 3, 2010—two full years after its inception.
- According to the US Treasury, the Government's investments in TARP earned more than $11 billion for taxpayers. The Government also contends that TARP saved more than 1 million jobs and helped stabilize banks, the auto industry, and other sectors of business.
- We believe that the Government should consider a similar step like TARP. Government can sponsor a fund or liquidity facility to buy out stressed real estate projects at fair valuation and ensure their completion. The fund will have the potential to make significant profits and even at present, ready properties are housed at locations where there is enough demand.

DEVELOPMENTAL AND REGULATORY POLICY MEASURES

- ***Steps for Primary (Urban) Co-operative Banks****:* The unfortunate events of the past few months had dented the public confidence in the overall functioning of the Primary (Urban) Co-operative Banks. To bring this confidence back, RBI in today's policy announcements, has taken some very important and long term measures viz-a-viz the UCBs. The decision to amend the exposure norms for single and group/interconnected borrowers will go a long way in strengthening the overall resilience and sustainability of UCBs and thereby protect the interests of their depositors.
- Further, over past few years a perception has gathered currency that the UCBs are not regulated enough as far as their lending practices are concerned. The regulatory supervision for these entities was also found lacking on many occasions.

Rating Upgrade to Downgrade Ratio

Industry	FY19			FY20		
	Upgrade	Downgrade	U/D Ratio	Upgrade	Downgrade	U/D Ratio
Housing Finance Company	12	5	2.40	4	7	0.57
Microfinance	22	2	11.00	10	5	2.00
Non-Banking Financial Company - Deposit Taking	5	-	NA	2	6	0.33
Non-Banking Financial Company - Non-Deposit Taking	41	18	2.28	9	46	0.20

Source: Crisilquantix; SBI Research; Period - April to November

- Extension of the Central Repository of Information on Large Credits (CRILC) umbrella for the UCBs with assets of Rs 500 crores and above is a much required step in this direction. This will go a long way in strengthening the offsite supervision and early recognition of the probable financial stress of such institutions in future, resulting in a new regime of lending discipline therein.
- RBI has also prescribed a new comprehensive cyber security framework for the UCBs. In today's age of ever-growing cyber security threat, this regulatory decision appears quite appropriate and natural. With their growing network and size, it was really a high time that the UCBs were made at par with the other players as far as the cyber security resilience and preparedness was concerned. This will further augment the public confidence in the UCBs and thereby help them grow in the coming months.
- ***Development of Secondary Market for Corporate Loans – setting up of Self Regulatory Body:*** Based on the recommendation of Task Force on Development of Secondary Market for Corporate Loans, RBI has proposed to set up of a self-regulatory body (SRB) which will be responsible, for standardising documents, covenants and practices related to secondary market transactions in corporate loans and promoting the growth of the secondary market in line with regulatory objectives. In present scenario, the secondary market for loans has not fully evolved to the scale of its potential owing to various factors like, a) lack of a sufficient number of active participants, b) lack of an effective, reliable and diligent price discovery mechanism, c) absence of a systematic loan sales platform, d) lack of standardisation in loan and transfer documentation, e) information asymmetry. Development of secondary market will benefit banks in capital optimization, liquidity management and risk management.
- ***Baseline Cyber Security Controls for ATM Switch application service providers of RBI regulated entities***: In order to enhance the cyber security framework, RBI decided to adopt certain baseline cyber security controls that shall be mandated by the regulated entities in their contractual agreements with the service providers. We believe this is *sine quo non* for the economy that is largely digitally dominated and where the number of cyber frauds are increasing rapidly.
- ***Hedging of foreign exchange risk by residents and non-residents*:** The regulatory change of allowing over the counter (OTC) currency derivative transactions up to USD 10 million, without the need to evidence underlying exposure is a welcome move which will increase trading. Further, Banks can in exceptional circumstances now pass on net gains on hedge transactions booked on anticipated exposures which will increase liquidity. However, what constitutes exceptional circumstances has not been underlined and once that is defined in the final guidelines more clarity will come.

- ***Review of NBFC-P2P Directions- Aggregate Lender Limit and escrow accounts :*** In order to give a fillip to the Peer to Peer (P2P) lending sector where NBFCs carries their business, RBI has increased the lending cap for each individual lender from the current Rs 10 lakh to Rs 50 lakh. P2P lending platforms offer an easy solution to NBFCs to borrow money for short-term requirements. It connect borrowers with individual lenders, who come together to meet the borrowers' loan requirements. Such, borrowings from P2P platforms are unsecured loans and interest rates are higher for borrowers compared to bank. Further, RBI also proposed to do away with the current requirement of escrow accounts to be operated by bank promoted trustee for transfer of funds having to be necessarily opened with the concerned bank. This will help provide more flexibility in operations. Necessary instructions in this regard will be issued by RBI shortly.
- ***New Pre-Paid Payment Instruments (PPI):*** RBI has proposed to introduce a new type of PPI which can be used only for purchase of goods and services up to a limit of ₹10,000 for making only digital payments such as bill payments, merchant payments, etc. We believe this is an excellent step and will boost the overall PPI transactions and per transaction value (which is under ₹500 for the last 3 years).

Progress of PPIs

Month	Volume (Lakh)	% YoY	Value (Rupees Crore)	% YoY	Per Txn Value (Rs)
Sep-2019	4034	12.7	17835	0.5	442
Sep-2018	3579	48.9	17749	61.7	496
Sep-2017	2403	147.5	10977	95.0	457
Sep-2016	971	67.3	5628	37.9	580
Sep-2015	580	154.0	4081	132.1	704
Sep-2014	228	-	1758	-	770

Source: RBI; SBI Research

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