RBI PACKAGE TO INSTILL CONFIDENCE

The latest measure by RBI of opening up a liquidity window for Mutual Funds likely to instill confidence in the markets to the extent that the central bank is ready to act as the lender of last resort, in case the need arises. While this move is laudable and timely, it may be noted that similar windows were opened earlier in 2008 and 2013, however they saw very limited utilisation.

The current turmoil in financial markets globally (India included) is the fear of credit risks and this could act as a significant constraining factor in the markets returning to normalcy anytime soon. The problem with the current COVID-19 crisis is whether the significant negative supply shock can ultimately trigger a much larger demand shortage that leads to a contraction in output and employment larger than the supply shock itself. Such supply shocks termed in economic literature as Keynesian supply shocks / temporary negative supply shocks, arise when the goods that are not available now because of closed down sectors will be bought in future by consumers when they are available. If not, it will result in demand-led recession. Under such a situation, financial institutions will continue to remain risk averse.

We believe for such lending to be successful, RBI might have to come in the fray and do an effective lending against corporate bond collateral, by making a beginning with say AAA PSUs which are quasi sovereigns. Central Banks around the world are carrying the entire credit risk on their books. Central Banks normally lend to depository institutions only but they can always buy assets they choose to. And therein lies the credit risk conundrum. The facility announced by the RBI will work more for boosting confidence and providing moral support to the market and reducing the volatility seen in the corporate debt market.

Interestingly, in 2008 global financial crisis, European countries were able, for example, to stabilise the situation by providing public guarantees to banks. Ireland was one of the first countries to make such a commitment. In the US the TARP was adopted, with the initial aim to purchase distressed assets for banks and thus relieve their balance sheets.

Again, it would be pertinent to mention here that MFs already have unutilized bank lines anyway. Also, even in normal times very few papers are fairly liquid. In AA and A papers bids are limited. In rupee terms, the total size of the investment corpus is around Rs 1.2 lakh crore in AA, A and BBB papers.

The other alternative, we believe the current problem faced by financial entities can be resolved by creating a Special Purpose Vehicle by infusing equity that could be further scaled up through adequate leverage.

We must emphasize that in the midst of a financial crisis, the first thing that financial institutions do when they realise losses is immediately price risk (might be more conservative) and de-leverage, which tends to fuel a spiral with negative effects on the real economy. Until and unless, such risk taking capabilities are not addressed, we may still not get an effective solution to the problem.

RBI SPECIAL LIQUIDITY FACILITY FOR MUTUAL FUNDS

The Reserve Bank of India (RBI) has announced a special liquidity facility for mutual funds (SLF-MF) worth Rs 50,000 crore as redemptions have risen after Franklin Templeton closed six of its open-ended debt funds, effective April 23 due to drying up of liquidity in the bond market, as yields of debt securities have risen sharply and thereby materially impacting the ability of companies to service their debt.

Under the SLF-MF, the RBI will conduct repo operations of 90 days tenor at the fixed repo rate. Funds availed under the SLF-MF shall be used by banks exclusively for meeting the liquidity requirements of MFs by extending loans, and undertaking outright purchase of repos against the collateral of investment grade corporate bonds, commercial papers (CPs), debentures and certificates of Deposit (CDs) held by MFs.

Deployment of funds by debt mutual funds indicate that almost 30% of funds are deployed in corporate debt followed by 17% in CPs. While investments in corporate bonds offer higher returns, the risk premium may not be commensurate with the current elevated risks in the corporate bonds market. However, category-wise investment by Mutual Funds reveals that around 61% is invested in AAA rating, 9% in AA category, 2% in A, while it is roughly 0.2% invested in BBB and below. In rupee terms, the total size of the investment corpus is around Rs 1.2 lakh crores in AA, A and BBB papers. Cash, Equity, SOV and others form 27% of the total investment by mutual funds.

The RBI move is likely to instill confidence in the markets to the extent that the central bank is ready to act as the lender of last resort, in case the need arises. However, for the lending to be successful, RBI has to come in the fray and do an effective lending against corporate bond collateral, by making a beginning with AAA PSUs which are quasi sovereigns.

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