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ICRA COMMENTS ON RBI'S FIFTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2019-20

MPC votes unanimously for a surprise pause in Repo rate, while maintaining policy stance as 'Accommodative'

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HIGHLIGHTS

- Contrary to expectations, the Monetary Policy Committee (MPC) voted unanimously to retain the Repo rate under the Liquidity Adjustment Facility (LAF) at 5.15%, in the Fifth Bi-monthly monetary policy statement for FY2020. Moreover, the Committee retained the stance of monetary policy as 'accommodative', also in a unanimous vote.

- With the status quo on the Repo rate, the Reverse Repo rate, Marginal standing facility (MSF) rate and bank rate were also kept unchanged at 4.90%, 5.40% and 5.40%, respectively.

- Previously, in December 2018, the MPC had proposed to reduce the Statutory Liquidity Ratio (SLR) by 25 bps every quarter, starting January 2019, until the same reaches 18% of NDTL. Accordingly, the SLR stands at 18.50%, whereas the Cash Reserve Ratio (CRR) remained unchanged 4.0%.

- The MPC revised its CPI inflation forecast for H2 FY2020 to 5.1-4.7%, with the risks broadly balanced, from 3.5-3.7% in October 2019, with the risks evenly balanced. Further, the inflation projection for H1 FY2021 was placed at 4.0-3.8%, with the risks broadly balanced.

- The MPC revised its GDP growth outlook downwards significantly to 5.0% for FY2020 (4.9-5.5% in H2 FY2020) from the earlier forecast of 6.1% for FY2020 (5.3% in Q2 FY2020 and 6.6-7.2% in H2 FY2020) in October 2019, whereas the GDP growth forecast for H1 FY2021 was placed at 5.9-6.3%.

- The average liquidity surplus under LAF rose from ~Rs. 2.0 trillion in October 2019 to ~Rs. 2.4 trillion in November 2019, despite the seasonal pickup in demand for cash during the festive and marriage season. Moreover, so far in December 2019, the magnitude of liquidity surplus stood at a high ~Rs 3.2 trillion (till December 4, 2019), partly benefitting from the Government of India's (GoI's) month-end spending. Going forward, ICRA expects the incremental bank credit to pick up somewhat, which may ease the magnitude of liquidity surplus.

- The MPC stated that monetary transmission had been complete across segments of the money market and the private corporate bond markets, but has been delayed in the credit market. This is expected to improve going forward, as the share of base rate loans decline, and as MCLR-based floating rates become due for resetting.

Outlook: The MPC's decision to retain the accommodative stance for as long as necessary to revive growth, and the explicit statement that there is monetary policy space for future action, suggests that another 25 bps rate cut shouldn't be ruled out. However, this is expected only after there is visibility that the headline CPI inflation will sustain below 4%. In our view, the CPI inflation will print at uncomfortably high levels above 5% in November-December 2019, led by food inflation and the recently announced hike in telecom tariffs. As a result, there appears to be a high likelihood of another pause in the February 2020 policy review. In the meantime, the focus is likely to remain on improving transmission of the past repo rate cuts to bank lending rates.

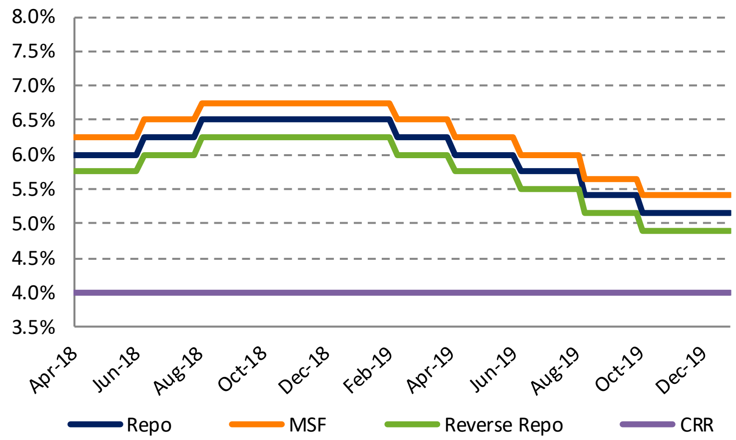
MPC votes for a pause in repo rate, maintains monetary policy stance at 'accommodative'

Contrary to expectations, the six-member MPC voted unanimously for a pause in the policy repo rate at 5.15% in the December 2019 policy review, given the prevailing uncertainty regarding growth-inflation dynamics, including the measures to support economic growth that may be unveiled in the Union Budget for FY2021. Moreover, the delayed and incomplete transmission of the earlier policy rate reduction of 135 bps, prompted the Committee to pause in the December 2019 policy review. However, the MPC reiterated that the stance will remain accommodative for as long as necessary to revive growth, and highlighted that there is monetary policy space for future action.

The CPI inflation had hardened considerably to a 16-month high 4.6% in October 2019 from 3.99% in September 2019, driven primarily by a sharp uptick in the inflation for food and beverages. According to the MPC, while vegetable prices may remain elevated in the immediate term, they would soften by early-February 2020, driven by a pick-up in the arrivals from the late kharif season, as well as measures taken by the Government to boost supply through imports. However, the emerging price pressures seen in other food items such as milk, pulses, and sugar may prove to be more enduring. Additionally, the inflationary expectations of households have risen significantly. However, the slowdown in domestic demand has softened the core-CPI inflation (excluding food & beverages, fuel & light, petrol and diesel for vehicles). In addition, crude oil prices are expected to remain range-bound, barring any supply disruptions on account of geo-political tensions. Overall, the MPC revised its CPI inflation forecast for H2 FY2020 significantly to 5.1-4.7%, with risks broadly balanced, from 3.5-3.7%, with risks evenly balanced, in October 2019. Further, the MPC placed its CPI inflation forecast for H1 FY2021 at 4.0-3.8%, with risks broadly balanced.

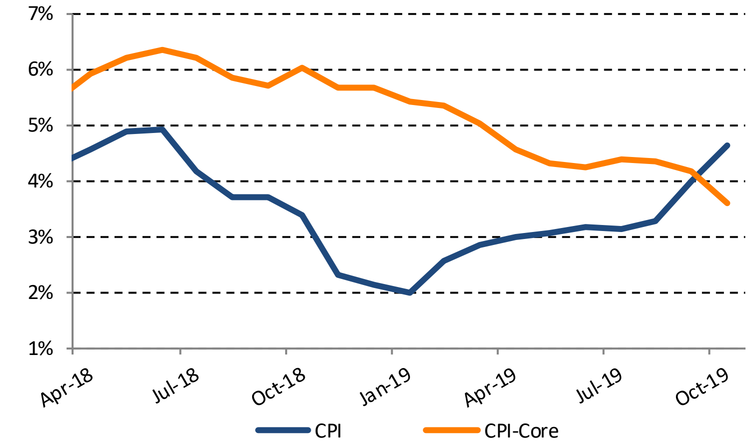
Following the continued dip in the GDP growth in Q2 FY2020, the MPC has considerably reduced its projection for economic growth in FY2020 to 5.0% in the December 2019 policy review, from 6.1% with risks evenly balanced in October 2019. However, the MPC noted that the recent measures announced by the Government of India, in conjunction with the cumulative monetary policy easing since February 2019, are expected to boost economic activity. Although the Committee highlighted that there are early signs of a recovery in investment activity, it expects only a mild uptick in the GDP growth from 4.8% in H1 FY2020, to 4.9-5.5% in H2 FY2020, and further to 5.9-6.3% in H1 FY2021. Further, the MPC noted that while improved monetary transmission and a resolution of global trade tensions are possible upsides to its growth forecasts, a delay in the revival of domestic demand, further moderation in global economic activity and geo-political tensions are downside risks.

Chart 1: Movement in Key Rates



Source: RBI; CEIC; ICRA Research

Chart 2: CPI Inflation and core-CPI inflation (YoY)



Source: CSO; CEIC; ICRA Research

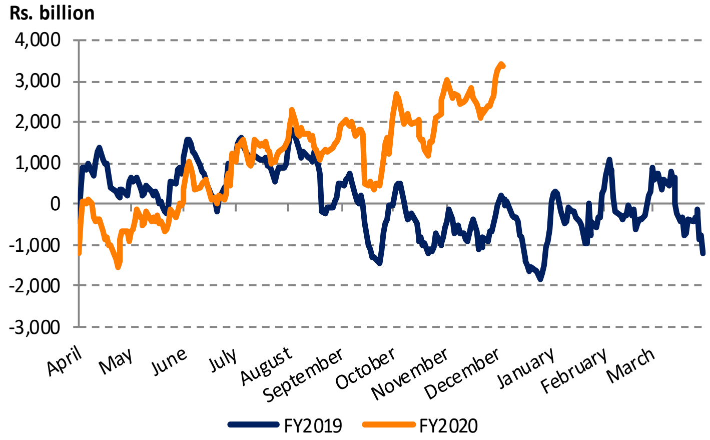
Monetary policy transmission to credit market expected to improve as share of base rate loans decline and MCLR-based floating rate loans become due for reset

The systemic liquidity surplus in the banking system has risen considerably in recent months. For instance, the average liquidity surplus under the LAF rose to Rs. 1.3 trillion in Q2 FY2020 from ~Rs. 281.6 billion in Q1 FY2020, on the back of a pickup in government spending after the presentation of the Union Budget in July 2019. This had also led to a drawdown in the GoI's cash balances, as well as a rise in incidents of availing the Ways and Means Advances (WMA) facilities. Following this, the average liquidity surplus rose further to ~Rs. 2.0 trillion in October 2019 and ~Rs. 2.4 trillion in November 2019, despite the seasonal pickup in demand for cash during the festive and marriage season. Moreover, so far in December 2019, the magnitude of liquidity surplus stood at a high ~Rs 3.2 trillion (till December 4, 2019), partly benefitting from the GoI's month-end spending. Going forward, ICRA expects the incremental bank credit to pick up somewhat, which may ease the magnitude of liquidity surplus.

The daily weighted average call money rate eased from 5.61% in July 2019 to 5.38% and 5.32%, respectively, in August 2019 and September 2019. This reflected the cumulative reduction of 110 bps in the Repo rate since February 2019, as well as the measures taken the by the RBI to improve monetary policy transmission, such as introducing external benchmarking of banks' floating rate loans. Subsequently, the daily weighted average call money rate fell further to 5.07% in October 2019, in line with another Repo rate cut by the MPC in that month. Moreover, with the rise in the average liquidity surplus under the LAF, the daily call rates declined to 5.00% in November 2019 and 5.02% in December 2019 (till December 3, 2019).

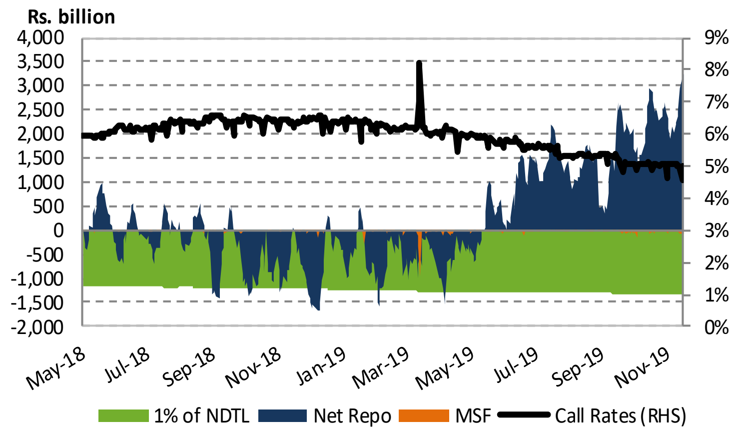
The MPC highlighted that monetary transmission had been complete across various segments of the money market and the private corporate bond market; the rates in overnight call money market and for the 3-month CPs of NBFCs fell by 137 bps and 218 bps, respectively, as against the 135 bps reduction in the Repo rate during February-October 2019. The MPC also stated that the transmission to government securities (G-sec) was partial at 113 bps for 5-year G-sec, and 89 bps for 10-year G-sec. However, the MPC highlighted that the monetary transmission in the credit market had been delayed, but it expected the same to improve in the future as there is a decline in the share of base rate loans, which have relatively sticky rates. The MPC also expects the transmission for credit markets to improve further when floating rate loans based on the MCLR become due for reset, which usually happens on an annual basis. The Committee also highlighted the need for greater flexibility in the adjustment in interest rates on small saving schemes, which provide an alternative avenue to saving in banks at higher interest rates than bank deposits of a comparable maturity. Therefore, such schemes have at times been highlighted as a factor that hampers transmission of monetary easing to bank deposit and lending rates.

Chart 3: Liquidity Infusion (-)/ absorption (+) (Net overnight & term Repos/Reverse Repos; MSF; MSS)



Source: RBI; CEIC; ICRA Research

Chart 4: Call money rates



Source: RBI; ICRA Research

Other Key Developments

The RBI provided an update on the various other initiatives undertaken in the fields of banking, financial markets, payments & settlements and financial literacy as it continued to further strengthen the domestic financial system.

Guidelines proposed for exposure norms for single and group exposure limits for Urban Cooperative banks (UCBs)

Urban Cooperative Banks currently lay down the credit exposure norms and policies with the approval of their boards, keeping in view the guidelines issued by the Reserve Bank of India which will be 15% of total capital (Tier 1 and Tier 2) for single borrower and 40% of total capital for group of borrowers. This is in comparison to single counterparty limit of 20% of Tier 1 capital (additional exposure of 5% subject to board approval) and 25% of Tier 1 capital for a group of connected counterparties for scheduled commercial banks (SCBs).

This apart, the priority sector lending (PSL) target stands at 40% of Adjusted Net Bank Credit (ANBC) for UCBs as compared to 75% for small finance banks (SFBs) and 40% for SCBs. In addition, 50% of the loans of SFBs should be less than 25 lakh ticket size.

With a view to reducing concentration risk in the exposures of UCBs and to further strengthen the role of UCBs in promoting financial inclusion, RBI will issue regulatory guidelines for UCB, which will specify the exposure norms, apart from the likely increase in the PSL targets for UCBs.

In our view, the increase in PSL target norms can potentially increase the granularity of the loan assets of UCBs and will also reduce the concentration risks for them, thereby strengthening the resilience and sustainability of UCBs and protecting the interest of depositors.

Reporting to Central Repository of Information on Large Credits (CRILC) by UCBs

RBI has set up the CRILC to collect, store and disseminate data on all borrowers' credit exposure including Special Mention Accounts (SMA 0, 1 & 2) having aggregate fund-based and non-fund based exposure of Rs.50 million and above. Credit information to CRILC is submitted by all SCBs. In addition, there is a similar CRILC system for NBFCs with reporting of credit information by the top NBFCs.

With a view to build a similar database of large credits extended by UCBs, it has been decided to bring UCBs with assets of Rs 500 crores and above under the CRILC reporting framework. RBI will issue detailed instructions in this regard by December 31, 2019.

Development of Secondary Market for Corporate Loans – setting up of Self-Regulatory Body

As per the recommendations of the task force constituted by the RBI for development of secondary market for corporate loans, the RBI will facilitate the setting up of a self-regulatory body (SRB) which will be responsible, inter-alia, for standardising documents, covenants and practices related to secondary market transactions in corporate loans.

As per the recommendations of the task force, the SRB may be an association set-up by SCBs, Public Financial Institutions and other related entities, and may be incorporated as a Section 8 Company under the Companies Act, 2013.

On Tap Licensing of Small Finance Banks

During June 2019, RBI announced that the Draft Guidelines for 'On tap' Licensing of Small Finance Banks (SFBs) will be issued and these draft guidelines were placed on the RBI's website in September 2019 for inviting comments from the stakeholders. After examining the responses received, the 'On tap' Licensing Guidelines for SFBs have been finalised and are being issued today.

Increase in limit of lender on NBFC-P2P platform

At present, the aggregate limits for both borrowers and lenders across all P2P platforms stand at Rs 10 lakh, whereas exposure of a single lender to a single borrower is capped at Rs 50,000 across all NBFC-P2P platforms and was last fixed in October 2017. To give the push to the lending platforms, the aggregate exposure of a lender to all borrowers, across all P2P platforms, is proposed to be increased to Rs 50 lakh.

New Pre-Paid Payment Instruments (PPI)

To further facilitate the usage of PPIs, RBI has proposed to introduce a new type of PPI which can be used only digital payments such as bill payments and merchant payments up to a limit of Rs 10,000. These new PPIs can be loaded and reloaded only from a bank account and are likely to reduce the know your customer (KYC) requirements. Such PPIs can also be issued based on minimum details from the customer. RBI will issue the details in this regard by December 31, 2019.

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

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Our services are designed to

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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