ICRA

STATE GOVERNMENT FINANCES - UPDATE JANUARY 2020

Indicated SDL issuance for Q4 FY2020 in line with ICRA's projections

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HIGHLIGHTS

- *The combined State Development Loan (SDL) issuance of all the state governments stood at Rs. 3,874 billion in 9M FY2020, a substantial 34.9% higher than the issuance of Rs. 2,872 billion in 9M FY2019. ICRA estimates that Rs. 1,068 billion SDLs were redeemed in 9M FY2020, more than double the estimated redemption of Rs. 443 billion in 9M FY2019. Accordingly, the net SDL issuance in 9M FY2020 is estimated by ICRA at Rs. 2,806 billion, 15.5% higher than the estimated net SDL issuance of Rs. 2,429 billion in 9M FY2019.*
- *Around 52% of the total SDLs issued in 9M FY2020 had a maturity of 10 years, 22% had a shorter maturity and the balance had a longer maturity. The recent issuance of SDLs in the 30-40-year segment by Telangana and Tamil Nadu (TN) at competitive rates in the current fiscal is an encouraging development as it aids in spreading out the redemption profile of their SDLs.*
- *The calendar of market borrowings by the state governments for Q4 FY2020, issued recently by the Reserve Bank of India (RBI), indicates a tentative gross issuance of SDLs of Rs. 2,086 billion, nearly in line with ICRA's estimate published in October 2019[1]. The indicative borrowing for Q4 FY2020 implies a moderate YoY growth of 9% for gross SDL for this quarter. ICRA estimates the SDL redemption in Q4 FY2020 to more than halve to Rs. 320 billion from Rs. 778 billion in Q4 FY2019. Accordingly, the net SDL issuance would increase by a sharp ~56% to Rs. 1,766 billion in Q4 FY2020 from Rs. 1,134 billon in Q4 FY2019.*
- *Maharashtra (Rs. 250 billion), Karnataka (Rs. 229 billion) and Uttar Pradesh (UP; Rs. 221 billion) are expected to account for more than a third of the total indicative borrowings of Rs. 2,086 billion in Q4 FY2020. The SDL issuance by Maharashtra in Q4 FY2020 is expected to be nearly as large as its total SDL issuance of Rs. 255 billion in 9M FY2019. Assuming Karnataka issues the indicated Rs. 229 billion in Q4 FY2020, it would imply a high 31.3% YoY growth in its SDL issuance to Rs. 520 billion in FY2020 from Rs. 396 billion in FY2019. UP's total SDL issuance would rise by 23.0% to Rs. 566 billion in FY2020 from Rs. 460 billion in FY2019, if it sticks to its indicated SDL issuance in Q4 FY2020, and it would emerge as the second largest borrower in the ongoing fiscal after TN.*
- *If the gross SDLs raised in Q4 FY2020 are in line with the indicated amount of Rs. 2,086 billion, the total gross SDL issuance in FY2020 would expand by 24.6% to Rs. 5,960 billion from Rs. 4,783 billion in FY2019. After adjusting for the redemptions in FY2020, the net SDL issuance in the current fiscal is projected at Rs. 4,572 billion, indicating a YoY growth of 28.3%. The expected gross and net SDL issuances in FY2020 are nearly in line the projections made by ICRA in October 2019.*

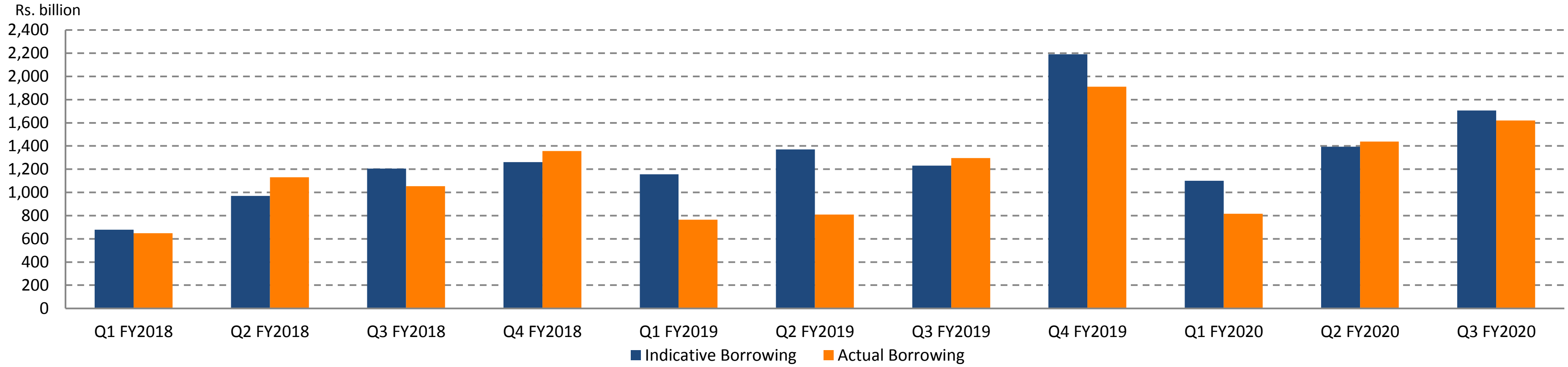
[1] Refer to ICRA's publication, *Lower than budgeted revenue receipts of states may push gross SDL issuance close to Rs. 6.0 trillion in FY2020*, published in October 2019.

Open market borrowings/SDLs are the chief source of funding of the gross fiscal deficit of the Indian state governments. After consultations with the state governments, the RBI releases an indicative quarterly calendar of market borrowings at the beginning of each quarter, which includes the range of the magnitude of likely market borrowings in each quarter, the names of the states that have confirmed participation and the tentative amount of borrowing by the participating states in the ensuing quarter. This note includes ICRA's comments on the key trends in the SDL auctions in Q3 FY2020, the highlights of the indicative borrowing calendar for Q4 FY2020 released by the RBI and the total gross SDL issuance expected in FY2020.

Key trends in SDL issuance in Q3 FY2020: In Q3 FY2020, the states issued SDLs of Rs. 1,619 billion, a modest Rs. 87 billion lower than the indicated amount of Rs. 1,707 billion (refer Exhibit 1). Notably, the actual SDL issuance had been appreciably lower than the indicative amount in Q1 FY2020 (Rs. 815 billion; Rs. 1,101 billion), and mildly higher than the indicative amount in Q2 FY2020 (Rs. 1,439 billion; Rs. 1,394 billion).

Out of the 27 states (including Puducherry) that participated in the SDL auctions in Q3 FY2020, 12 states issued lower-than-indicated SDLs in that quarter, with West Bengal (WB; Rs. 160 billion actual SDLs issued; Rs. 229 billion indicated), UP (Rs. 175 billion actual SDLs issued; Rs. 220 billion indicated), Haryana (Rs. 55 billion actual SDLs issued; Rs. 104 billion indicated) and Chhattisgarh (Rs. 20 billion actual SDLs issued; Rs. 50 billion indicated) being the key drivers of this trend.

Exhibit 1: Indicative versus actual SDL issuances



Source: RBI; ICRA research

The combined SDL issuance of all the state governments stood at Rs. 3,874 billion in 9M FY2020, a substantial 34.9% higher than the issuance of Rs. 2,872 billion in 9M FY2019 (refer Exhibit 2 and Annexure 1), despite small YoY declines in April-May 2019. TN was the largest issuer of SDL in both 9M FY2020 (Rs. 464 billion) as well as in 9M FY2019 (Rs. 299 billion). The SDL issuance by WB (Rs. 350 billion), UP (Rs. 345 billion), Karnataka (Rs. 291 billion) and Andhra Pradesh (AP; Rs. 290 billion) followed TN in 9M FY2020 (refer Exhibit 3).

Exhibit 2: Gross monthly SDL issuance in FY2019 and FY2020

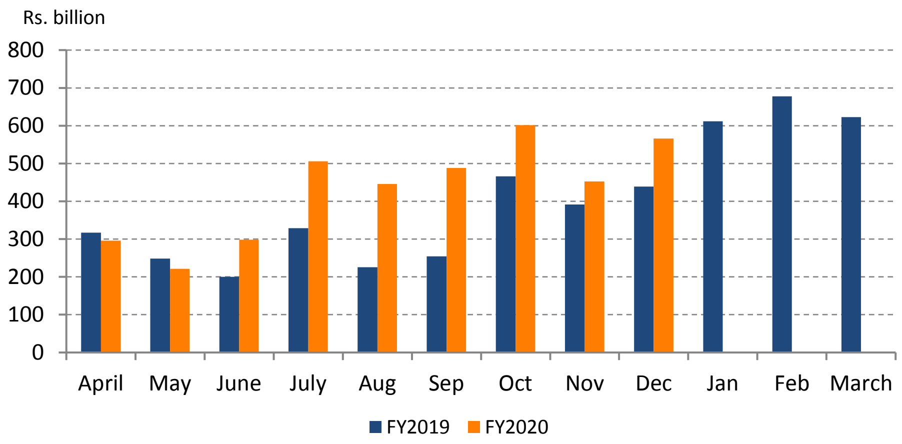
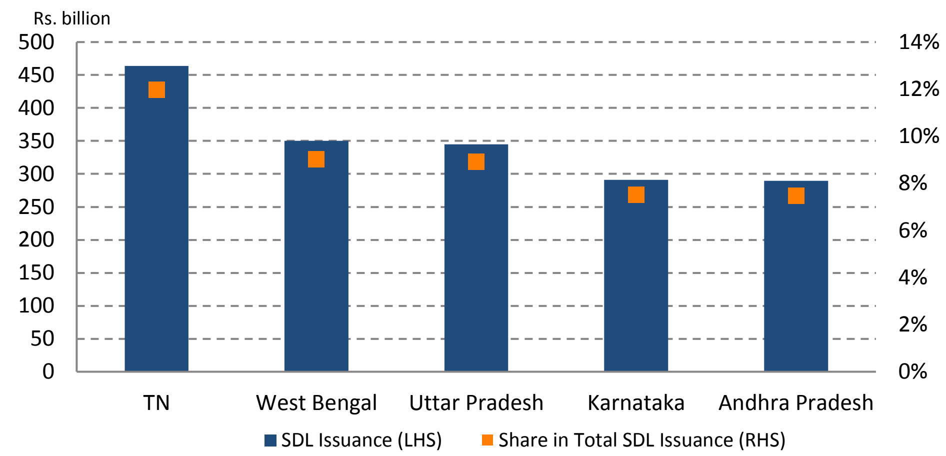


Exhibit 3: Top five borrowers in 9M FY2020



Source: RBI; ICRA Research

ICRA estimates that Rs. 1,068 billion SDLs were redeemed in 9M FY2020, more than double the estimated redemption of Rs. 443 billion in 9M FY2019. Accordingly, the net SDL issuance in 9M FY2020 is estimated by ICRA at Rs. 2,806 billion, a moderate 15.5% higher than the estimated net SDL issuance of Rs. 2,429 billion in 9M FY2019.

The instances of undersubscription of the notified amount of sale of SDLs declined from 23 in H1 FY2020 to 9 in Q3 FY2020; all of the latter pertained to the sale of AP SDLs. In seven out of the nine SDL auctions in which AP participated in Q3 FY2020, the amount accepted by the state government was lower than the notified amount. Moreover, in two out of these seven instances, AP rejected the entire notified amount. In terms of the absolute amount, AP had offered for sale Rs. 145 billion SDLs during various weekly auctions held in Q3 FY2020, of which, it accepted only Rs. 89 billion or around 61% of the notified amount. In all these instances of undersubscription, the aggregate (competitive and non-competitive) bid amount for AP SDLs, exceeded the notified amount of sale of these SDLs, indicating that there was sufficient interest of the market participants in investing in these SDLs. The Government of AP possibly would have found the yields demanded by the market participants to be higher than they were willing to accept, leading to the rejection of the full or partial amount offered for sale. Previously, there had been 12 instances in H1 FY2020, which were largely concentrated in Q2 FY2020, in which the states either did not receive any competitive/non-competitive bids, or the bid amount was less than the amount of SDL offered for sale. Four such instances had pertained to the sale of AP SDLs, and three each in case of Punjab SDLs and Rajasthan SDLs. Such instances could imply lack of investor interest in the SDL of these states in that period, which could be on account of various factors including, the market's perception of the relatively weaker fiscal profile of those states, negative news flow related to a particular state, relatively higher-than-normal amount of SDLs being offered for sale by these states etc.

Spread between 10-year SDL and 10-year Government of India securities (G-sec) in April-December 2019: The spread between the cut-off of the 10-year SDLs (weighted average) and the 10-year G-sec had broadly followed a declining trend during April 2019 (75 bps) to July 2019 (54 bps). The average spread increased to 63 bps in August 2019 before easing appreciably to 51 bps in September 2019 (refer Exhibit 4), led by an increase in the G-sec yields, while the average SDL cut-offs remained sticky at ~7.15% during these two months.

Exhibit 4: Spread between weighted average 10-year SDLs and 10-year G-sec in 9M FY2020

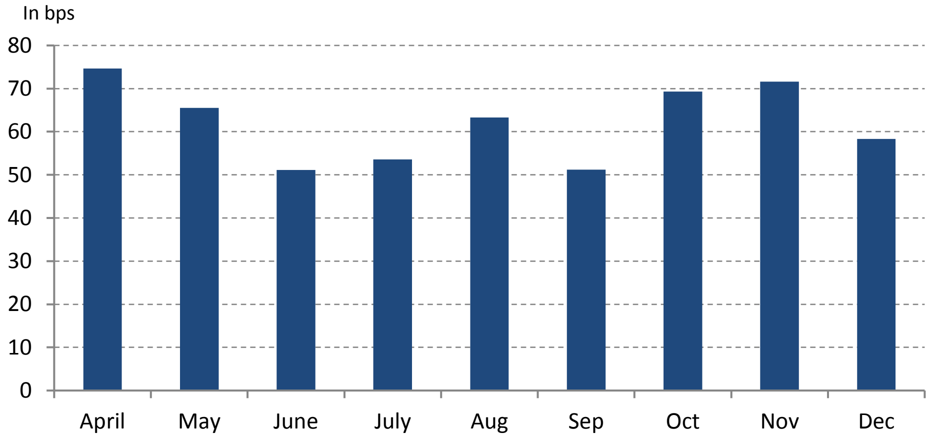
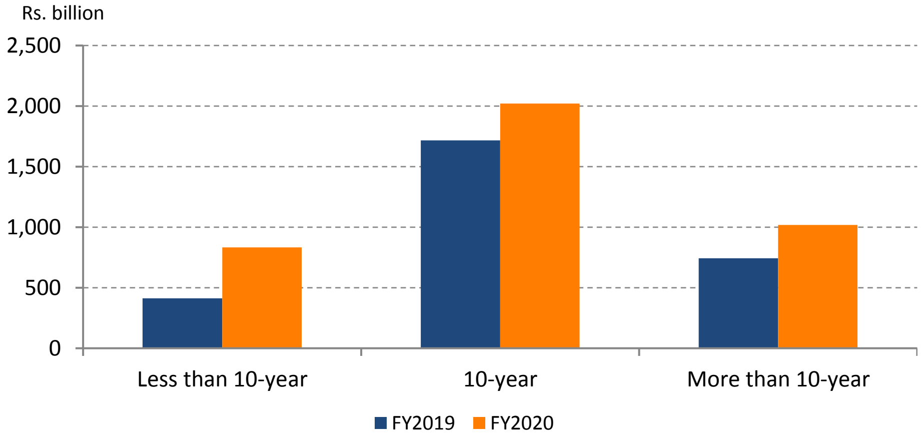


Exhibit 5: Tenor-wise SDL issuances in 9M FY2019 and 9M FY2020



Source: RBI; ICRA Research

In early October 2019, the new benchmark 10-year G-sec (06.45 GS 2029) was issued at a cut off of 6.45%, around 23 bps lower than the level at which the old 10-year G-sec was trading. The weighted average 10-year SDL cut-offs eased mildly to 7.18% in the first two weekly auctions in October 2019 from 7.26% in the end of September 2019. Relative to the closing yield of 6.48% of the new 10-year G-sec, the spread with the cut-off of the 10-year SDLs (weighted average) widened sharply to ~70 bps in the first two weeks of October 2019.

In the subsequent weekly auctions of SDLs until December 3, 2019, the spreads remained in a narrow range of 68–73 bps, reflecting limited movement of 6–8 bps in the 10-year SDL and the 10-year G-sec. Following the unexpected pause in the repo rate by the Monetary Policy Committee on December 5, 2019, the G-sec yields rose by around 25-35 bps over the subsequent two weeks, from 6.47% at the beginning of December 2019. The weighted average 10-year SDL cut-off stood at 7.26% in the SDL auctions held on December 10, 2019 and on December 17, 2019, 9 bps higher than the cut-off of 7.17% on December 3, 2017. Reflecting the relatively sharp increase in the 10-year G-sec yield in early December 2019 compared to the rise in cut off of the 10-year SDL, the spread between the two narrowed to 45-55 bps (similar to the level seen in September 2019) from around 70 bps seen during most part of October 2019-November 2019.

However, the increase in the 10-year G-sec yield displayed during the first fortnight of December 2019, largely reversed in the latter half of that month. On December 19, 2019, the RBI announced that it would simultaneously conduct an open market operation (OMO) purchase (of the current 10-year benchmark paper) and sale (of four shorter tenure G-secs that are scheduled for redemption in FY2021) worth Rs. 100.0 billion each on December 23, 2019, which led to a considerable easing in the benchmark G-sec yield to 6.57% on the latter date. Moreover, the RBI announced that another "Twist" OMO would be conducted on December 30, 2019 (followed by a third to be conducted on January 6, 2020), which led to a further dip in the 10-year G-sec yield to 6.52-6.55% in the remainder of that month. However, the "Twist" OMOs had a limited impact on SDL yields; the weighted average 10-year SDL cut-off softened by only 9-12 bps during the second fortnight of December 2019, leading to a mild widening of the spread to 58-62 bps. Accordingly, the average spread for December 2019 stood at 58 bps.

Maturity profile of SDL issuance in Q3 FY2020: In terms of tenor, around 53% of the total SDLs issued in Q3 FY2020 had a maturity of 10 years, ~25% had a shorter maturity (less than 10-year) and the balance ~22% had a longer maturity (more than 10-year). In Q3 FY2020, Rs. 406 billion shorter tenor SDLs were issued, of which nearly 54% had a maturity of 8-9 years and ~24% were issued in the 5-7 year maturity bucket. The balance ~22% had a very short-term maturity of 2-4 years and were mainly led by TN and Karnataka, which aided in reducing the dips in their SDL redemption profile in those years.

Out of the Rs. 361 billion longer tenor SDLs issued in Q3 FY2020, Rs. 73 billion or nearly 20% were issued in the 30-40-year segment by Telangana and TN. In Q3 FY2020, Telangana raised Rs. 20 billion by issuing a 30-year SDL, Rs. 30 billion through two 35-year SDLs and Rs. 3 billion through a 40-year SDL; the latter is the longest tenor SDL issued by any state government till December 31, 2019. Moreover, TN issued Rs. 20 billion by issuing a 35-year SDL in Q3 FY2020, in addition to the aforementioned issuance in the 2-4 year maturity bucket, indicating a diverse maturity profile of its issuances in 9M FY2020. Besides the 30-40-year SDLs, the bulk of the longer tenor SDLs were concentrated in the 11-15-year segment. These longer dated SDLs were issued at a cut-off of 7.33% - 7.43%, which was only a modest 12 bps -17 bps higher than the weighted average cut-off of the 10-year SDLs issued by other states in the same auctions.

Overall, in 9M FY2020, around 52% of the total Rs. 3,874 billion SDLs issued had a maturity of 10 years (refer Exhibit 5), 22% had a shorter maturity and the balance had a longer maturity.

The issuance of SDLs in diverse maturity buckets by the state governments in the recent years is an encouraging development, as this would spread out the redemption profile of the SDLs. States having a highly back-ended redemption of their SDLs may have chosen to issue shorter maturity securities, and vice versa in FY2019 and FY2020. Moreover, if a state government believed that the interest rates prevailing at the time of issuance were competitive, it may have decided to issue longer-dated SDLs to lock in the presumably attractive yields. Additionally, the asset-liability profile of a section of market participants (insurance companies and provident funds) typically find investing in highly long dated papers appealing. The recent instances of issuance of 30-40 year SDLs at attractive rates is likely to have catered to the demand of such investors and may encourage other states to issue SDLs maturing in this segment.

Indicative borrowing in Q4 FY2020: On December 30, 2019, the RBI released the indicative calendar of market borrowings by the state governments for Q4 FY2020, which pegged the total market borrowing of 30 states (including the UTs of Puducherry and Jammu and Kashmir) at Rs. 2,086 billion. This is nearly in line with the upper band of ICRA's estimate (published in October 2019), of Rs. 1,794 billion to Rs. 2,021 billion of gross SDL issuance in Q4 FY2020.

The indicative gross SDL issuance for Q4 FY2020 is expected to be ~9% higher than the actual borrowing of Rs. 1,912 billion in Q4 FY2019. ICRA estimates the SDL redemption in Q4 FY2020 to more than halve to Rs. 320 billion from Rs. 778 billion in Q4 FY2019. Accordingly, the net SDL issuance would increase by a sharp ~56% to Rs. 1,766 billion in Q4 FY2020 from Rs. 1,134 billon in Q4 FY2019.

ICRA expects the revenue receipts of the state governments to be lower than the level that they have budgeted for FY2020, led by a substantial likely shortfall in Central tax devolution (CTD), even as the timing of receipt of Goods and Services Tax (GST) compensation could affect the cash flows of the states, especially those requiring substantial compensation. Lower-than-budgeted revenue receipts are likely to be the key factor that has led to considerable ~56% expansion indicated for net SDL issuance in Q4 FY2020.

In our assessment, the devolution of taxes to the states in FY2019 was higher than mandated by Rs. 0.6-0.7 trillion. The CTD to the states in FY2019 was presumably based on the Government of India's (GoI's) FY2019 Revised Estimates (RE) of gross tax revenues of Rs. 22.5 trillion. However, the provisional data for FY2019 had pegged the GoI's gross tax revenues at Rs. 20.8 trillion, Rs. 1.7 trillion lower than the RE for that year. A portion of the adjustment of the excess devolution in FY2019 appears to have been undertaken already in FY2020, with the CTD to all states contracting by 2.3% to Rs. 4.2 trillion in April-November FY2020 from Rs. 4.3 trillion in April-November FY2019, as per the provisional data released by the Controller General of Accounts. Additionally, the pace of growth of the gross tax revenues of the GoI stood at a subdued 0.8% in April- November FY2020, sharply lower than the target of 18.3% enshrined in the Revised Budget Estimate (RBE) for FY2020 relative to the FY2019 Provisional Actuals. ICRA expects the GoI's actual gross tax revenues to trail the FY2020 RBE of Rs. 24.6 trillion by a considerable Rs. 3.0-3.5 trillion, which would entail lower CTD to the states of Rs. 1.1-1.5 trillion relative to the GoI's FY2020 RBE. Based on the shortfalls in gross tax collections in FY2019 and the estimated gap in FY2020, the aggregate CTD to all the Indian states may be as much as Rs. 1.7-2.2 trillion lower in the current year than what was budgeted by the GoI, in ICRA's assessment.

In terms of the state wise trends, Maharashtra (Rs. 250 billion), Karnataka (Rs. 229 billion) and UP (Rs. 221 billion) are expected to account for more than a third of the total indicative borrowings of Rs. 2,086 billion in Q4 FY2020. The SDL issuance by Maharashtra in Q4 FY2020 is expected to be nearly as large as its total SDL issuance of Rs. 255 billion in 9M FY2019. Since FY2016, Karnataka has been following a strategy of issuing SDLs largely in H2 of a fiscal. In the current fiscal, the state government issued nil SDL in Q1 FY2020, and a modest Rs. 50 billion in Q2 FY2020, followed by a substantial Rs. 241 billion in Q3 FY2020, making it the largest issuer of SDLs among all states in that quarter. Assuming Karnataka issues the indicated Rs. 229 billion in Q4 FY2020, it would raise 90% of its entire borrowing for FY2020 in H2 FY2020, in continuation with the trend seen in the last three fiscals. Also, this would entail a high 31.3% YoY growth in Karnataka SDLs to Rs. 520 billion in FY2020 from Rs. 396 billion in FY2019. UP's total SDL issuance would rise by 23.0% to Rs. 566 billion in FY2020 from Rs. 460 billion in FY2019, if it sticks to its indicated SDL issuance in Q4 FY2020, and it would emerge as the second largest borrower in the ongoing fiscal after TN. While TN has indicated its SDL issuance would decline sequentially to Rs. 145 billion in Q4 FY2020 from Rs. 232 billion in Q3 FY2020, it is expected to issue total SDLs of Rs. 609 billion in FY2020, a substantial 41.2% higher than Rs. 431 billion in FY2019.

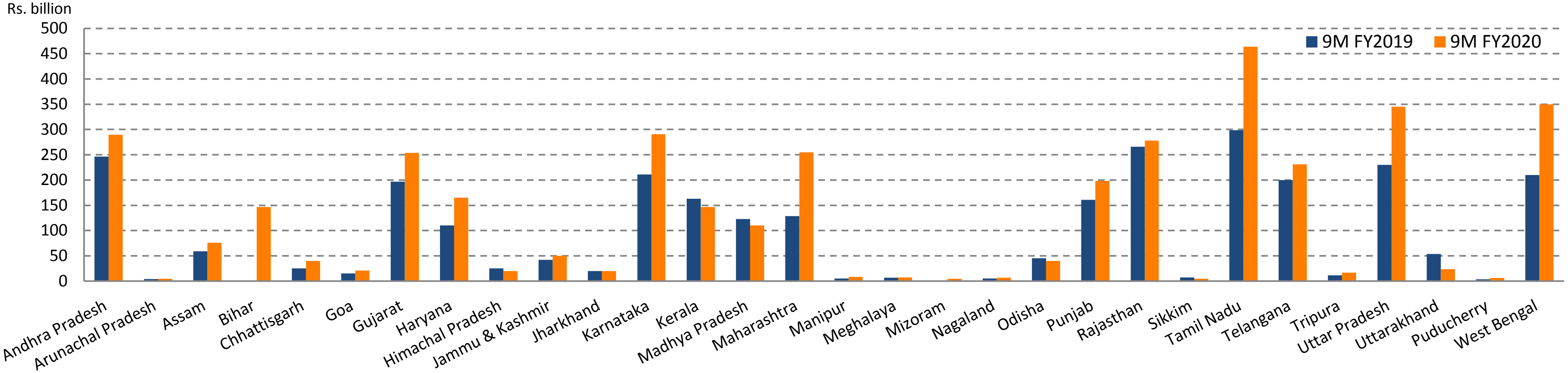
Expected gross and net borrowing in FY2020: If the gross SDL raised in Q4 FY2020 is in line with the indicated amount of Rs. 2,086 billion, the total gross SDL issuance in FY2020 would expand by 24.6% to Rs. 5,960 billion from Rs. 4,783 billion in FY2019 (refer Exhibit 6). After adjusting for the redemptions in FY2020, the net SDL issuance in the current fiscal is projected at Rs. 4,572 billion, indicating a YoY growth of 28.3%. The expected gross and net SDL issuances in FY2020 are in line with ICRA's estimates projected in October 2019.

Exhibit 6: Gross and net market borrowing of state governments in FY2020

Rs. Billion	FY2018	FY2019	YoY growth in FY2019	FY2020 (Expected)	YoY growth in FY2020 (Expected)
Gross Borrowing	4,191	4,783	14.1%	5,960	24.6%
Redemption	778	1,221	56.9%	1,388	13.7%
Net Borrowing	3,413	3,562	4.4%	4,572	28.3%

Source: RBI; ICRA Research

Annexure 1: State-wise borrowing in 9M FY2019 and 9M FY2020



Source: RBI; ICRA Research

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