Monetary Policy Review

EVENT UPDATE

December 4, 2020

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Wait and watch on Inflation

RBI kept Repo rate and Reverse Repo Rate unchanged

Key highlights

- The RBI maintained status quo on the rate and stance unanimously. The repo rate remains at 4% and stance at accommodative.
- The inflation and GDP forecast has been revised upwards and inflation remains a concern and monitorable. However, reviving growth and employment is of utmost priority currently.
- For the same, it has not proclaimed any specific measures to withdraw liquidity as the current focus is on credit availability and fulfil the government borrowing program at a reasonable price. It continues to manage FX liquidity.
- While it remains watchful on inflation, causes of which are beyond its control, it has, nevertheless, not missed an opportunity to improve transparency, governance and markets for financial products; increase supervision and responsibility within banks, NBFCs and UCB, importantly plans to revive the regulatory guidelines for NBFCs – which is a positive.

Inflation revised upwards; outlook adverse

The CPI has remained above the RBI's comfort parameters. Driven by food inflation, it stood at 7.3% in September and 7.6% in October. There is evidence that price pressures have been spreading further as well. The food inflation continues to be driven by supply side constraints and cost push pressures. While the cereals and kharif crop is likely to ease food inflation, the other sub baskets are expected to remain elevated beyond the ability of the banker to control with tools at their disposal. It has, therefore, revised CPI inflation at 6.8% for Q3FY21, 5.8% in Q4FY21 and 5.2% - 4.6% in H1FY22 with risks balanced.

GDP revised upwards as well but is driven by policy support

With high frequency indicators improving and PMI in expansion, the RBI revised GDP to -7.5% in FY21 from -8.6%; implying 0.1% in Q3FY21, 0.7% in Q4FY21; with risks balanced. However, it remains driven by policy support and is not secular. The rural sector is likely to continue to surpass urban as both kharif and rabi are likely to remain healthy but private investment is slack and capacity utilisation relatively weaker, which need consideration.

Focus on credit availability and government borrowing

The RBI has been pursuing to maintain enough liquidity to ensure easy credit availability and fulfil the government borrowing program at a reasonable cost. The weighted borrowing cost for the centre was at the lowest level of 5.82% as on December 1 (6.88% last year) even with additional borrowings for state governments. Similarly, spread of AAA (3Y) corporate bond fell from 60 bps on October 8 to 17 bps on November 27, 2020. The spreads on lower rated bonds by 34 bps for AA-rated and BBB- in the same period. Spreads have narrowed to pre-pandemic levels across the term structure. The RBI plans to maintain sufficient liquidity to ensure a smooth government borrowing program, which is at its peak, and ease for the private sector which has not yet been on its feet.

While it remains in wait and watch mode, it has not missed an opportunity to ensure improved governance, transparency, participation in financial markets. It plans to overhaul major segment to facilitate higher liquidity and pricing.

- **Expansion of On tap TLTRO** to cover other stressed sectors in synergy with the credit guarantee available under the Emergency Credit Line Guarantee Scheme (ECLGS 2.0) to encourage banks to extend credit support to stressed sectors at lower cost. Currently, the cost of funding for banks under our coverage is between 4.2%-4.5% for large banks and Kotak and a high of 5.5-6% for other such banks as IndusInd bank. This is, hence, a positive.
- To **review the current regulatory regime for the NBFC sector** to a scale-based regulatory approach linked to the systemic risk contribution rather than on the principle of proportionality.
- To conserve capital - **No dividend to be declared by banks** in FY21 as well.
- To put in place a **transparent criterion for declaration of dividends** by different categories of NBFCs as per a matrix of parameters.
- Access to **Regional Rural Banks to the liquidity windows** and the call/notice money market.
- To **review the extant guidelines on Credit Default Swaps** to facilitate the development of credit derivatives market and a liquid and vibrant market for corporate bonds, especially for lower rated issuers.
- To review comprehensive **guidelines for derivative products** to promote efficient access to derivative markets while ensuring high standards of governance.
- To bring **consistency across products of one-year maturity** in call, notice and term money markets, Certificate of Deposits (CDs), commercial papers (CPs) and non-convertible debentures (NCDs).

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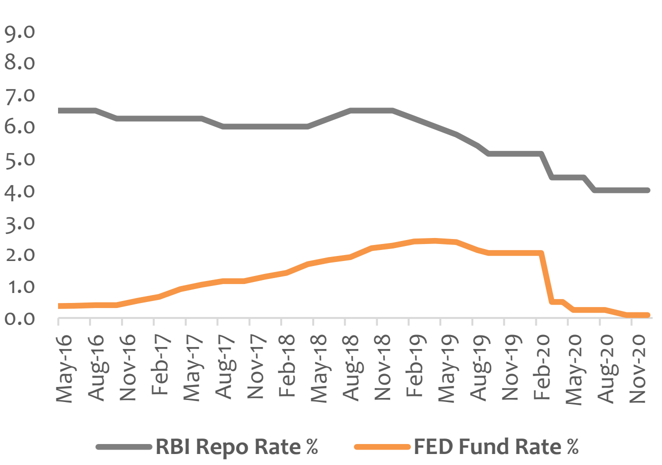
- To **increase supervision** in risk and internal audit in large UCB and NBFC, and guideline for statutory auditors of banks UCB and NBFC.
- To **implement Digital Payment Security Controls Directions** for the regulated entities for robust governance, implementation, and monitoring of certain minimum standards on common security controls for channels like internet and mobile banking, card payments, etc.
- To **enhance disclosures on customer complaints**, monetary disincentives in the form of recovery of cost of redress of complaints and undertaking intensive review of grievance redress mechanisms and supervisory action against regulated entities failing to improve their redress mechanisms.
- To delegate power of authorised dealers (banks) to ease the process for exports and import.
- To **make the RTGS system 24x7** to reduce default risk.
- To **increase the limits for contactless card transactions** and e-mandates for recurring transactions through cards (and UPI) from INR 2,000 to INR 5,000 from January 1, 2021.

Our View:

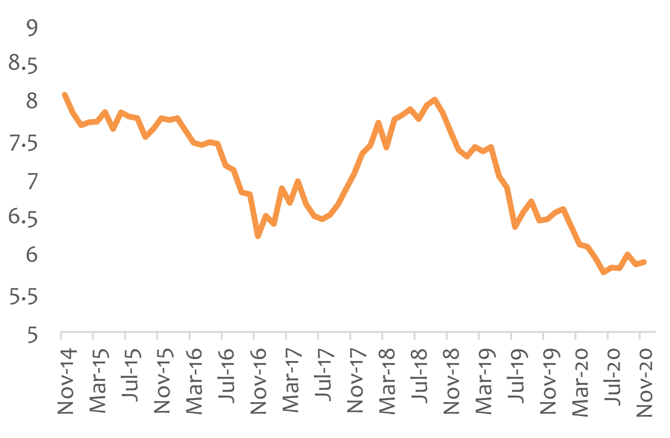
- While we await nuances of guidelines, change in regulatory guidelines for NBFCs is likely to be a positive. Often larger, well governed NBFCs have been impacted for flaws in the smaller ones. Criteria based framework is likely to reduce collateral damage and smooth the vagaries within NBFCs and in turn for the small borrowers dependent on them.
- The absence of withdrawal of liquidity support is likely to ensure that yield remain largely at the current levels and the steady interest rate forecast is unlikely to impact treasuries of the bank. On tap TLTRO is a positive for access to cheap funds.

Key Parameters: Charts

Policy rate: Status Quo



Bond Yield (10Y): Liquidity remain, yields at ~5.9%



Source: RBI, Bloomberg, KRChoksey

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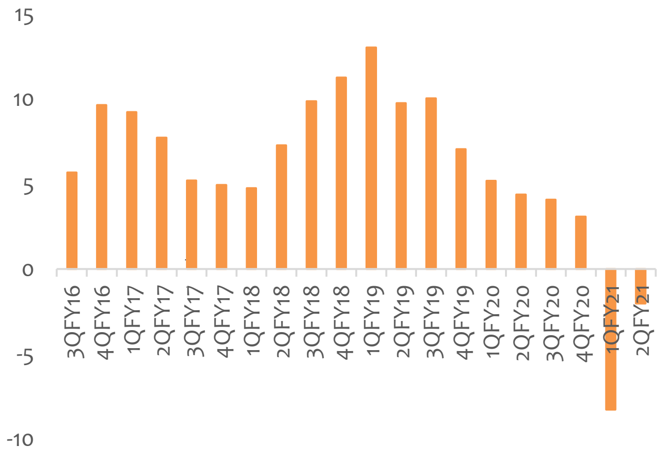
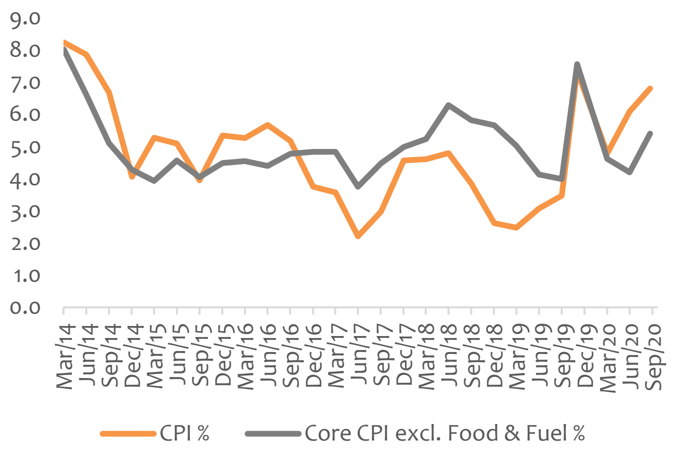
Real GDP growth (YoY): Gradual recovery, Revised upwards

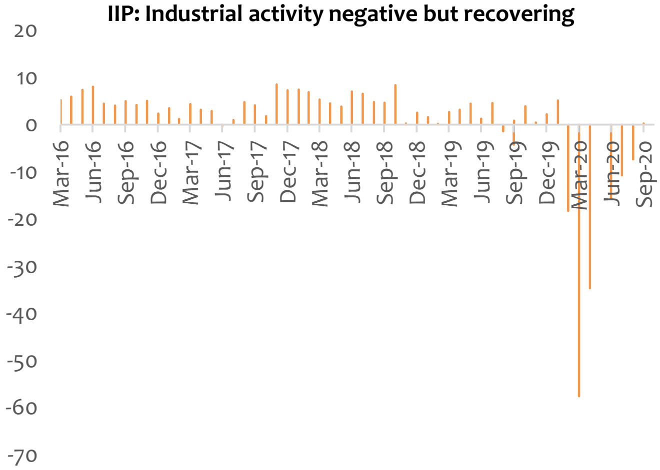


Inflation: Remains high, forecast revised upwards

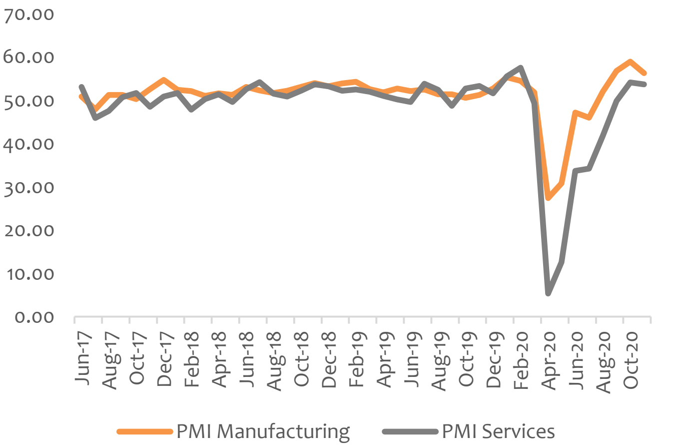


Source: RBI, Bloomberg, KRChoksey

IIP: Industrial activity negative but recovering



PMI (Manufacturing and Services): In expansion



Source: RBI, Bloomberg, KRChoksey

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