



ICRA Comments on the RBI's Annual Policy Statement for 2009-10

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Highlights of the RBI's Annual Policy Statement for 2009-10 – April 2009

- Benchmark Repo and Reverse Repo rates cut by 25 bps each to 4.75% and 3.25% respectively.
- Bank rate and CRR kept unchanged at 6% and 5% respectively
- SLR Kept unchanged at 24.00%
- GDP forecast at 6% for 2009-10 compared to an estimate of 6.5-6.7% for 2008-09
- Inflation to be maintained at around 4% by March 2010 with a medium term objective of 3%
- Money supply projected to grow by 17% in 2009-10
- Moderation in credit and deposits growth during 2009-10
- Branch expansion policy likely to be relaxed; setting up of ATMs liberalized.
- Coverage areas for banking correspondents (like NGOs and MFIs) increased to 30 KM from 15 KM.
- Saving Account to earn daily interest from April 2010
- Separate trading for STRIPS and Interest rate futures on 10-year notional coupon bearing government bond to be launched
- FCCB buy-back limit doubled to \$100 million from \$50 million
- Higher CRAR requirements for NBFCs-ND-SI deferred
- ARCs to now get more time to recover bad assets they bought from banks or other lenders.
- Minimum lock in period and retention criteria for securitizing loans originated and purchased by the banks to be introduced.
- Close watch on Credit rating Agencies
- Thrust on preserving financial stability while arresting moderation in growth momentum taking into account the lessons from the Global Financial Crisis

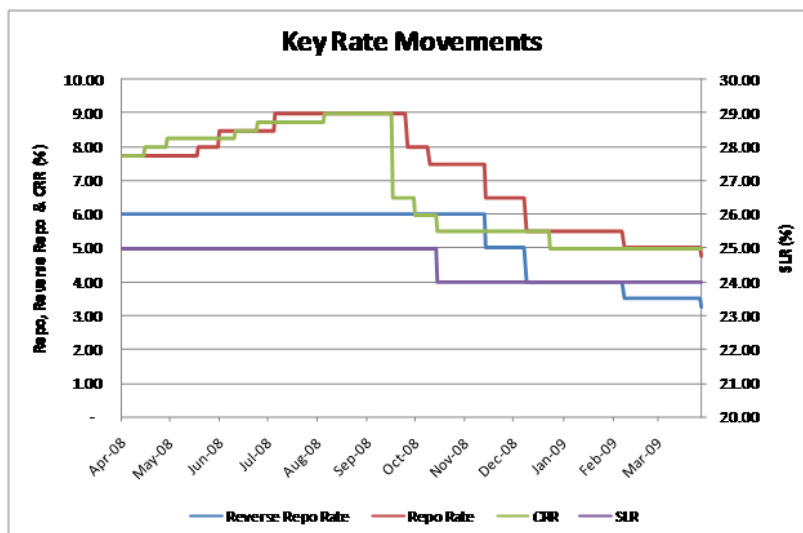
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CRR maintained; benchmark interest rates cut, RBI prods banks to reduce rates

The RBI has maintained the Cash Reserve Ratio (CRR) at 5% after a series of cuts during 2008-09 that brought it down by 400 bps from a peak of 9% in September 2008. The reduction has led to liquidity infusion of over Rs. 1,600 billion into the banking system since mid-September 2008. RBI has also used other means such as introduction of special refinancing windows, reduction in SLR, unwinding of MSS bonds etc. to infuse liquidity into the banking system.

RBI has now cut the Repo and Reverse repo by 25 bps each to 4.75% and 3.25% respectively. However, it has continued to maintain the 150 bps differential between the two implying that the RBI wants banking systems to deploy resources efficiently.

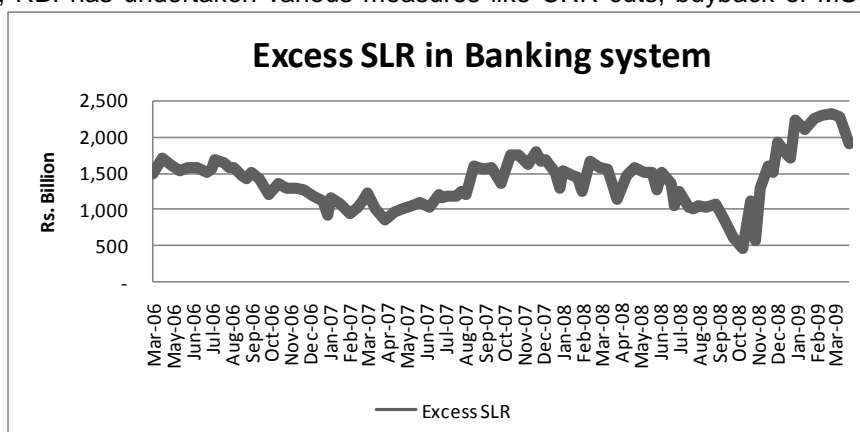
While RBI acknowledges that the cost of funds for banks are higher than in the past and consequently there could be a lag in banks reducing their rates, it continues to prod the banks to lower the lending and borrowings rates. RBI clearly believes that there is scope for further reduction since despite the PLR cuts announced by the banks, the commensurate benefits have not yet been passed on to the ultimate borrowers. With the Government and the RBI exploring options to ensure adequate credit to the MSME and other weaker sectors, we expect to see some new guidelines on the same during the current year.



By reducing the benchmark rates only by 25 bps and no reduction in the CRR, RBI has held on to its options to utilise these later during the year as it attempts to ensure price and financial stability in the system. The bond markets have reacted positively with the 10 year yields declining to 6.18% as compared to 6.40% the previous day. We expect further cuts in rates during the year by the RBI as the higher market borrowings programme of the Central & State Governments could impact the systemic liquidity.

Systemic liquidity remains comfortable

Over the past few quarters, RBI has undertaken various measures like CRR cuts, buyback of MSS securities, special refinancing window etc. to counter the tight liquidity conditions. Total liquidity infusion has been Rs. 4,228 billion since mid-September 2008 and no further CRR cuts have been administered. Since early April 2009 banks have been parking over Rs 1 trillion with the RBI under the liquidity adjustment facility window. However, with



the Net Market borrowings programme of the Central & State Governments for FY 2010 pegged at Rs. 4.35 trillion, the liquidity conditions could get tight in FY 2010. Assuming the banking sector would cater to around 70% of Govt's borrowings and an 18% growth in the overall deposits, funds available for credit growth would suffice for only 12% - 15% credit growth at current CRR levels. Any additional requirement for credit growth may necessitate a further cut in CRR (which at 5%, is 2% more than long term target set by RBI). Each additional cut in CRR could support an additional credit

of around 1.5% - 1.7%. In this context, the excess SLR to the extent of ~Rs 1.90 trillion (as on March 27, 2009) and the surplus cash with the banking system presently, provides cushion.

Inflation targets maintained

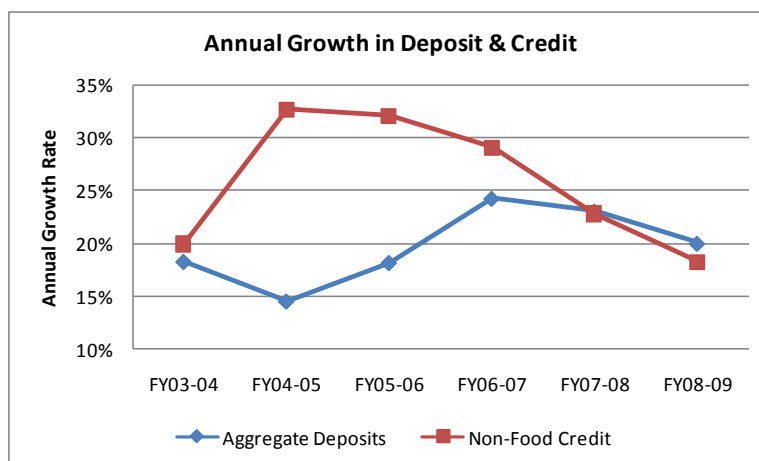
The RBI has maintained its inflation target based on wholesale price index at 4%-4.5% in the current fiscal with a medium term objective of reducing it further to 3%. The latest inflation data is 0.26% and is likely to move in the negative territory over the next few weeks. We believe the demand contraction in India is not as significant as seen globally and hence supported by Government spending, the inflation indicators could rise in the current year. Also with a medium term target of 3%, we expect RBI to use all tools available with them to manage inflation

GDP growth targets revised to 6%

RBI expects GDP growth to slowdown further to 6% in fiscal 2010 compared to the estimated 6.5-6.7% in fiscal 2009. While all sectors (Agriculture, Industry and Services) have slowed down, the 9.7% growth in services sector continues to support the overall growth indicators. The domestic system is further supported with the financial system having limited exposure to the risky assets.

Sharp slowdown in credit & deposit growth

Credit from the banking sector grew by 17% in 2008-09 as compared with the earlier expectations of around 24% sharp decline in the last quarter. There are sharp variations in the credit growth across various banking groups and across sectors. Credit growth for private sector and foreign banks was significantly lower at 9% (19% the previous year) and Foreign Banks at 1.6% (29%). This was partly due to tight liquidity and partly due to risk aversion. However, gross banking credit growth for PSBs (who dominate the market) was marginally higher at 23.9% (till Feb 27, 2009) compared to 22.3% the last year (Feb 15, 2008). Within this growth in credit flow to Industry was still higher at 31% compared to 23% growth in the corresponding period the previous year.



The credit growth was good till the first half driven largely by oil sector companies. The tight liquidity conditions since September 2008, deferment of capacity expansion plans across Industries and deferment of purchase decisions (especially in housing segment, which constitutes around 50% of the overall retail credit) and the stricter lending norms (especially for retail loans) led to lower credit off take in the later half. But for the rate cuts and the relaxations in restructuring of advances along with the Government Stimulus packages, the growth levels would have been lower. With business confidence index lower than in the past on account of the tough operating environment, credit is likely to remain subdued in 2009-10 as well. The RBI data suggest that the credit growth has been uneven across sectors and it aims to boost the flow of credit to all productive sectors of the economy, particularly to MSMEs, to aid the process of economic recovery. The rate cuts and the relaxations in restructuring of advances along with the Government Stimulus packages could help fuel credit growth in the current fiscal. We believe that RBI expectations of a 20% credit growth for 2009-10 could be achievable. However, concerns on the deterioration in the asset quality of commercial banks remains paramount.

Deposit growth, too, moderated to 19.8% in FY 2009 from 22.4% in FY 2008 as banks cut deposit rates by 75-250 bps during fiscal 2009. The rate cuts could have a favourable impact on banks' cost of funds but the declining CASA levels could keep cost of deposits high. As a result net interest margins of banks could remain tight in the current fiscal as well though there is a possibility that banks may not pass on the full benefit of the rate cuts in order to protect the interest spreads. RBI expects an 18% growth in deposits during 2009-10.

The incremental credit-deposit ratio declined to 66% in 2008-09 as compared with around 70% in 2007-08 and 83% in the previous year. As a result, the investment portfolio of banks grew by 20% in the same period and the excess SLR investments of the banking system increased to around 5% of net demand and time liabilities.

RBI continues to tighten regulatory controls to strengthen the system

Pursuant to the sub-prime crisis in the global markets, the RBI (and other regulators) have been trying to take pro-active steps to ensure that financial stability in their markets is maintained with overriding importance on the need to improve on their risk management and monitoring systems. RBI has stated that it will soon come out with a slew of guidelines related to areas like integrated liquidity risk management, stress testing, using and building floating provisions etc. in the next few months.

Opening up of Indian banking system put on hold

In February 2005, the Government of India and the Reserve Bank released the 'Roadmap for Presence of Foreign Banks in India' laying out a two-track and gradualist approach aimed at increasing the efficiency and stability of the banking sector in India. With the first phase of the roadmap being over (March 2005 - March 2009), there was an anticipation of announcement of measures like opening up of the Indian banking system. However with the financial meltdown and serious concerns surrounding the financial strength of global banks around the world, all such measures have been put on hold. The Indian corporate sector, too was expecting some guidelines on them owning / controlling banks. They too would now have to wait till the RBI comes up with its revised timelines and plans.

However, the RBI has liberalised the ATM rollout for banks as banks can now set up ATMs without prior approval subject to reporting the same. This should help smaller the private and foreign banks as they still seek to increase their network through ATMs and branches.

Interest on savings deposits to rise

As on date, banks compute the interest on savings bank accounts on the minimum balances held in the accounts during the period from the 10th day to the last day of each calendar month. However from April 1, 2010, the interest would be computed on a daily product basis. Depositors can be happy as they would now get higher interest on their idle funds parked in savings accounts of banks. This could potentially increase the cost of funds for banks by 10-20 basis points and banks with higher savings deposit base would be affected more. Assuming other parameters remain constant, we can see decline in overall profitability for the banking system as a result of the rise in cost of funds.

Respite on capital adequacy norms for Non-Banking Financial Companies

The systemically important non deposit taking NBFC would now have to maintain a regulatory capital adequacy of 12% from March 31, 2010 and 15% from March 31, 2011 instead of the earlier deadline of March 31, 2009 and March 31, 2010 respectively. Given the tough operating environment and the difficulty in raising equity capital, NBFCs would now not be constrained for capital to build on their portfolio in the current year. We could see increased issuance of Lower Tier II bonds by these companies in order to meet the business and new capital adequacy requirements that become applicable from the current financial year end.

Limited utilization of the Special Liquidity Facility for Eligible NBFCs-ND-SI

In order to meet the liquidity mismatches being faced by the NBFCs, the Central Government through the Industrial Development Bank of India Stressed Asset Stabilisation Fund (IDBI SASF) Trust had announced an arrangement for providing liquidity support to eligible NBFCs-ND-SI. This facility with an overall ceiling of Rs 200 billion is available up to June 30, 2009. However with liquidity pressure easing in the last quarter of 2008-09 and the relatively high interest rates charged by IDBI SASF, the utilization of funds is modest at only Rs 7.5 billion as on date as the NBFCs cannot use these funds for growing their book size. The relatively higher interest rate on these funds also acted as a dampner.

STRIPS to be introduced in 2009-10

A long standing request from the market participants – introduction of Separate Trading for Registered Interest and Principal of Securities (STRIPS) is likely to be introduced in the current year. While only select identified G-Secs will be converted into STRIPS, their availability of STRIPS across the term structure will aid the development of a sovereign zero-coupon yield curve. We await the RBI draft guidelines on the same by May 2009.

Corporate bonds to be traded on DvP-I basis

Unlike in trading in G-Secs, there was still no DvP for settlement of Corporate Bonds. The current policy allows OTC corporate bond transactions in real-time gross settlement (RTGS) system on a DvP-I basis (i.e., on a trade-by-trade basis), thereby reducing the settlement risk in such transactions. Henceforth, the clearing houses of the exchanges would have a transitory pooling account facility with the Reserve Bank wherein the the buyer of securities will transfer the funds through his bank to this transitory account through RTGS and the clearing house will thereafter transfer the securities from the seller's account to the buyer's

account and effect the release of funds from the transitory account to the seller's account. This is the first step in moving towards the DvP-III basis that is being used for G-Sec trading.

Minimum lock-in period and minimum retention criteria for securitisation of bank loans

RBI was viewing with concern the practice of some banks to securitise loans immediately on origination or purchase from other banks. Securitisation of some tranches of a project loan even before the total disbursement is complete was also reported as a concern. With RBI looking at prescribing a minimum lock-in-period and minimum retention criteria for securitising the loans, we feel that securitisation market related to corporate loan sell-downs could get impacted in the current year as the share of such issuance in the domestic securitisation market is significant.

More time given for Securitisation Companies/Reconstruction Companies to recover

As per the extant extant guidelines, securitisation companies (SCs)/ reconstruction companies (RCs) are required to realise the financial assets within a period of 5 years from the date of acquisition of such assets. Given the current environment, RBI has as an interim measure, provided an extension of 2 more years for realisation of the assets in respect of the security receipts (SRs) issued by SCs/RCs which have completed five years. While RBI has given the extension now, ICRA expects RBI to state its stance on treatment of such assets that have not been realized within the stipulated period shortly.

Extension of Relaxation of all-in-cost Ceilings for ECB's

The relaxation on the total cost for ECB under the approval route has been extended till December 2009. This should provide borrowers with more avenues to meet any funding needs. However quantum of funds that would get mobilised is dependent on the risk appetite of the global lenders.

Liberalisation of the Policy on Buyback of FCCBs

RBI has increased the quantum of FCCB's Indian companies can buyback from US\$50 million to US\$ 100 million based on the minimum discount on the buyback of the same. With global markets still risk averse and lot of these bonds quoting at significant discounts, Indian companies can use the opportunity to buyback the same. If companies use their own funds to buyback the capital structure of these companies could improve. With limited number of corporate having access to funds, we expect only few corporate to take advantage of this policy.

Overall Comment

The RBI has reiterated its soft interest rate stance by reducing the benchmark rates but retained the flexibility of further measures, should the need arise, by maintaining the CRR for now. We believe that RBI would continue to take measures to further strengthen the financial system by adopting best practices while balancing its stance to maintain price and financial stability in the system. While the RBI has been more direct in this policy on its expectation from the banking system to reduce rates, the quantum of monetary transmissions of its policies remains to be seen given the higher government borrowings during the current year and the difficult operating environment.



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