ICRA Comment

ICRA Comments on the RBI's Mid-Term review of the Annual Policy Statement for 2009-10

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Highlights of the RBI's mid-term review of the Annual Policy Statement for 2009-10 – October 2009

- SLR increased by 1% to 25%
- Benchmark Repo and Reverse Repo rates retained at 4.75% and 3.25% respectively.
- Bank rate and CRR kept unchanged at 6% and 5% respectively
- GDP forecast maintained at 6% for 2009-10
- Inflation estimate revised upwards to 6.5%; but RBI to continue stance to maintain at around 4% by March 2010 with a medium term objective of 3%
- First Financial Stability report to be released by December 2009
- Final guidelines on repo in corporate bonds to be introduced by end November 2009.
- STRIPS to be launched in the current financial year
- Corporate Bonds to be traded on DVP-I basis
- Credit default swaps to be introduced in corporate bonds
- Short term Non Convertible debentures to be brought under regulatory lens
- To permit the recognized stock exchanges to offer currency futures contracts in currency pairs of Euro-INR, Japanese Yen-INR and Pound Sterling-INR, in addition to US dollar-rupee contracts which are already permitted
- A committee of the Government of India to suggest a roadmap to raise the CRAR of regional rural banks to 9% by March 2012.
- Greater flexibility to banks for opening branches to enhance banking penetration and promote financial inclusion
- RBI to issue detailed guidelines on the use of duration gap analysis for management of interest rate risk by end-November 2009
- It is proposed to increase the provisioning requirement for advances to the commercial real estate sector classified as standard assets from present level of 0.40% to 1%
- Banks to augment their provisioning cushions such that their total provisioning coverage ratio is not less than 70%. Banks should achieve this norm by September 2010
- Minimum lock in period for all types of loans would be one year before these can be securitized and the minimum retention by the originators will be 10% of the pool of assets being securitized.
- Reserve Bank of India has initiated discussions with SEBI to assess the rating agencies' compliance with the enhanced Code of Conduct Fundamentals of the IOSCO.
- Introduction of a new category of NBFCs as 'infrastructure NBFCs', defined as entities which hold minimum 75% of their total assets for financing infrastructure projects

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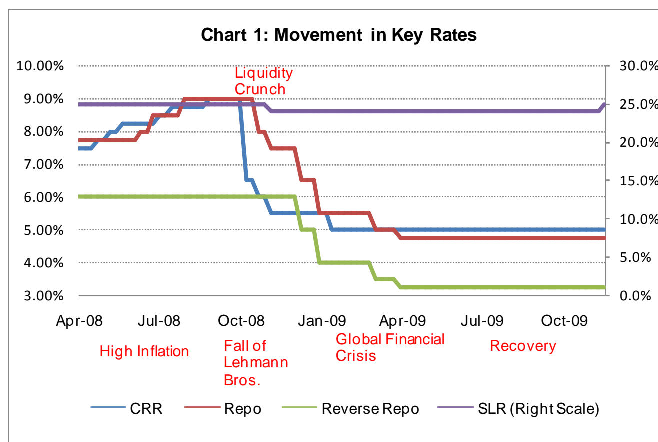
CRR, benchmark rates unchanged; abundant liquidity and soft monetary policy stance to keep interest rates low

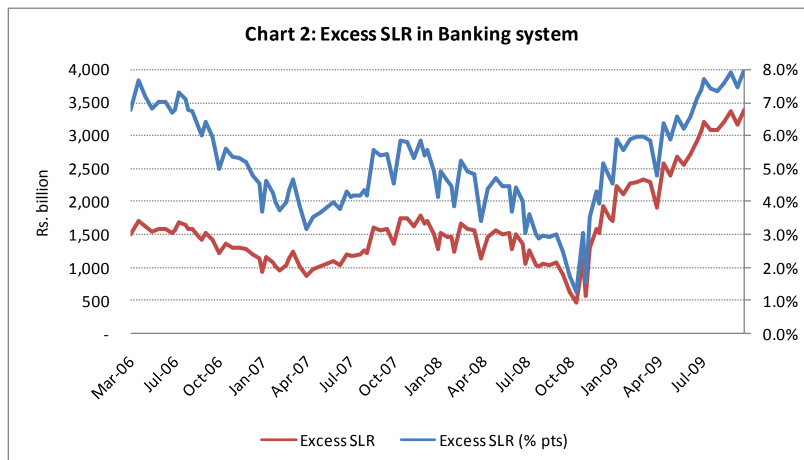
The RBI has maintained the Cash Reserve Ratio (CRR) at 5%, unchanged since January 2009. During the financial crisis, CRR was reduced by 400 bps within a period of 6 months leading to a liquidity infusion of over Rs. 1600 billion. While CBLO liabilities now come under the ambit of CRR, it is not expected to be significant given the abundant liquidity in the system, though there could be a marginal impact on interest margins.



After the last cut in Repo and Reverse Repo rates in April 2009, most banks took RBI's cues and reduced their deposit and lending rates. In the last one year, deposit rates have fallen by 175-350 bps (public sector banks), while the reduction in BPLR was lower in the range of 125-275 bps. The lag in reduction of lending rates to the ultimate borrowers can be attributed to the overhang of significant relatively high cost deposits mobilised in the past besides risk aversion shown by banks. As these high-cost liabilities have started running down, banks' cost of funds have shown a decline in the past quarter. We think that RBI is likely to reverse its accommodative stance in the near future and has just taken a pause at this time by not changing the key benchmark rates.

Systemic liquidity remains comfortable

The liquidity levels in the domestic banking system has increased sharply since November 2008 supported by the steps taken by the Government and the Reserve Bank in light of the global financial crisis. Total liquidity infused in since October 2008 has been in excess of Rs 4.2 trillion. With credit off-take remaining subdued, banks have been parking excess of Rs 1 trillion on a daily basis (since April 2009) with the RBI under the liquidity adjustment facility window. Post this hike in SLR, the estimated SLR is expected to come down by Rs 400 billion to around Rs 2.9 trillion. As over 70% of the government borrowings completed for this financial year, the current excess liquidity of around Rs 3.2 trillion and steady deposit growth should suffice for a credit growth of over 15% for the current year.



Unwinding of liquidity measures of the past has begun

In the wake of tight liquidity in the last financial year, RBI had provided various refinance / special liquidity facilities to banks and financial institutions for specific purposes. Keeping in mind, low utilisation of these facilities and ample liquidity in the system, RBI has now reduced the limit of export credit refinance facility from 50 per cent to 15 per cent of eligible outstanding rupee export credit extended under Section 17(3A) of the RBI Act. RBI has also discontinued the special term repo facility for scheduled commercial banks for funding to mutual funds, non-banking financial companies and housing finance companies and has also discontinued the Forex Swap facility for banks with immediate effect. These steps point that the RBI could tighten the accommodative stance in the short term in light of the expected inflationary concerns over the next few quarters. The status of various measures taken by RBI in the last 12 months is as under:

Steps taken during financial crisis	Liquidity Impact	Status as on date	Liquidity Impact (current status)
CRR reduced by 400 bps to 5% of NDTL	(+) Rs 1,600 billion	CRR maintained at 5% of NDTL	-
Term repo facility	(+) Rs. 600 billion	Term repo facility to be withdrawn with immediate effect	(-) Rs. 600 billion
Increase in Export credit refinance from 15% to 50%	(+) Rs. 255 billion	Export credit refinance rolled back to 15% with immediate effect	(-) Rs. 255 billion
Special refinance facility	(+) Rs. 385 billion	Special refinance facility with immediate effect	(-) Rs. 385 billion
Refinance facility for SIDBI/NHB/Exim Bank	(+) Rs. 160 billion	Refinance facility for SIDBI/NHB/Exim Bank available upto Mar-10	-
Liquidity facility for NBFCs through SPV	(+) Rs. 250 billion	Liquidity facility for NBFCs through SPV available upto Dec-09 (All outstandings to be collected by Mar-10)	-
Total	(+) Rs. 4228 billion		(-) Rs. 1240 billion
Memo item:			
SLR reduced from 25% to 24% of NDTL	(+) Rs 400 billion	SLR revised back to 25% of NDTL	(-) Rs 400 billion

While the RBI has withdrawn much of the liquidity measures introduced last year, most of these facilities have remained unutilised in the current year because of abundant systemic liquidity. Hence, the impact of withdrawal of these measures is not expected to be material.

Projected inflation hiked to 6.5%; RBI's ideal range maintained at 4%-4.5%

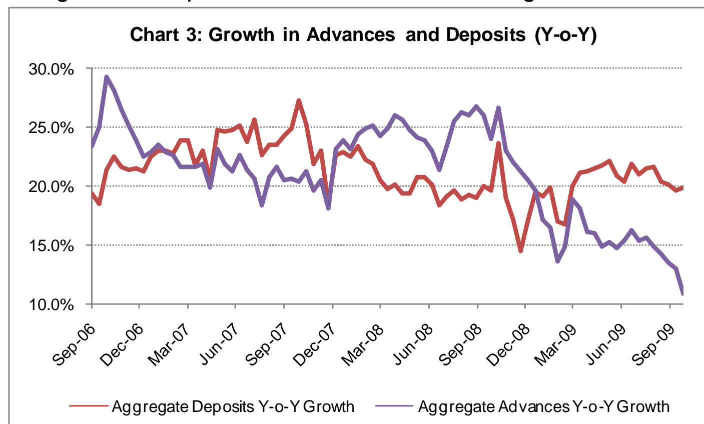
RBI has revised its inflation estimate for the current fiscal to 6.5%, but has nonetheless indicated the monetary policy stance would be to "condition and contain perception" of inflation at 4%-4.5% by March 2010. The WPI inflation, which had fallen into the negative territory early in the current fiscal, has turned around to 1.21% as on October 10, 2009. The turnaround has largely been on account of the relentless increase in the prices of food articles, which still remained high at 13.34%, aggravated by a deficient monsoon across the country. While ICRA believes RBI has started unwinding of liquidity measures introduced during the financial crisis, it is unlikely liquidity would be tightened significantly in the current fiscal. Planned Central Government borrowings could draw out an additional amount of Rs. 625 billion from the system (Rs. 1924 billion till date) upto March 2010. However, the threat of inflation increasing beyond projections remains as the monetary policy tightening is expected to be only gradual and given the increased government spending. Nonetheless, with a medium term target of 3%, we expect RBI to use all tools available with them to manage inflation.

GDP growth targets maintained at 6%

RBI has placed GDP growth for the current fiscal at 6% with an upward bias, unchanged from July 2009. While external demand continued to contract, domestic demand for industrial goods have been bolstered by the recovery in the industrial sector. The Services sector is also expected to follow suit, though with a lag. However, according to RBI, agricultural production could decline marginally in the current fiscal because of the weak monsoon, and this could pull down overall growth.

Robust growth in deposits maintained while credit decelerates

The deposit base of the Indian banking system increased to Rs 41.61 trillion as on October 9, 2009 representing a 20%y-o-y growth (9% growth over March 2009 levels) driven by large volumes of time deposits mobilised by the banking system during the third quarter of 2008-09 amidst the global credit crisis and increased risk aversion amongst the investors. With banks also tightening their credit filters, we saw a decline in the absolute levels of demand deposits in the system. During the current financial year, with a turnaround in business and economic outlook, the demand deposits too have reported a 10.3% y-o-y growth till October 9, 2009.



On the other hand, the non food credit of the Indian banking system stood at Rs 28.48 trillion as on October 9, 2009 representing a 11%y-o-y growth (4% growth over March 2009 levels). While the credit growth by public sector banks is still at over 15% y-o-y, the growth for private sector banks stood at nominal 2% while foreign bank have actually shrunk their portfolio by 15% during the last 12 months. Major reasons for this significant slowdown in the non-food credit have been slowdown in the overall credit demand from the manufacturing sector, reduction in borrowings from oil marketing and fertilizer companies as oil prices moderated, and slowdown in retail credit. With the Government and the RBI focussed on ensuring adequate credit to the micro, small and medium enterprises (MSME) and other weaker sectors, we could see some guidelines on the same during the current year.

Banks continue to cut deposit rates in the current year as well and consequently incremental cost of deposits continue to slide as banks have cut rates on account of the ample liquidity in the system and lower credit off-take till the first half of the current financial year. The net interest margins have been positively impacted as the deposit costs have declined at a faster rate and with expected higher credit off-take in the balance part of the year, margins could improve at least over the next few quarters.

While the RBI retains its estimates of deposit growth at 18% for the current financial year, it as revised the credit growth to 18% from 20% as indicated earlier. ICRA expects the systemic deposit growth at 18-19% during 2009-10 as compared with 20% reported in 2008-09, while the credit could grow by 13-15% as compared with 19% last year.

Increase in credit provisions on Standard Commercial Real Estate Exposures

This would increase the SCBs' caution towards lending to the sector (which currently constitutes around 3.3% of total banking credit) and could increase the interest rates charged by SCBs on such exposures.

Increase in provisioning cover on NPAs to 70% by September 2010

Increased provisioning cover on NPAs indicates an end to the temporary relaxation given by RBI to SCBs on NPA classification and hence on credit provisioning. While the increased provisioning cover would help the SCBs in protecting their solvency profiles and hence is a credit positive. It is likely to dilute the earnings of the SCBs as they would have to make incremental credit provisions (on NPAs) of around Rs. 750 billion (Rs. 120 billion on existing NPAs and around Rs. 630 billion on fresh slippages over the next two years) as against around Rs. 330 billion credit provisions created in the last two years ending March 31, 2009. Assuming a 20% annualized growth in total assets of the SCBs, this could lead to lowering in earnings (PBT as % of Total assets) by 15 to 25 basis points from March 2009 levels. Annualized credit provisions as % of average total assets have remained less than 0.5% over the last two years.

Increased provisioning requirement could also lead to lower write offs (as the banks may prefer to keep the fully provided NPAs on the balance sheet to improve the overall provisioning cover) and hence an increase in Gross NPA%. However, such an increase in Gross NPA% because of change in write-off policy is unlikely to impact the credit profile and therefore the credit rating of ICRA rated banks.

RBI looks to further strengthen the financial 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. In addition to the increase in provisioning norms, RBI has indicted that that it will soon come out with a slew of guidelines

related to areas like integrated liquidity risk management, stress testing, managing interest rate risks using duration gap analysis etc. in the next few months.

Regional Rural Banks to maintain minimum capital adequacy ratio by March 2012...

On the lines of capital adequacy requirements for the commercial banks, RBI has proposed to introduce CRAR for Regional Rural Banks (RRBs) in a phased manner with an intention to raise CRAR of RRBs to nine percent by March 2012.

Branch opening licence freed keeping financial inclusion in mind

RBI continues to focus on financial inclusion thereby access to banking system is available to a larger section of the population. The pilot project initiated in this regard is completed with a number of districts achieving 100% financial inclusion. Further steps would be initiated after evaluation the lessons learnt from the project. RBI has also enlarged the category of persons who qualify as business correspondents, which should give a further fillip to increase financial inclusion. RBI has given the freedom to scheduled commercial banks to open branches in Tier 3 to Tier 6 cities while they would need to obtain RBI approval for opening branches in Tier 1 and Tier 2 cities.

Fourth category of the NBFCs introduced

RBI has again highlighted the importance of infrastructure sector by introducing a fourth category of NBFCs as “Infrastructure NBFCs” defined as NBFCs which hold minimum 75% of their total assets for financing infrastructure projects. Currently, the Reserve Bank classifies NBFCs under three categories, viz., asset finance companies, loan companies and investment companies. Under Basel II framework, the risk weights for bank’s exposure to systemically important non deposit taking NBFC (NBFCs-ND-SI) is 100% while the Asset Finance Companies (AFCs) carry a risk weight based on their credit ratings. Now the NBFCs defined as “Infrastructure NBFCs” would have a benefit of risk weight age lower than earlier 100% depending on their credit rating. This is expected to benefit direct and indirect lending for infrastructure projects.

RBI continues to reiterate commitment in developing the bond market in India

- **Introduction of STRIPS**

Earlier during the year, RBI had finalised the guidelines for introducing “Separate Trading for Registered Interest and Principal of Securities (STRIPS)” in India. 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. Under the facility, Banks will be permitted to strip/reconstitute eligible securities held in their held to maturity (HTM)/available for sale (AFS)/held for trade (HFT) portfolios. RBI has indicated that STRIPS would be launched in the current financial year.

- **Corporate Bond trading on DVP-I basis**

RBI had earlier allowed 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. With DvP-I based clearing and settlement system for OTC trades in corporate bonds being operationalised by the clearing houses of the exchanges, RBI has indicated that repo in corporate bonds can now be introduced shortly. The final guidelines on repo in corporate bonds will be issued by end-November 2009. Unlike in trading in G-Secs, there is still no DvP for settlement of Corporate Bonds and this is the first step in moving towards the DvP-III basis that is being used for G-Sec trading.

- **Short Term NCDs now to be regulated**

RBI has deliberated that the short term Non-Converted Debentures (NCD) with a maturity of less than one year, being money market instruments, would be brought under the SEBI’s regulatory purview. RBI may regulate such debentures on the lines of the guidelines for issuance of commercial paper (CP). At present, issuance of NCDs with maturity of less than one year is not subjected to regulation by the SEBI or the Government of India.

- **Credit Default Swaps in Corporate Bonds to be introduced**

In line with the international financial markets, RBI has proposed to introduce plain vanilla OTC single-name CDS for corporate bonds for resident entities subject to appropriate safeguards. To begin with, all CDS trades will be required to be reported to a centralised trade reporting platform and in due course they will be brought on a central clearing platform. Earlier, RBI had introduced guidelines for CDS in 2007 and then withdrawn this during the financial crisis. Introduction of CDS, which is a derivative used to offset risks in debt market, is expected to bring reform in corporate debt market of India, which as of now is marred by the lack of liquidity. CDS would allow creditors to insure themselves against the possibility that a borrower might default. However, taking a cautious approach after the role played by CDS in global financial crisis, RBI as of now has proposed to introduce only plain vanilla OTC single name CDS and not the exotic CDS.

RBI continues to focus on widening and strengthening the financial system

RBI has announced several measures for widening and deepening of the financial systems while maintaining prudent supervisory oversight on its functioning. Some of the key measures announced and the expected timeline are given below:

Measures	Expected Timeline
Draft guidelines for regulation of Short Term NCDs issuance; expected to be inline with those for commercial papers	Nov-09
Plain vanilla OTC single-name CDS for corporate bonds for resident entities to be introduced	Not indicated
NBFCs holding 75% of assets for financing infrastructure projects to be classified as “Infrastructure NBFCs”	Immediate
STRIPS to be introduced	Fiscal 2010
Guidelines for forex, commodity and freight derivatives to be reviewed	Nov-09
Review of BPLR System – RBI to consider recommendations of the report of the Working Group	Not indicated
Final guidelines on introduction of Repo in Corporate Bonds with DvP-I based clearing and settlement	Nov-09
Guidelines on enhancements to the Basel II framework	Nov-09
Introduction of Duration-gap analysis for Asset-Liability management	Nov-09
Draft circular & guidelines on liquidity risk management	Dec-09 (Deferred from Jun-09)
Guidelines on stress testing	Jan-10
Final guidelines for revision in Repo accounting	Nov-09
Liberalisation of Branch expansion	Immediate
Guidelines on sound compensation practice to private and foreign banks	Not indicated

Exchanged based trading in currency futures extended to other currency pairs...

Earlier in August 2008, RBI and SEBI had allowed exchanged based trading in currency futures in US Dollar – Indian Rupee (INR) pair in three recognised Stock Exchanges. In order to enable the market participants to directly hedge their currency exchange risks in other currency pairs, RBI has now proposed to permit the recognised stock exchanges to offer currency futures contracts in currency pairs of Euro-INR, Japanese Yen-INR and Pound Sterling-INR, in addition to US dollar-rupee contracts. The combined average daily turnover of the USD – INR contracts in all the three exchanges has increased from US$ 1.1 billion in March 2009 to US$ 2.5 billion in September 2009 and introduction of new currency pairs will add to the overall volumes.

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

In order to ensure that the originators do not compromise on due diligence of assets generated for the purpose of securitisation and also to make them more accountable, RBI has proposed a minimum lock-in period of one year for all types of loans before they can be securitised. In addition, RBI has also proposed minimum retention criteria for the originators as 10% of the pool of assets being securitised. While RBI has not clearly specified the date from which these guidelines become applicable, they have indicated that further detailed guidelines on this subject would be issued in due time (based on outcome of similar work being done on this subject in European unions and US market).

ICRA estimates that more than 80% of the loan sell down that happen in India are short term loans. With this move, we believe that the securitisation market related to corporate loan sell-downs could get impacted in the current year as the share of such issuance in the overall domestic securitisation market is significant.

While the policy is not yet clear if the guidelines are applicable to NBFC originators, these guidelines could adversely impact even the conventional transactions like retail loan securitisation as most of the underlying loans have seasoning of less than 6 months. In addition, if originators retain a minimum of 10% of the securitised pool, it may become difficult to derecognize the pool of assets from the balance sheet of the originator as per IFRS accounting standards, which becomes applicable shortly.

Overall Comment

RBI has started reversing its stance both on monetary policy and regulatory policy front as reflected in increase in SLR, increase in provisioning on standard advances extended to Commercial real estate, introduction of minimum provisioning cover on NPAs for SCBs (70% as against the current provisioning cover of a little over 50%) and stricter norms for securitization of loans. With the operating environment showing signs of improvement and the raising of funds, both in the debt and equity markets, turning easier, we believe that RBI could focus more on measures to maintain price and financial stability in the system.

The Statutory liquidity ratio (SLR) restored to 25% from 24% earlier would not have much impact currently as most banks are holding SLR of 27-28 % (net of LAF deployment). Increased provisioning cover on NPAs for SCBs indicates an end to the temporary relaxation given by RBI to SCBs on NPA classification and hence on credit provisioning. While the increased provisioning cover would help the SCBs in protecting their solvency profiles and hence is a credit positive. It is likely to dilute the earnings of the SCBs (PBT as % of Total assets) by 15 to 25 basis points from March 2009 levels.

Minimum lock-in period and minimum retention criteria for securitisation of loans could impact the loan sell down market as more than 80% of the loan sell down in India are short term loans. These guidelines could adversely impact even the conventional transactions like retail loan securitisation as most of the underlying loans have seasoning of less than 6 months. In addition, if originators retain a minimum of 10% of the securitised pool, it may become difficult to derecognize the pool of assets from the balance sheet of the originator as per IFRS accounting standards, which becomes applicable in a few years time.

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