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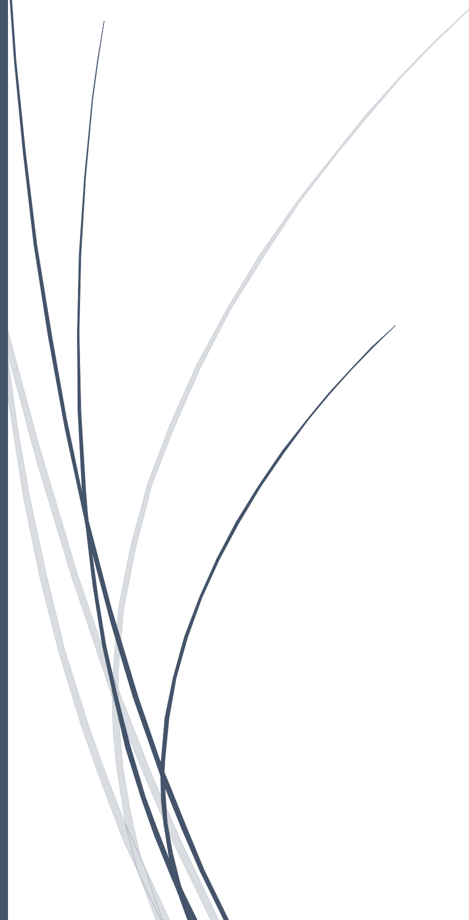

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Decoding RBI measures to tackle COVID-19 economic disruptions

COVID-19 has altered the path of the global economy as almost no country is now unscathed from this highly contagious disease. Some countries seem to have peaked its trajectory while some countries like India are yet to reach the peak. With the countrywide lockdown of 40 days, the wheels of economic machinery have slowed down and, in many sectors, like travel & tourism, airlines, etc., almost stopped.

The prevailing situation is already causing widespread economic ramifications. With businesses and factories being shut, many companies are fighting for survival. Companies that are working are operating at very low capacity. The hardest hit are the small businesses and informal sectors where demand has dried up due to the lockdown. Access to affordable credit has become a big challenge for these businesses, including large companies.

Last Friday, RBI announced the second round of measures to contain the effects of these economic disruptions. Some key measures are:

1. Cut Reverse Repo rate by 25 bps to 3.75%, repo rate unchanged to 4%

2. TLTRO 2.0 of 50,000 crores - 50% to go to NBFCs, MFIs

3. Barred Scheduled Commercial Banks and Cooperative Banks to declare dividend until further notice

4. Liquidity Coverage Ratio for SCBs brought down to 80% from 100%

5. Providing special refinance facilities to AIFIs to the tune of 50000 crores

Let's try to decode each in simple terms and its implications.

1. Cut Reverse Repo rate by 25 bps to 3.75%, repo rate unchanged to 4%

To understand the Reverse Repo rate, let's understand Repo Rate first. Repo rate is the rate at which banks borrow from the RBI. Well, this is the most important and pivotal rate as all other rates (like home loans or car loans) are pegged to this reference rate and is determined by Monetary Policy Committee. RBI had cut repo rate drastically by 75 bps to 4.40% on 27th March. Note that this is the lowest repo rate ever.

When banks have surplus liquidity, they park their money with RBI for the overnight or short term. The rate at which RBI pays to the bank is called Reverse Repo Rate.

Last Friday, this is the rate which RBI has reduced from 4% to 3.75%. So now, the gap between repo and reverse repo has widened to 65bps. So why widened this gap? Because banks have been parking close to a whopping 6.9 Lakh crores with the RBI per day under reverse repo operations (see Exhibit

1). That's like 3% of our GDP. So, RBI wants to disincentivize banks to park excess cash and encourage them to bring money in circulation through lending and investment activities. By reducing the reverse repo rate to 3.75%, parking money with RBI would be less attractive for banks as they are still paying between 3.5% to 6% interest on savings deposits (except SBI which pays 2.75%). We might see a further reduction in deposit rates.

RBI OPERATIONS@					
	Auction Date	Tenor (Days)	Maturity Date	Amount	Current Rate / Cut off Rate
C. Liquidity Adjustment Facility (LAF) & Marginal Standing Facility (MSF)					
	I. Today's Operations				
1. Fixed Rate					
(i) Reverse Repo	Thu, 16/04/2020	1	Fri, 17/04/2020	6,99,312.00	4.00
2. Variable Rate&					
(I) Main Operation					
(a) Reverse Repo					
(II) Fine Tuning Operations					
(a) Repo					
(b) Reverse Repo	-	-	-	-	-
3. MSF	Thu, 16/04/2020	1	Fri, 17/04/2020	0.00	4.65
4. Long-Term Repo Operations	-		-		-
5. Targeted Long Term Repo Operations					

Exhibit 1

Let's see how the reverse repo operations have trended over the last month. (Exhibit 2)

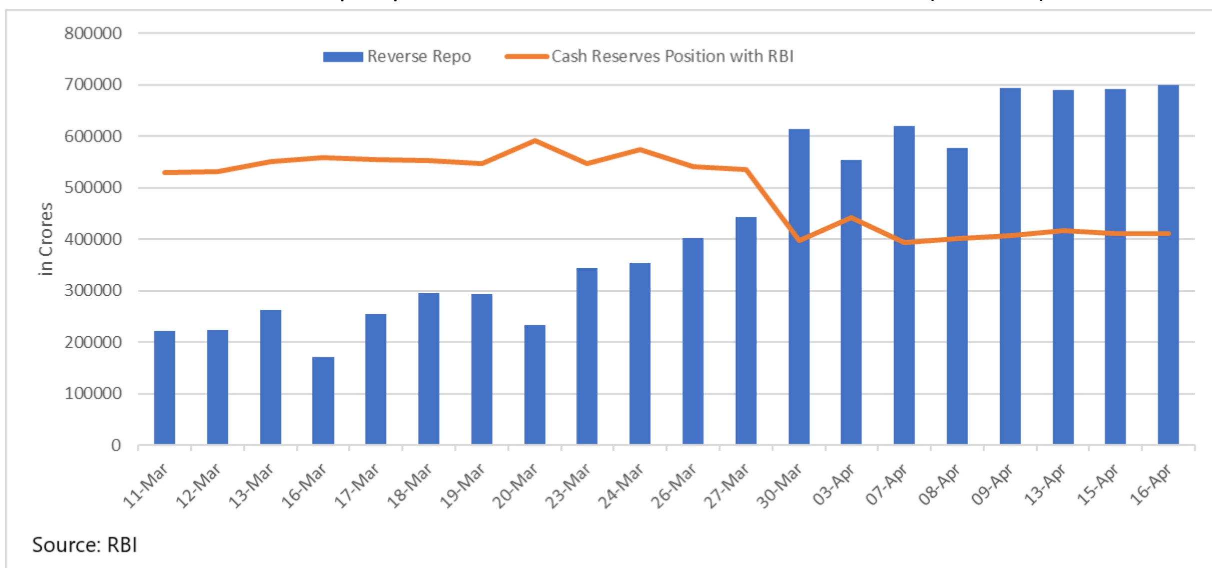

Exhibit 2

We see a sudden increase in Reverse Repo amount after 27th March. This is because of the cut in Cash Reserve Ratio (another jargon, phew!). Well, when you deposit money in a bank, the bank must put aside 4% of that money (technically, 4% of fortnightly Net Demand and Liabilities) with the RBI on which they don't get any interest. This is to maintain liquidity and security for the depositors if there is a sudden spurt in withdrawal (remember, Yes Bank!). RBI reduced the CRR from 4% to 3% on the 27th March. This released about 1.3 Lakh crores from the CRR reserves, which is again parked with RBI under reverse repo. You can see, in Exhibit 2, the CRR position dipped by a similar amount after 27th March.

So why banks are parking such a high corpus with RBI rather than lending?

There are primarily two reasons:

First, with this ongoing COVID-19 situation, the NPAs are expected to shoot up dramatically which will damage their bottom-line. With gloomy economic conditions, stalling manufacturing activities and rising unemployment, banks are afraid of the raised likelihood of defaults. The risk returns ratio doesn't seem favourable for the risk-averse banks which seems to be valid concerns from their perspective. So instead of lending, banks prefer to park money with the RBI even if it fetches low returns.

The other reason is weak demand. Even before the COVID-19 situation, our economy was already witnessing falling demand and consumption. The current lockdown has aggravated the situation as demand for non-essential items have dropped substantially as people are refraining from purchasing discretionary items to preserve cash for the uncertain future. Another reason for reduced demand is the substantial drop in purchasing power due to pay-cuts and unemployment.

2. TLTRO 2.0 of 50,000 crores - 50% to go to NBFCs, MFIs

Again, to understand the TLTRO, we need to understand the LTRO first. Under the repo operations, banks borrow cash from the RBI at the repo rate and provide Government securities as collateral. These repo operations are usually short term in nature, i.e. less than 28 days. When RBI cuts the repo rate, the cost of funds for banks gets reduced as they can now purchase the same amount at a relatively cheaper rate from RBI. Ideally, the banks should pass on the benefits to consumers by reducing their loans rate. And when you get cheaper loans, the demand for credits increases which spurs the economic activities. But what RBI was noticing that, even after a rate cut of 135 bps in the last calendar year, banks had hardly passed on the rate cuts to consumers.

LTRO

So early this year, taking cues from the European Central Banks, RBI introduced a new tool called Long Term Repo Operations (LTRO) to inject more liquidity in the system and ensure the transmission of rate cuts. What happens in LTRO is that, banks can borrow one to three-year loans from RBI at the current repo rate, by giving collateral (usually Government bonds) of similar tenure.

How LTRO will reduce interest rates?

Generally, the yield curve is upward sloping, i.e. as the maturity increases, the rate also increases (Exhibit 3). You would have noticed that your 3 -5 years Fixed Deposits fetch you more returns that 3-6 Months Fixed deposits. Similar is the case for the banks, they have to pay a relatively higher amount to purchase GSecs of higher maturity. But with LTRO, now banks can get 3 years of loans at the repo rate. As the cost of funds reduces, banks should reduce the loan rate as well. So, without changing the repo rate, RBI can achieve the objective of passing rate cuts to borrowers.

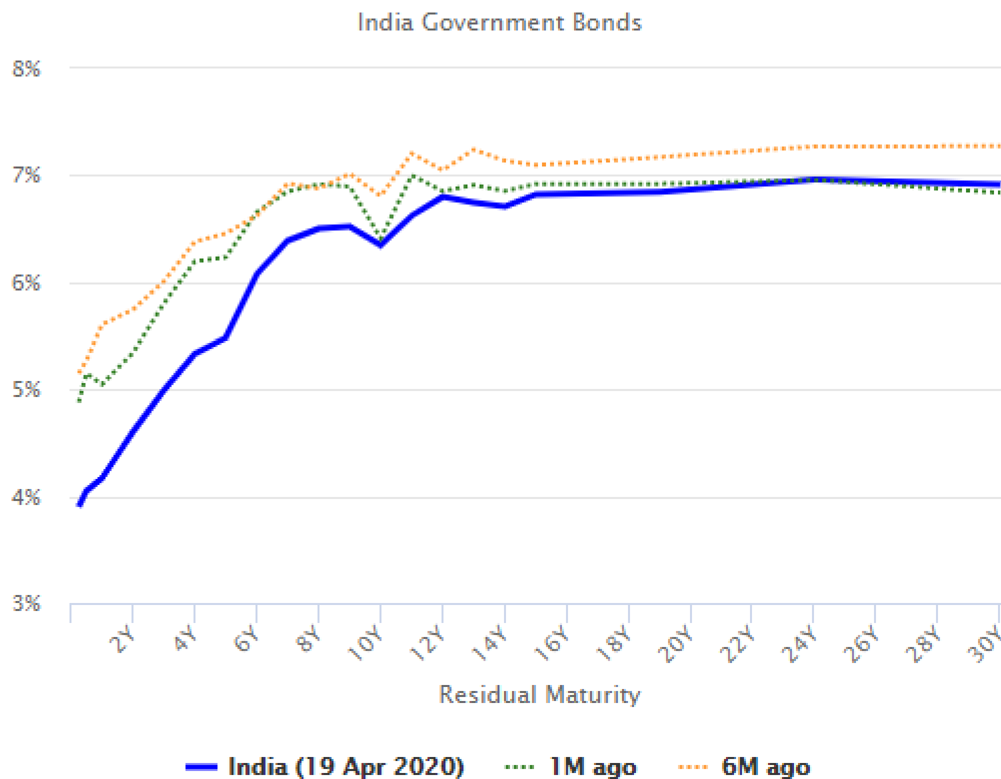

Exhibit 3

Another objective that LTRO fulfills is that it reduces the short-term market rates. As mentioned earlier, when banks participate in LTRO, banks have to provide Government securities (GSecs) of similar tenure as collateral. Before the LTRO, these 3-5 years GSecs were trading at a substantial premium i.e. the yields were relatively higher. To provide as collateral to RBI for LTRO, banks have to purchase these 3 Year GSecs. As the demand increases, bond prices will go up. And since the yield is inversely related to bond prices, the yield of these instruments will go down, driving the short-term market rates to lower values.

But then what is TLTRO?

Banks are the primary source of capital for most institutions/corporates in India, including NBFCs. NBFCs also used to borrow from Mutual Funds through Commercial Paper routes but due to the stock market crash, MFs are facing redemptions pressure and are not able to provide liquidity to these NBFCs. The lack of credit had led to the shooting up of corporate bonds yield, leading to a near-crisis liquidity situation. This can be viewed from the fact that the credit spreads, which is the difference between the yield of corporate debt and Government bond of the same maturity, for AAA and AA bonds, have risen from 95bps and 166bps respectively, to 130bps and 197bps respectively, between 3rd March and 23rd March. Note, wider the credit spread, worse for the economy. This is where RBI pitched in, on 27th March, with Targeted LTRO (TLTRO 1.0) to ease the liquidity constraints and de-stress the bond market.

Through TLTRO 1.0, RBI offered up to 1 Lakh crore, through auction, to banks to deploy these funds to investment-grade corporate bonds (not Government bonds). The provision of TLTRO put these funds under held-to-maturity bucket (HTM), so the banks don't have to worry about mark to market risk. This helped in calming the bond markets and credit spreads came down.

TLTRO 2.0

However, most of these funds were invested in Public Sector Undertakings (PSUs) or large corporates. This is where RBI came up with TLTRO 2.0, on 17th April, offering up to 50,000 crores. The funds availed by banks under TLTRO 2.0 would be invested in investment-grade bonds, commercial paper, and non-convertible debentures of NBFCs, with at least 50 percent of the total amount availed going to small and mid-sized NBFCs and Micro Finance Institutions. That's a big relief for the NBFC and Micro Finance sector, especially the small and mid-sized ones as they are the ones badly hit under this lockdown with stalling collections and the lack of access to affordable credit.

3. Barred Scheduled Commercial Banks and Cooperative Banks to declare dividend until further notice

As a business, when you have retained earnings, either you re-invest in the business to grow further or distribute this income in forms of dividends to your shareholders or do partly both. But when the future of business is quite gloomy and uncertain, it's prudent to conserve your capital. That's what RBI is asking banks to do. Preserve your capital by not giving dividend. As the situation will improve, this restriction would certainly be lifted.

4. Liquidity Coverage Ratio for SCBs brought down to 80% from 100%

Liquidity Coverage Ratio requirement was brought as part of the Basel-III 'International framework for liquidity risk measurement, standards and monitoring' after the aftermath of 'The Global Financial Crisis' of 2008. The objective of this ratio is to ensure that the bank maintains high-quality liquid assets that can be converted into cash to meet its funding need over the next 30 days under a highly stressed scenario. The idea behind LCR was that in times of crisis, banks should have enough 'liquid assets' to meet their customer needs. A major part of these high-quality liquid assets comprises of assets like CRR, excess SLR requirements, foreign sovereign securities, etc. By bringing down LCR requirements from 100% to 80%, RBI is relaxing regulatory restrictions of banks to manage their liquidity prudently and reduce the demand of Government securities, indirectly, encouraging banks to lend and invest in the economy.

5. Providing special refinance facilities to AIFIs to the tune of 50000 crores

All India financial institutions (AIFIs) like NABARD, SIDBI and NHB play an important role in meeting the long-term funding requirements of agriculture and the rural sector, small industries, housing finance companies, NBFCs, and MFIs. In the wake of the COVID-19 pandemic, these institutions are also facing challenges in raising funds from the market. Hence, RBI decided to provide them with

refinancing facilities up to 50,000 crores at the repo rate. This will help them in availing credit at a low rate to meet their sectoral needs. In a way, through these institutions, RBI is financing small scale institutions, start-ups, Housing Finance Companies, etc., indirectly, rather than through banking routes.

Conclusion

RBI is vigilant on all aspects of financial markets and monetary policies and is taking targeted measures to address the disruptions caused by the COVID-19 pandemic.

Given the lower credit growth, steps like cutting reverse repo will encourage banks to bring money in circulation through lending and investment activities. For banks, reduction in LCR requirements will help in managing their resources effectively. By putting restrictions on dividend declaration, it has asked banks to preserve capital for the uncertain future. By taking measures like TLTRO it has infused additional liquidity up to 1.5 Lakh crores in the financial system to ease the tightening liquidity situation. By mandating 50% of this sum to go to small and mid-sized NBFCs and MFIs, it has taken sector-specific actions to ease their access to liquidity. Through institutions like NABARD, SIDBI & NHB, it is providing credit access to rural sector, small-scale industries and housing finance companies, indirectly.

To cushion the impact of COVID-19 disruptions, these are welcome measures from RBI, which was much needed to maintain adequate liquidity in the system, provide easier access to the credit to various sectors and incentivise credit flow. What we need is a parallel coordinated response from the Government in terms of a fiscal stimulus package to protect millions of businesses and individuals. And the time for that response is now.

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