India Economics

Inflation risks to keep the RBI from cutting rates until Dec'20?

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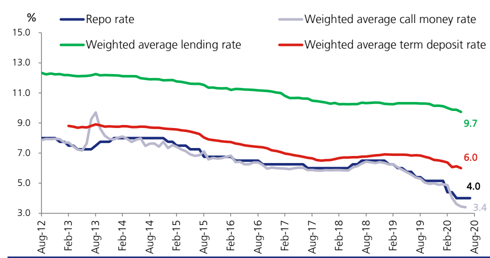
Inflation concerns have unexpectedly hit the RBI. Unlike the 5:1 vote for a 40:25bps rate cut in May'20 policy, all members of the Monetary Policy Committee (MPC) unanimously voted for status quo policy rates in Aug'20. This is in line with our expectations as- i) daily food prices data for Jul'20 suggests food inflation to have inched up by c.2ppts over Jun'20 to 10-11% YoY, and ii) Jun'20 headline inflation was c.80bps higher than the consensus view with broad-based inflationary pressures. Since the MPC has decided to stay on hold until visible signs for durable reduction in inflation, we believe that the probability of a rate cut in Oct'20 too remains low (not impossible) as for now we expect food inflation to remain in high single-digits till Oct'20, and then moderate to low single-digit from Nov'20-Jan'21. Further, of the total reductions in weighted average lending rate since Feb'19 (146:52bps for fresh:outstanding loans) against the 250bps repo rate cuts, we note faster transmission in 1QFY21- i) 32% for fresh loans, and ii) 50% for outstanding loans. We therefore expect the RBI to continue with liquidity measures incl. OMOs and operation twist to further facilitate the channelling of the cumulative rate cuts while also supporting the bond markets. Lastly, we expect the announced one-time restructuring of exposures- MSME, corporate and personal loans impacted by COVID-19 to positively impact the banking sector in the longer run by being assured of no further extension of the moratorium (Refer to our report)

- **RBI leaves policy rates unchanged:** Unlike the Jun'20 monetary policy, where 5 members voted for a 40bps cut, and 1 voted for (Chetan Ghate) 25 bps cut, the RBI unanimously voted for status quo policy repo rate in Aug'20. This was accompanied by the commitment of maintaining accommodative stance as long as it is necessary to revive growth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target. This is in line with our expectations as- i) daily food price data for Jul'20 suggests food inflation to have inched up by at 2ppts over Jun'20 to 10-11% YoY, and ii) June'20 inflation was c.80bps higher than consensus view, with broad-based upward pressures. Further, the MPC has decided to stay on hold until visible signs for durable reduction in inflation. Lastly, the MPC did not release growth projections for FY21, but expects it to be negative for 2020-21.

- **Inflation outlook benign in 2HFY21:** The RBI expects Inflation to remain elevated until 1HFY21, and then moderate in 2HFY21 aided by large favourable base effects. This is primarily due to the benign impact of i) bumper rabi harvest, ii) moderate increased in minimum support prices for Kharif crops, and iii) good monsoon; being offset by higher prices in i) key vegetables dependant on normalisation of supplies, ii) tight demand supply balance for pulses, iii) broad-based cost-push pressures from higher taxes on petroleum products, and iv) volatility in market. Notably, the RBI stated household expectations on inflation to remain lower for the longer run- i.e. 1-year ahead vs. their 3-month expectations, but data reveals that- i) these differ by merely 20bps, and ii) current inflation expectations inched up by 60bps in Jul'20 vs. May'20 round. In our view, food inflation could remain in high single-digits till Oct'20, and then moderate to low single-digit from Nov'20-Jan'21, facilitating rate cuts from thereon.

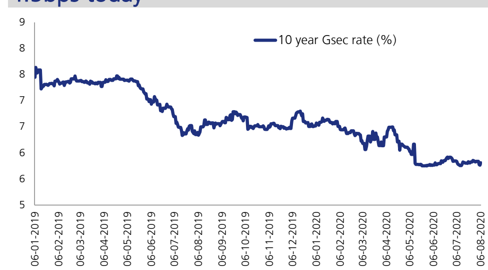
- **Transmission improving in 1QFY21, but slowly for outstanding debt:** The RBI has cut repo rate by 250bps since Feb'19. The RBI has stated transmission to improve with- i) falling weighted average lending rate (WALR) on fresh rupee loans by 47bps during 1QFY21, ii) declining spreads of 3-year AAA rated corporate bonds from 276bps on 26Mar'20 to 50bps by end-Jul'20, and iii) lower spreads for lowest investment grade (BBB-) bonds by 125 bps by end-Jul'20. Even as the fall in WALR on outstanding loans in 1QFY21 stood at 26bps in 1QFY21, lower than that in fresh loans; this fall constitutes c. 50% of the 52bps fall in WALR since Feb'19-Jun'20.

Exhibit A. Repo rate maintained at all-time low of 4.0%, call money rate below repo; MCLR and deposit rate also falling



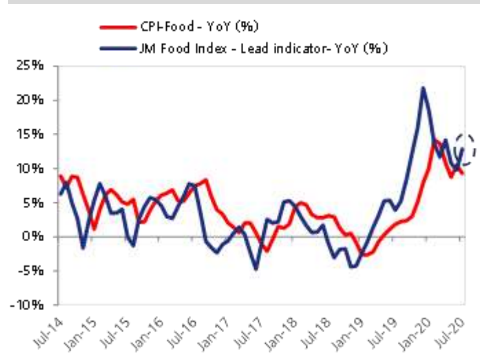
Source: RBI, Bloomberg, JM Financial

Exhibit B. Gsec rates closed at 5.81, higher by 4.5bps today



Source: Bloomberg, JM Financial

Exhibit C. Food inflation could inch up by at least 2ppts to 10-11% YoY in Jul'20 over Jun'20



Source: CEIC, JM Financial

- One-time restructuring for exposures impacted by COVID-19: The RBI also allowed banks and NBFCs to implement a one-time restructuring for exposures impacted by Covid19- 1) restructuring of corporate exposures under the guidance of Expert Committee (which will specify parameters on leverage, liquidity, debt serviceability based on sectors) b) restructuring of MSME loans under the existing framework which was put in place in Feb-2020 and c) restructuring of personal loans. Restructurings under the Covid19 resolution framework will have to ensure than residual tenure of the loans restructured need not be extended beyond 2 years. Loans which were non-overdue or SMA-0 (but not SMA-1 or SMA-2) as on 1st March 2020 are eligible for this restructuring. Banks will be required to make provisions of 10% on loans that are restructured (and 20% for corporate restructurings for lending institutions which do not sign ICA within 30days of invocation of plan). We believe the restructuring mechanism is a welcome step and that moratoriums have not been extended is a positive.

  Unlike the restructuring mechanisms in the past cycle where a) project implementation timelines were extended due to various external issues (e.g. govt approvals, judicial matters); b) fresh credit granted to impacted projects was used to repay existing obligations (without regard for proper asset classification) hence true recognition of underlying asset quality was delayed, we expect the current forbearance to be time bound (unlike the 2009 one which kept getting extended) since restructurings are to be invoked before Dec-20.

  In our view, a sizeable proportion of loans under moratorium at Aug-end are likely to flow into the restructuring pool. For banks that have reported earnings in our coverage universe, 9-24% of loans were under moratorium as of Jun-20. As per RBI's latest FSR, exposures below investment grade (but standard or SMA0) formed 6.8% of banks' portfolios (refer Exhibit 1 and 2) In our view, size of the restructured pool is likely to be clearer with banks' 3QFY21 earnings and will indicate the potential loan losses emerging out of the Covid19 lockdown in 1QFY21. We continue to factor higher credit costs in FY21/FY22E given that second round impact of the continued sporadic lockdowns is likely to be felt over next 12-18 months.

Exhibit 1. SCB's standard portfolio and its composition

	Mar-17	Mar-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Standard Asset with 0 dpd and SMA-0	85.15	86.25	95.75	94.75	94.08	94.59	93.97
Performing but vulnerable (SMA 1/2)	14.85	13.75	4.25	5.25	5.92	5.41	6.03

Source: CRILC, RBI, JM Financial

Exhibit 2. Rating distribution of standard portfolio

	Mar-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
'AA' and above	39.04	45.27	45.38	46.11	45.39	47.46
Investment grade till rating grade 'A'	28.55	27.41	27.23	26.49	27.17	26.04
Sub-investment grade	8.77	6.78	7.22	6.55	6.92	7.34
Unrated	23.64	20.54	20.17	20.85	20.52	19.16

Source: CRILC, Prime Database, RBI, JM Financial

Other measures taken by the RBI to support the economy ate given in Exhibit 3.

Exhibit 3. Other measures taken by the RBI to support the economy

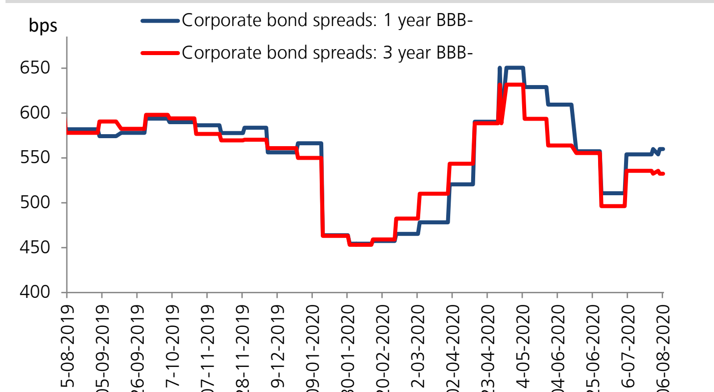
Measure	Details
Additional liquidity facility	Worth INR 50bn each to be provided to NHB (for supporting HFCs) and NABARD (for supporting NBFC-MFIs and small NBFCs with asset size of INR 5bn or lower) over and above INR 100bn and INR 250bn already provided. The facility will be for a period of one year and will be charged at the RBI's repo rate
Resolution framework for corporate exposures and personal loans	A window under the Prudential Framework on Resolution of Stressed Assets" dated June 7, 2019 to enable the lenders to implement a resolution plan in respect of eligible corporate exposures without change in ownership, and personal loans, while classifying such exposures as Standard subject to specified conditions:
	a. Only those borrower accounts **classified as standard, but not in default for more than 30 days** (i.e. SMA 0 – we believe SMA 0 could be around 6-7% of loans) with any lending institution **as on 1Mar'20** shall be eligible
	b. **Resolution plan may be invoked anytime till 31Dec'20** and shall have to be implemented within 180 days from the date of invocation
	c. Lenders shall have to keep **additional provisions of 10% on the post-resolution debt**. However, **lending institutions not signing the inter-creditor agreement (ICA)** within 30 days from the date of invocation shall attract **higher provisions of 20%**
	d. Post-implementation, the **asset classification of the account shall be retained as standard,** or if the account had slipped into NPA after invocation but before implementation, the asset classification shall be restored upon implementation
	e. Lending institutions may allow **extension of the residual tenor** of the loan, with or without payment moratorium, by a **period not more than 2 years**
	The RBI constituted an Expert Committee (Chairman: Shri K.V. Kamath) which shall make recommendations to the RBI on the financial parameters and sector-specific benchmark ranges for such parameters
	With respect to **personal loans, a separate framework is being prescribed**. The **resolution plan for personal loans** under this framework may be **invoked till 31Dec'20** and shall be implemented within 90 days thereafter. The contours of the plan may be decided based on the Board approved policies of the lenders subject to **extension of the residual tenor of the loan**, with or without payment moratorium, by a **period not more than two years**
Restructuring of MSME debt	In respect of **MSME borrowers** facing stress, lending institutions may **restructure the debt** under the existing framework, provided the borrower's account was classified as **standard with the lender as on March 1, 2020**. This restructuring shall be implemented by 31Mar'21
Increase in LTV for gold loans for non-agri purposes	Permissible loan to value ratio (LTV) for loans against pledge of gold ornaments and jewellery for non-agricultural purposes (for banks) to increase from 75% to 90%. This relaxation shall be available till March 31, 2021. Guidelines to be issued later today

Source: RBI, JM Financial

Exhibit 4. Corporate spreads for AA rated bonds have been declining

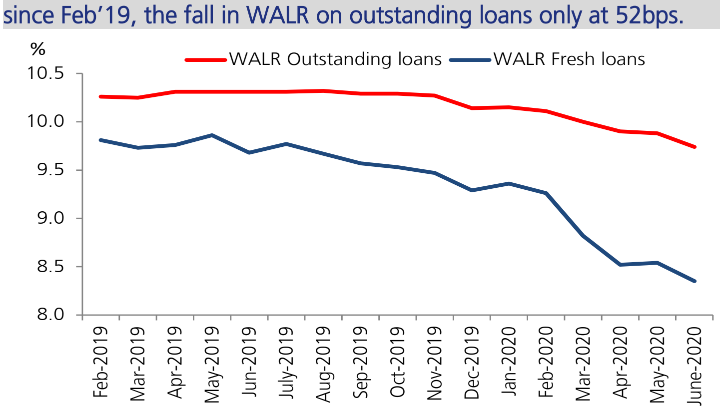
Source: Bloomberg, JM Financial

Exhibit 5. …those for BBB- too also have fallen since mid-June



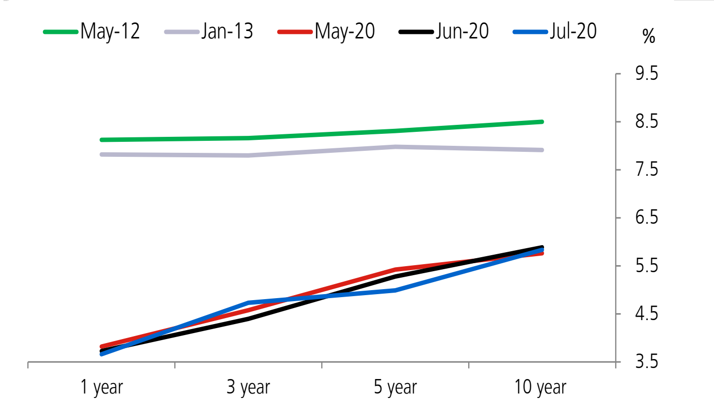
Source: Bloomberg, JM Financial

Exhibit 6. Even as the WALR for fresh loans has come off by 146bps since Feb'19, the fall in WALR on outstanding loans only at 52bps.



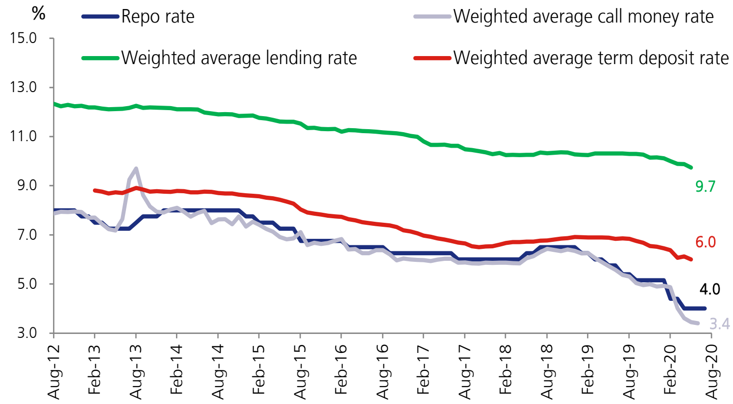
Source: RBI, JM Financial

Exhibit 7. Yield curve: Lower 5yr yields, higher 3yr yields in Jul-20



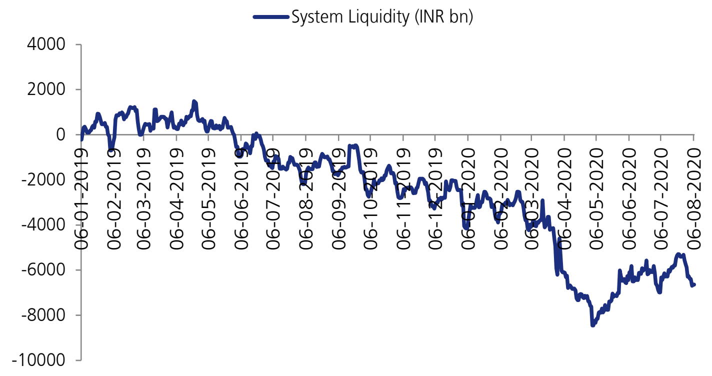
Source: Bloomberg, JM Financial

Exhibit 8. Call money rate falls below the repo rate



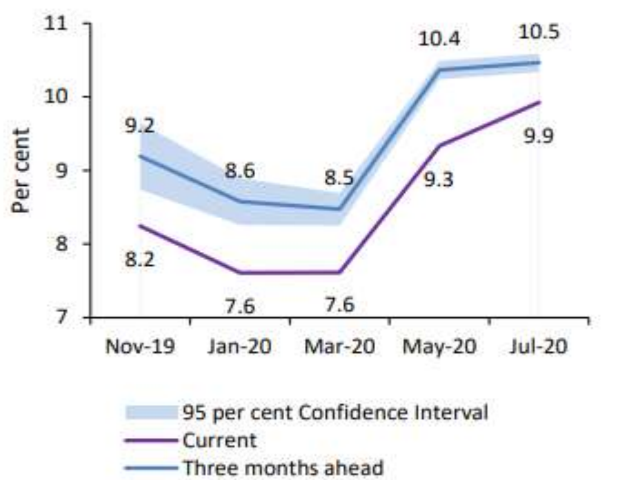
Source: Bloomberg, JM Financial

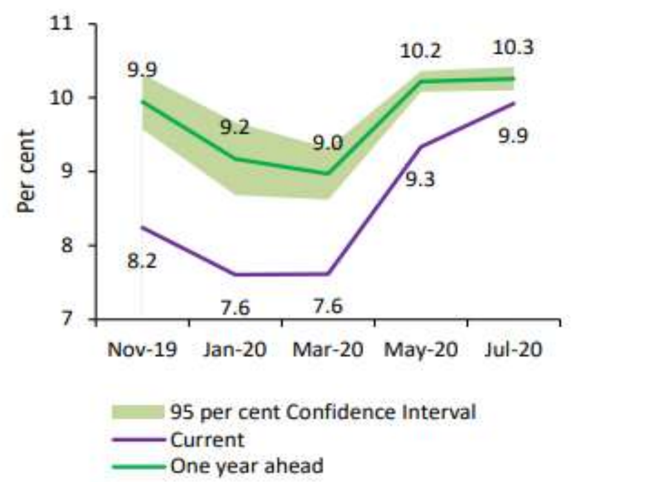
Exhibit 9. Outstanding liquidity surplus has reduced to INR 6.6trn vs. >INR 8trn in Jun'20



Source: Bloomberg, JM Financial

Exhibit 10. Household inflation expectations for one-year ahead inflation marginally lower than 3-month ahead inflation





Source: RBI, JM Financial

APPENDIX I

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