Infomerics Ratings

# Infomerics Valuation And Rating Pvt. Ltd.

SEBI REGISTERED / RBI ACCREDITED / NSIC EMPANELLED
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# INDUSTRY OUTLOOK

# BANKING SYSTEM LIQUIDITY IN INDIA

27 August 2020

Banking system liquidity is important to an economy as adequate liquidity fosters growth, investment and stability of interest rates& exchange rate. Liquidity is a pre-requisite to smooth operation of banking businesses. Infact liquidity is an important determinant of growth, development and survival of banks.

An excess liquidity situation leads to appreciation in asset prices or inflation; a deficit position mutes demand and leads to contraction of economic activities. Therefore, adroit management of system liquidity is crucial for all economies and the responsibility is assigned to the Central Bank, being the monetary authority.

In India, the Reserve Bank of India, which is the sole monetary authority, has been managing the system liquidity well even in challenging situations. The RBI has been ensuring that the banking system in India is well positioned in terms of liquidity for providing adequate resources for growth in all productive sectors of the economy.

The RBI has been announcing a bi-monthly monetary policy statement based on the decision of the Monetary Policy Committee (MPC) on the monetary and credit policy. This decision is factored on the prevailing and expected liquidity conditions vis-à-vis inflation expectations and changes in regulatory interest rates to achieve the targeted inflation corridor. The RBI also comes out with Statement of Developmental and Regulatory Policies as part of the Monetary Policy statement for modulating liquidity flow to the desired sectors.

## FRICTIONAL (TRANSIENT) LIQUIDITY VS DURABLE (STRUCTURAL) LIQUIDITY

On any given day, the systemic liquidity can be in deficit (banking system is a net borrower from RBI) or in surplus (banking system is a net lender to RBI) through its liquidity windows. The deficit or surplus can be frictional (transient) or durable (structural). According to the RBI, the optimal liquidity in the system shall range between 0.25% to -0.50% of the NDTL of banks.

The changes in system liquidity are caused by the following factors:

1. The pace of growth of deposits & credit
2. Foreign Exchange flows
3. Cash in circulation
4. Government balances with RBI
5. Government Securities held by RBI (Open Market Operations)
6. Change in Reserve Requirement (CRR)

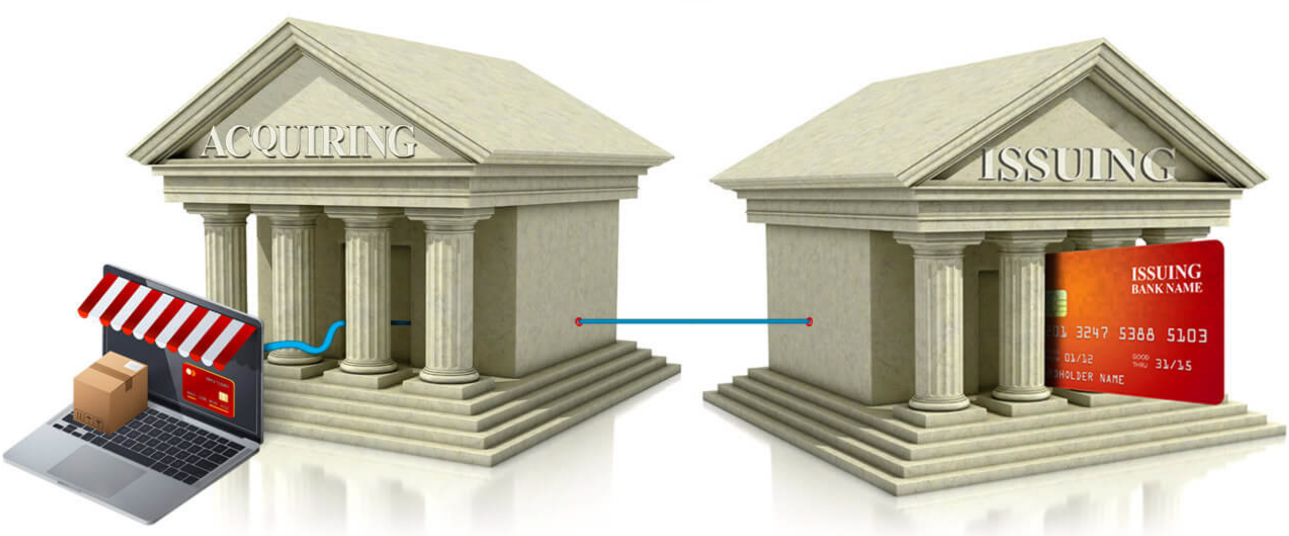
While changes in cash in circulation during festive seasons, tax payment at quarter end& government balances with RBI create transient liquidity demand, there are other structural factors. The structural liquidity demand is more durable in nature as the factors driving this demand are considered to be more persistent. The RBI manages these changes in liquidity demands through various tools.

# RECENT LIQUIDITY CHANGES IN INDIA

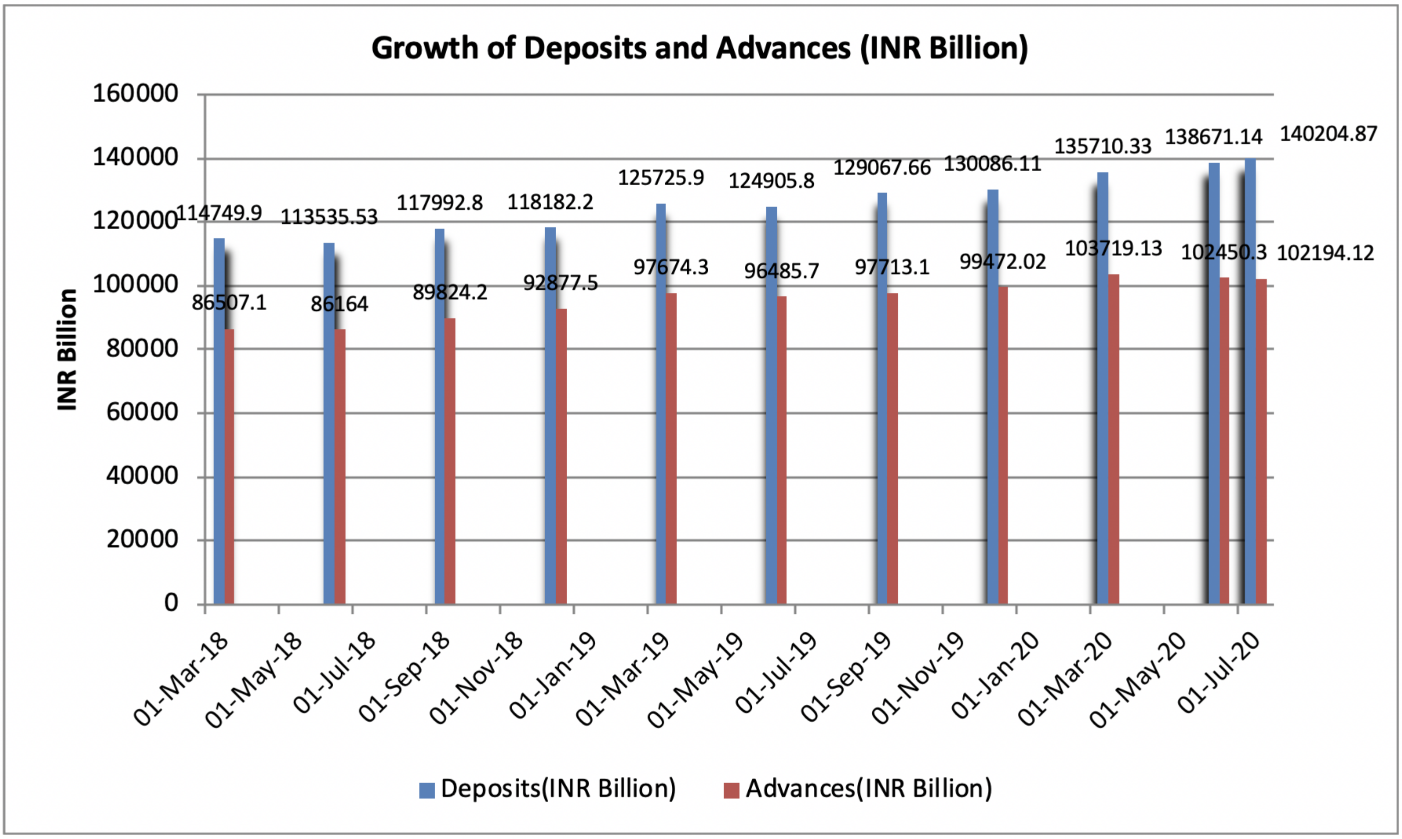
## CREDIT & DEPOSIT GROWTH

India stood next to China in terms of the GDP growth in the last three years, in some quarters even overtaking the dragon country. India's savings, both household and corporate, have grown with macro-economic growth. Credit disbursement by banks / shadow banks has also been keeping pace with the economic growth, notwithstanding the increasing toxic assets.

The position of aggregate deposits & aggregate credit is shown in Chart 1. The excess deposit creation over credit growth infuses liquidity into the system. The total liquidity created from this is about Rs.10 lakh crore in the past 3 years, of which Rs.6 lakh core is in the four-month period of the current financial year. Withdrawals from the volatile financial markets to safe haven of bank deposits despite declining interest rates and lack of credit demand substantiate this position.



## Chart 1: Trend of Aggregate Deposit and Advances (INR Billion)




# FOREIGN EXCHANGE FLOWS

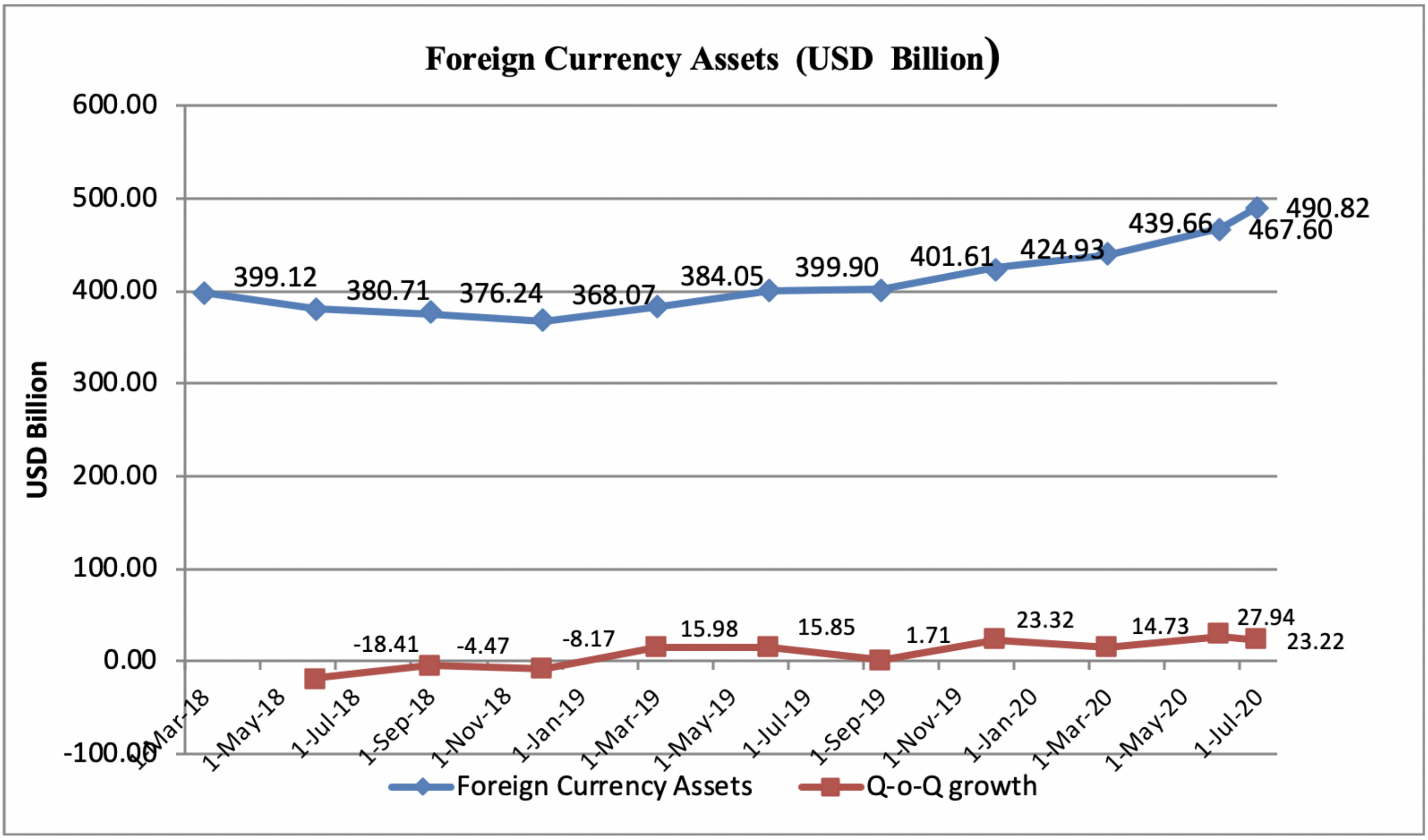
India has been a significant net foreign exchange earner through FDI, FPI,ECB and remittance flows since 2002.India's international trade flows continues to be in the negative. These forex flows impact the exchange rate of the local currency as net inflows result in appreciation and the outflows, depreciation in the exchange value. To obviate bouts of volatility in the exchange rates, Central Banks intervene in the foreign exchange market by buying or selling the foreign currency against the local currency. But it needs to be borne in mind that the RBI has repeatedly stressed that it does not target any exchange rate but intervenes in the forex markets only to curb volatility and prevent disruption of macroeconomic stability.

While buying of foreign exchange infuses liquidity, sale of foreign exchange results in liquidity contraction of the domestic or local currency. RBI may also do simultaneous swap transactions to buy/sell forex without affecting the system's liquidity.

As a measure to keep the exchange rate of Indian Rupee against major foreign currencies, RBI has been intervening in the market by buying/selling of FC. Since India has been a net recipient of forex flows, RBI's forex reserves position has swelled to over USD 534 billion and India has now the World's 5th largest forex reserves. Foreign Currency Assets (excluding gold, SDR & IMF reserve) constitutes more than 95% of the reserves which has come from the intervention operations of RBI.

Chart 2 shows the growth of forex currency assets since March 2018. At current exchange rate of Rs.75 to a USD, the liquidity created by RBI from the forex operations is close to Rs.7 lakh crore. Of this, close to Rs.4 lakh crore has been added during the 4 months of the current financial year that witnessed buoyant FDI flows into Reliance Jio Platform, favourable balance of trade.

## Chart 2: Foreign Currency Assets (USD Billion)



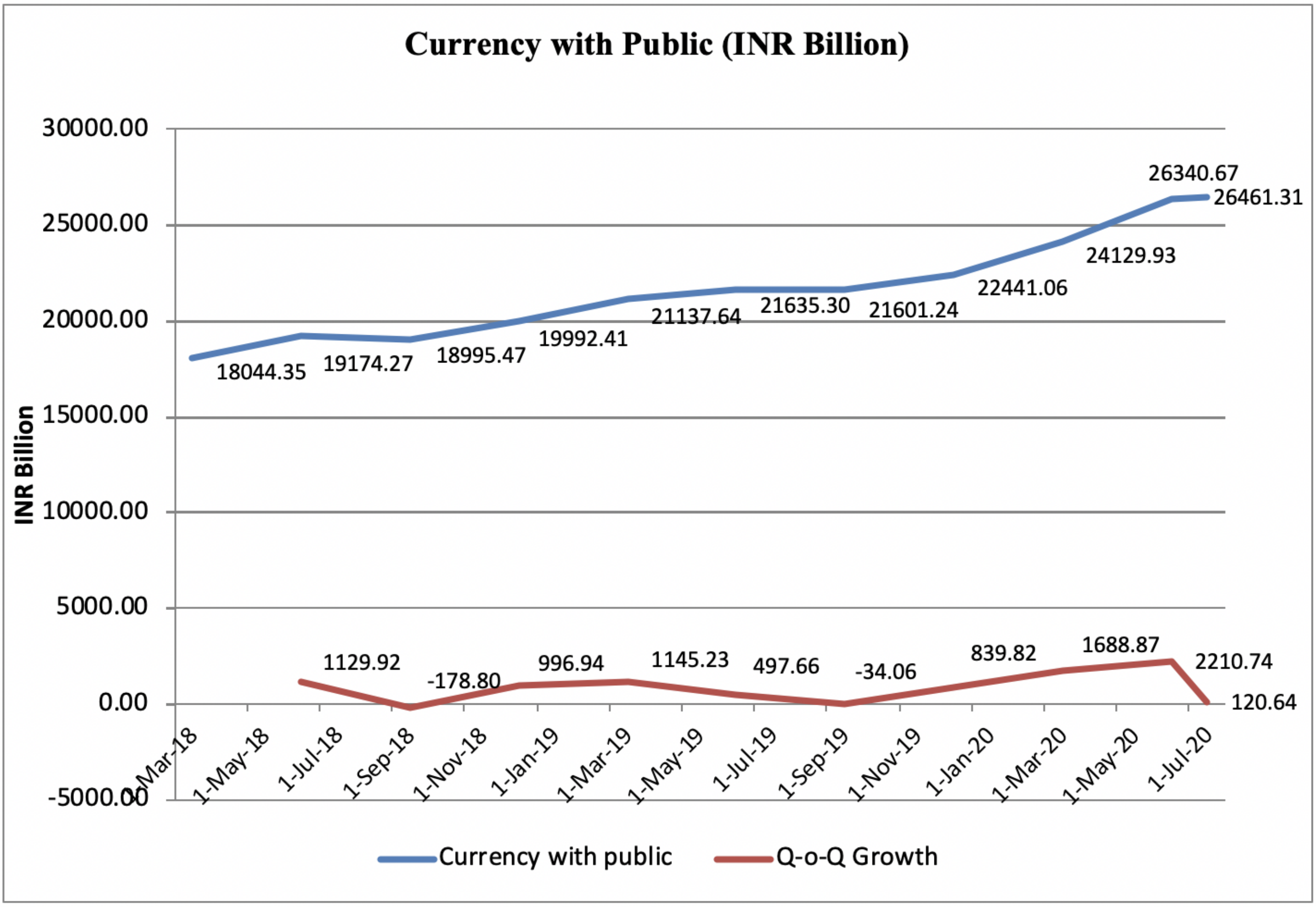

# CURRENCY WITH PUBLIC OR IN CIRCULATION (CiC)

Cash is used for payment and as a store of value. While low denomination currency is used for payments, higher denomination is seen to be used for storage. In India, digital payment systems are evolving and the evidence of its increased usage was seen post demonetization of currencies in November 2016 and during the current COVID 19 pandemic period. However, the currency in circulation is on the rise as currency still rules as a predominant means of payment despite strict regulatory limits for cash transactions. Earlier, substantial increase in CiC could be observed in festive seasons but the rise has been agnostic in recent years. Therefore, in the Indian context, liquidity demand created by increase in CiC can be considered structural. Increase in CiC results in compression of bank liquidity.

The increase in CiC in India is one of the steepest in the world, closely followed by China[1]. Since 2014-15, the CAGR of CiC is in excess of 10% and as a percentage of GDP also, it remains above 10%, as against negative growth in countries like Australia & Japan and low single digit increase in Korea & Singapore, the study shows. China's growth of CiC is close to 10%. Only during 2016-17, the increase was lower on account of demonetization of currencies.

Chart 3 shows the increase in CiC in the last 3 years. Close to Rs.8.5 lakhs liquidity has been drained by the CiC.

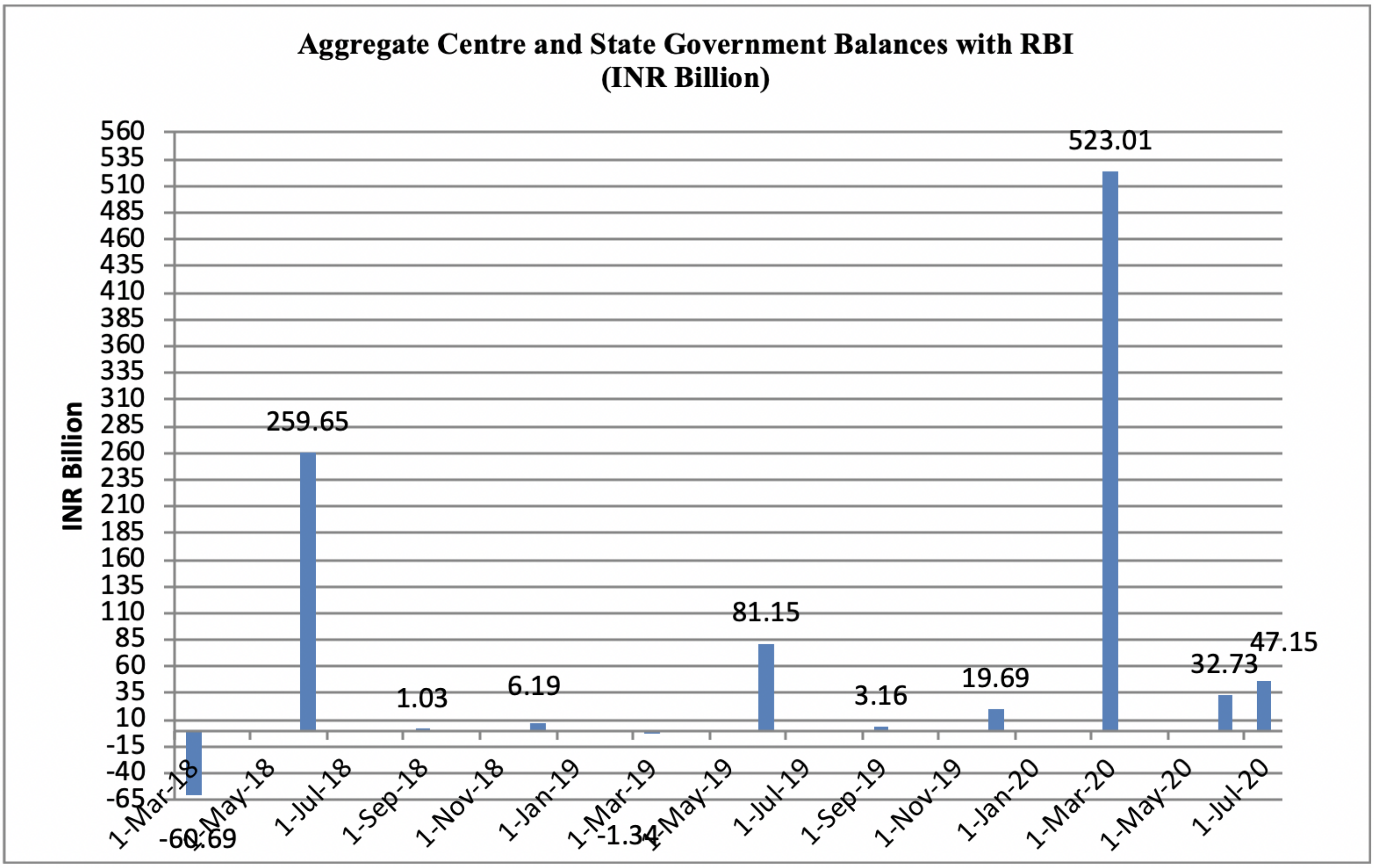
## Chart 3: Currency with Public (INR Billion)



## GOVERNMENT BALANCES WITH RBI

Fiscal deficits are met in India by the Central Government & State Governments through a pre-announced domestic borrowing program in consultation with Reserve Bank of India. With the formation of Primary Dealers (PD) in 1996, the Reserve Bank of India has moved away from monetizing Government borrowing programmes. Un/Under subscribed portion of the Central Government borrowing programmes are now devolved on and subscribed by the PDs that underwrite these programmes. Though the subscription to these borrowings temporarily affects the system liquidity, as and when these funds are utilized by the Government, the liquidity is released to the system. Hence, as a measure of transient liquidity assessment, the balances held by the RBI in Government Accounts are taken into account. Higher balances with RBI indicate squeeze on liquidity while an overdraft position (Ways & Means Advance) or a low balance in Current Account will indicate liquidity release. It is observed that the Central/State Governments keep minimal balances in their current account with RBI and therefore, does not normally create stress on system liquidity. Chart 4 indicates the Government balances with RBI.

### Chart 4: Government Balances with RBI (INR Billion)



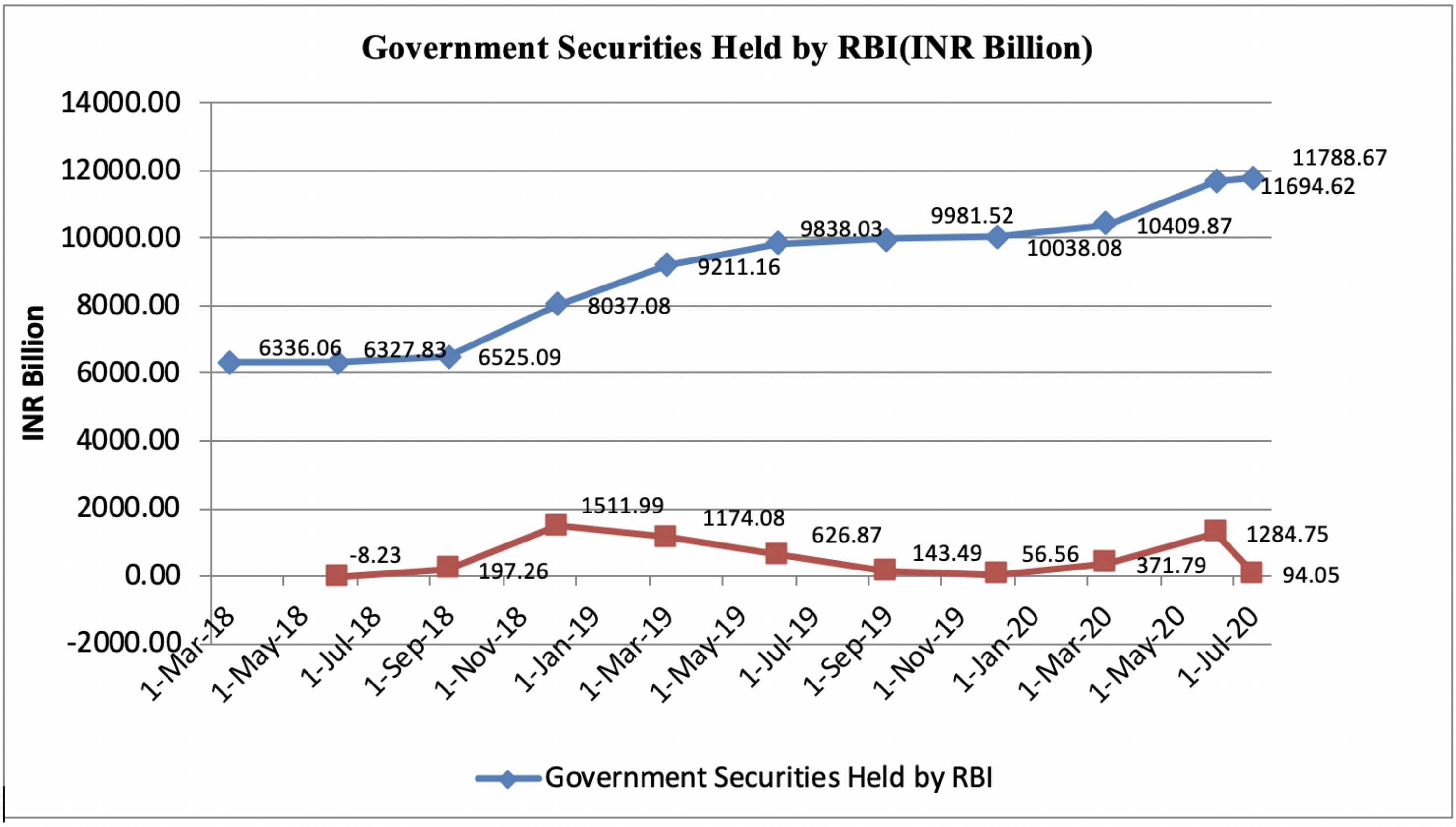
# OPEN MARKET OPERATIONS BY RESERVE BANK OF INDIA

Purchase or sale of Government Securities by the Reserve Bank of India from market participants is called Open Market Operations(OMOs). Besides being used as a tool to signal the desired market yield curve for the sovereigns, it is also used to infuse / drain liquidity from the system. In the liquidity context, the RBI infuses liquidity by undertaking these operations through notified programmes or through intervention in the Government Securities market. Further, RBI also requires adequate stock of Government Securities to collateralize the reverse repo transactions. (RBI needs to sell Government Securities to the lenders under reverse repo with a buy back arrangement).

It is observed that RBI has been regularly infusing liquidity into the system through OMOs. The position of Government Securities held by RBI is a reflection of the OMOs of RBI. During 2020-21 (up to July 31), ₹1,24,154 crore was injected through open market operation (OMO) purchases[2].

Chart 5 gives data on Government Securities held by RBI at quarter ends::

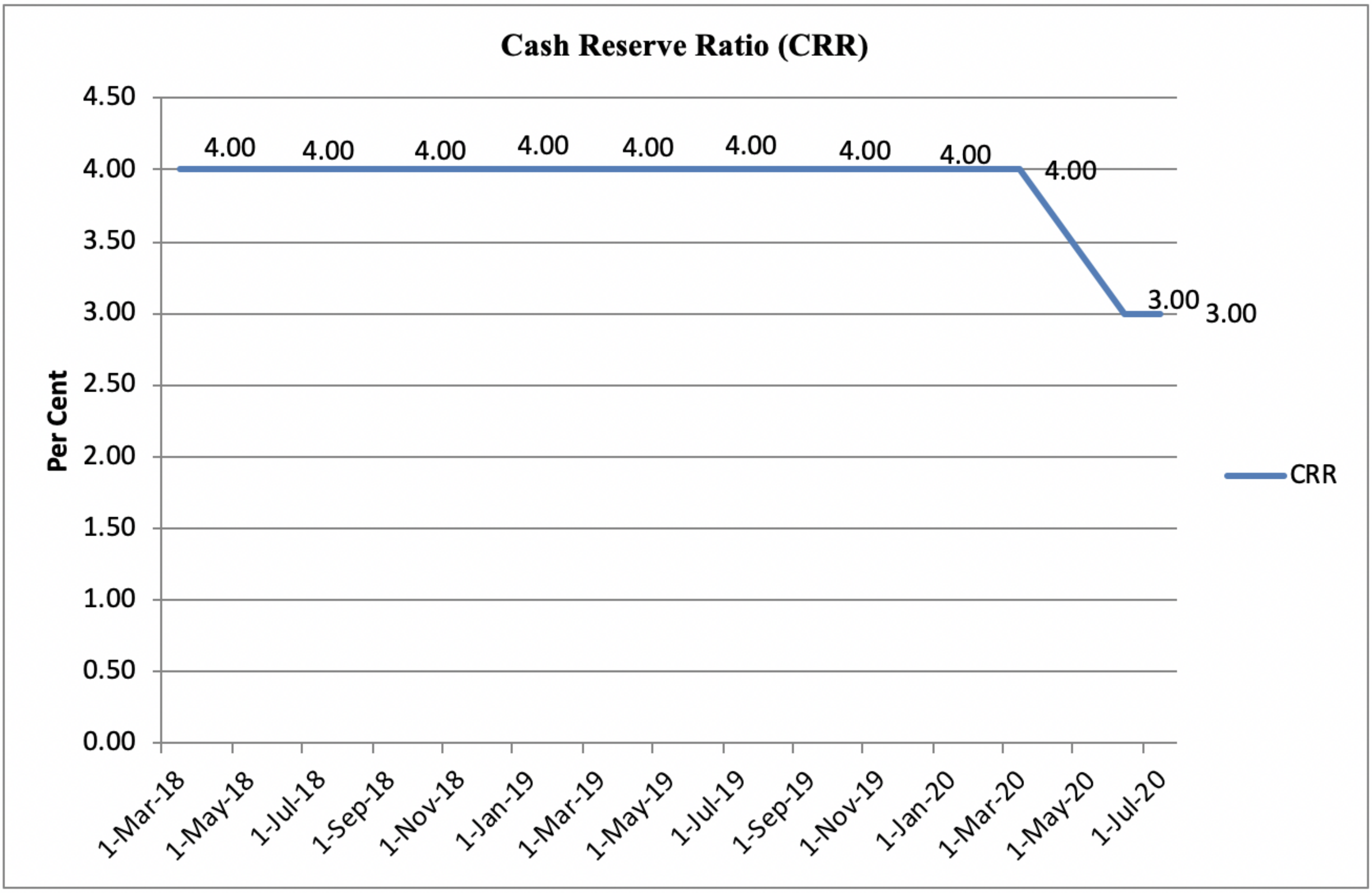
## Chart 5: Government Securities held by RBI (INR Billion)



# CASH RESERVE RATIO (CRR)

Under Section 42(1) of RBI Act, 1934, a certain percentage of the deposits & liabilities of Commercial Banks are to be kept with RBI in current accounts, which is at present 3%.These balances are interest free and therefore, have no cost for the RBI. These balances are to be maintained on an average basis, with a minimum prescription of 80% till September 2020. An increase or decrease in CRR drains or infuses liquidity. On 27th March 2020, the RBI announced reduction of CRR from 4% to 3% which released about Rs.1.37 lakh crore of liquidity to the system. The RBI uses CRR to infuse/drain liquidity on a durable basis.

## Chart 6: Cash Reserve Ratio (CRR) (in Percent)




# TOOLS OF LIQUIDITY MANAGEMENT BY RBI

## LIQUIDITY ADJUSTMENT FACILITY (LAF)

The best measure of the liquidity demand of the banking system is central bank liquidity because any surplus/deficit in the banking system liquidity is ultimately reflected in borrowing from or lending to the Reserve Bank of India.

Liquidity Adjustment Facility (LAF) is the primary instrument of the Reserve Bank of India for modulating liquidity and transmitting interest rate signals to the market. It absorbs the excess liquidity through reverse repo & infuses liquidity through repo at regulatory interest rates. These regulatory rates are announced periodically as part of the monetary policy statement which are called the repo or reverse repo rates. 'Corridor' refers to the difference between the two key rates viz. repo rate and reverse repo rate. In a liquidity surplus scenario, the operative rate will be reverse repo rate and in a deficit situation, the repo rate will be operative. Weighted average call rates (market rates) move closely to these operative rates.

It is seen that the variations in these regulatory rates are immediately transmitted to money market instruments and later to other Debt Market instruments & Bank Lending Rates.

Since February 2020, Money markets have remained flush with surplus liquidity due to the Reserve Bank's support. The net LAF position, which was around Rs.3.0 lakh crore on an average during Jan – March 20 quarter, increased to an average of Rs.4.7 lakh crore during April – June 2020. In July 2020 it has moderated to Rs.4 lakhs as Government spending subdued. On some days, RBI absorbed excess liquidity up to Rs.7 lakhs crore. Due to abundant surplus liquidity, the weighted average overnight money market rate (WAMM) has been languishing at the bottom of the policy corridor, i.e., reverse repo rate rather than the repo rate.

## TERM REPO & TARGETED LONG-TERM REPO (TLTRO)

Systemic liquidity remains in large surplus, due to the conventional and unconventional measures by the Reserve Bank since February 2020. Cumulatively, these measures infused liquidity of the order of ₹9.57 lakh crore[3]. The unconventional tools included Targeted Long Term Repo Operations whereby RBI provided liquidity to banks for specific operations like investment in primary & secondary corporate bonds, debt of NBFCs including micro finance institutions. The liquidity infusion gave a lifeline to the corporate bond market which was reeling under pressure in the later half of March 2020.

The spreads of 3-year AAA rated corporate bonds over G-Secs of similar maturity declined from 276 bps on March 26, 2020 to 50 bps by end-July 2020. Even for the lowest investment grade bonds (BBB-), spreads have come down by 125 bps by end-July 2020. Lower borrowing costs have led to record primary issuance of corporate bonds of ₹2.1 lakh crore in the first quarter of 2020-21[4].

RBI has been regularly conducting term reverse repo / repo operations to modulate the excess / deficit frictional liquidity depending upon its assessment of future liquidity expectations.

## MARKET STABILISATION SCHEME

Market Stabilization scheme (MSS) is a monetary policy intervention by the RBI to withdraw excess liquidity (or money supply) by selling government securities – namely Market Stabilization Bonds (MSB) in the economy. The MSS was introduced in April 2004. Since the only objective of the scheme is to sterilize the excess liquidity in the system, the proceeds are kept in a separate account and will not be available to the Government for utilization. The cost of issuing these bonds is met from Union Budget. As of now, there is no outstanding under MSS.

## CONCLUSION

Repeated Repo reductions with the clear downward bias of the interest rate spelt out by the RBI have failed to nudge the banks sufficiently forward to lend aggressively to the productive sectors of the economy. The issue of bankers becoming risk-averse is quite complex and multilayered because of mounting NPAs, weak demand, pending wages, and economic uncertainty and defies a naïve and simplistic solution. The RBI's Financial Stability Report (FSR) for July 2020 brought into focus that post-pandemic issues, including the prolonged national lock-down are likely to significantly increase bad loans for the banking sector. In a "very severe stressed scenario", the gross non-performing assets (GNPAs) of the banking sector could rise to even 14.7% of total loans by March 2021[5] .

The RBI's stress test covering 53 scheduled commercial banks revealed that under the baseline scenario, the gross NPA ratio could rise to 12.5%. This projected surge in NPAs needs to be viewed against the NPAs as of March 2020, when the ratio stood at 8.5% of total advances[6] . The results of the RBI stress tests show that public sector banks (PSBs) could see their gross NPAs rise to 15.2% by March 2021 from 11.3% a year earlier in the baseline scenario. In the "very severe stress" scenario, this could even reach 16.3%[7] . Private banks and foreign banks would also see a spike in their bad loans because of the worsening macroeconomic factors.

A detailed discussion would also involve aspects like Asset Quality Review (AQR), absence of deterrent action against wilful defaulters, policy paralysis because of the humongous 2 G, 3G and 4G issues, the fear of the 4 Cs-CVC, CBI, CIC and the Courts and the use of several dreaded words in the commercial banking segment. Some such words are accountability, due diligence, fixing of responsibility, systems and procedures, vigilance angle, reopening NPA cases even after a gap of 10–15 years. Hence, we cannot have a simplistic solution to a complex multidimensional issue.

The system liquidity in India presently has a huge surplus which is being absorbed through LAF window of RBI. The easy liquidity conditions, as a result of extra ordinary measures taken under extra ordinary circumstances has paved way of easy transmission of policy rates to the short term money market instruments. Commercial Paper & Certificate of Deposit rates have fallen below repo rate. The cut off of recent T Bills auction have been below the prevailing repo rate and in the case of 91 days T Bills it is lower than the reverse repo rate anchoring expectations of further rate cuts and continuing easy liquidity conditions.

The transmission to bank lending rates has improved further, with the weighted average lending rate (WALR) on fresh rupee loans declining by 91 bps during March-June 2020.

On May 08, 2020 the Government of India revised its budgeted estimate and announced that it would borrow Rs.12 lakh crore instead of Rs. 7.80 lakh crore in 2020-21. The borrowing limits for the States for the year were also raised to 5 per cent of GSDP from 3 per cent. Despite the increase in government borrowings 3-year yields have dropped by 188 bps, the 7-year yield by 92 bps, the 10-year yield 86 bps and the 15-year yield has dropped by around 68 bps.

In the corporate bonds market, the fall in the spread of AAA-rated NBFCs has been the maximum at 170 bps, followed by PSUs, FIs and banks (147 bps) and corporates (146 bps). For AA-rated entities, the fall in spreads was 156 bps for NBFCs, 143 bps for PSUs, FIs and banks and 138 bps for corporates. Spreads on the instruments issued by the PSUs, FIs and banks category have reverted to the pre-COVID levels[8] .

The abundance of liquidity was experienced by the Indian economy from 2002 onwards when India started receiving higher allocation from overseas entities. Interest rates fell across spectrums. The abundance led to banks, with least regard to its ALM mismatches started funding long gestation infrastructure projects & low rated entities. The culmination has been the baggage of non-performing assets accumulated over a period that is having a heavy burden on the public sector banks. Despite having adequate liquidity, they are not willing to take credit risks. They are also finding it difficult to raise the required growth capital. Their risk aversion is aided by lower credit demand as many industries are yet to come back to heels as their supply chain / labour are severely hit by the pandemic.

In the process, the banking system is losing on an average Rs.22,600 crore per annum (calculated at an average lending rate of 9.00% vs reverse repo rate of 3.35% on Rs.4 lakh crore). On the other hand, the RBI has also to incur a cost of Rs.13,400 crore to manage this excess liquidity. To sum up, Government of India is the ultimate loser as the owner of both RBI and Public Sector banks. It is high time Government of India utilized the current liquidity situation as an opportunity to revive the sagging fortunes of our real sectors & rev up the economy. An incentive linked bank credit to fast track the incomplete infrastructure projects, relaxation of conditions regarding utilization of enhanced borrowing limit of the state governments, review of the GST regime to examine a reduction in tax slabs of core sectors, increase in farm credit in the lines of Emergency Credit Line Guarantee Scheme (ECLGS) for stressed Micro, Small and Medium Enterprises (MSMEs) are some of the measures the Government of India can examine at this point in time.

FOOTNOTES

1. RBI publication -Assessment of the progress of digitisation from cash to electronic dated 24.2.20202. 'Indian Sugar export dispatches hit 2 lakh tonnes, says
2. Monetary Policy Statement 2020-21 dated 6th August 2020
3. Monetary Policy Statement 2020-21 dated 6th August 2020
4. Monetary Policy Statement 2020-21 dated 6th August 2020
5. RBI'S Financial Stability Report July 2020
6. Ibid.
7. Ibid.
8. RBI bulletin July 2020.

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