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RBI Event Note @ Dalal & Broacha

RBI POLICY REVIEW *(The mood is shifting from fear and despair to hope)*

- RBI's monetary policy committee has decided to keep key policy rates unchanged at 4%, amid rising inflation and growing uncertainty. Headline CPI inflation increased to 6.7% during July-Aug 20 as pressures accentuated across food, fuel and core constituents on account of supply disruptions and higher taxes.
- Consequently, the reverse repo rate under the LAF also remains unchanged at 3.35% and the MSF rate and the Bank Rate at 4.25%.
- The committee has maintained an accommodative monetary policy stance and intending to keep it that way as long as necessary to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy.
- These decisions are in consonance with the objective of achieving the medium-term target for CPI inflation of 4% within a band of +/- 2%.

Key Policy rates:

Policy Tools	Policy rates	Status
Repo	4.00%	Unchanged
Reverse Repo	3.35%	Unchanged
Marginal Standing Facility (MSF)	4.25%	Unchanged
Bank Rate	4.25%	Unchanged
CRR	3.00%	Unchanged
SLR	18.0%	Unchanged

Economic Indicators:

- **Growth Forecast:** According to the central bank's estimates, the economy will contract by 9.5% in FY21, with risks tilted to the downside. GDP is estimated to contract by -9.8% in Q2 FY21, by -5.6% in Q3, and 0.5% inQ4. Meanwhile, Real GDP growth for Q1 FY22 is placed at 20.6%
    - While rural economy will recover faster, the turnaround in urban demand is likely to lag.
    - Manufacturing firms expect capacity utilization to recover in Q3 FY21, while contact intensive services will take time to revert to pre-covid levels.
    - Both private investment and exports are likely to be subdued, especially as external demand is still anemic.
- **Inflation Estimates:** According to the central bank, CPI inflation is projected at 6.8% for Q2 FY21, at 5.4-4.5% for H2 FY21 and 4.3% for Q1 FY22, with risks broadly balanced.
    - Pressures on prices of key vegetables like tomatoes, onions and potatoes should ebb by Q3 with kharif arrivals.
    - International crude oil prices have traded with a softening bias in September on a weak demand outlook, but domestic pump prices of petroleum products may remain elevated in the absence of any roll back of taxes.
    - Supply disruptions, including labour shortages and high transportation costs, are getting mitigated by progressive easing of lockdowns
- **Liquidity Measures:**
    - In order to maintain comfortable liquidity conditions in the market, RBI will conduct outright and special open market operations (OMO). The size of auctions will be increased to Rs 200 Bn per auction. The central bank will conduct OMO, for the first time, in state development loans.
    - Policymakers has decided to conduct on tap TLTRO with tenors of up to three years for a total amount of up to Rs 1 trillion at a floating rate linked to the policy repo rate. Liquidity availed under this facility should be deployed in corporate bonds, debentures and bank loans to specific sectors
    - The enhanced held-to-maturity limit of 22% of government bonds has been extended till March 2022.

Outlook

- Since the latest headline Inflation reading remains above its comfort level of 6%, RBI held back from cutting policy rates, though maintained the policy stance accommodative. Policymakers are waiting for a durable reduction in inflation, before using elbow room to support growth. According to the central bank, inflation will likely to come down in the third and fourth quarter as supply constraints ease with kharif arrivals.
- By the RBI's own assessment, economic activity continues to be fragile, and we strongly believe that a durable economic recovery requires timely fiscal and monetary policy response.
- In current policy, the central bank has announced several measures to support economy by ways of enhancing liquidity for financial markets, and regulatory measures to augment flow of credit. Doubling of the size of OMO to Rs 200 Bn, participation in state development loans, rationalization of risk weights on Individual housing loans are combined big-ticket announcements for both bond market and financial stocks.
- Overall, the tone of the policy was dovish, and we expect RBI to easy policy rates in Q4 FY21.

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Measures to support economy

- **RBI to rationalise the risk weights and link them to LTV ratios**
  - Under the current regulations, differential risk weights are applied to individual home loans, based on the size of the loan as well as the loan-to-value ratio (LTV). This has been changed and risk weights for new housing loans are now being only linked to LTV as RBI believes real estate sector is extremely important in generating employment and economic activity.
  - The housing loans shall attract a risk weight of 35% where LTV is less than or equal to 80%, and risk weight of 50% where LTV is more than 80% but less than or equal to 90%.
- **Announces on-tap TLTRO of Rs 1 lakh crore**
  - RBI has decided to conduct on tap TLTRO with tenors of up to three years for a total amount of up to Rs 100,000 Cr at a floating rate linked to the policy repo rate. The scheme will be available up to March 31, 2021 with flexibility with regard to enhancement of the amount and period after a review of the response to the scheme.
  - Liquidity availed by banks under the scheme has to be deployed in corporate bonds, commercial papers, and non-convertible debentures issued by the entities in specific sectors over and above the outstanding level of their investments in such instruments as on September 30, 2020.
  - Banks that had availed of funds earlier under targeted long-term repo operations (TLTRO and TLTRO 2.0) will be given the option of reversing these transactions before maturity.
- **SLR Holdings in Held to Maturity (HTM) category**
  - To engender orderly market conditions and ensure congenial financing costs, RBI on September 1, 2020, increased the limits under Held to Maturity (HTM) category from 19.5% to 22% of NDTL, in respect of SLR securities acquired on or after September 1, 2020, up to March 31, 2021.
  - To give more certainty to the markets about the status of these investments in SLR securities after March 31, 2021, it has been decided to extend the dispensation of enhanced HTM limits of 22% up to March 31, 2022 for securities acquired between September 1, 2020 and March 31, 2021.
  - The HTM limits would be restored from 22% to 19.5% in a phased manner starting from the quarter ending June 30, 2022. It is expected that banks will be able to plan their investments in SLR securities in an optimal manner with a clear glide path for restoration of HTM limits.
- **Round-the-Clock availability of Real Time Gross Settlement System (RTGS)**
  - To support the ongoing efforts aimed at global integration of Indian financial markets, facilitate India's efforts to develop international financial centers and to provide wider payment flexibility to domestic corporates and institutions, it has been decided to make available the RTGS system round the clock on all days.
  - With this, India will be one of the very few countries globally with a 24x7x365 large value real time payment system. This facility will be made effective from December 2020.
- **Perpetual Validity for Certificate of Authorisation (CoA) issued to Payment System Operators (PSOs)**
  - To reduce licensing uncertainties and enable PSOs to focus on their business and optimise utilisation of scarce regulatory resources, it has been decided to grant authorisation for all PSOs (both new applicants as well as existing PSOs) on a perpetual basis, subject to certain conditions. Detailed instructions will be issued separately.
  - Currently, the Reserve Bank issues "on-tap' authorisation under the Payment and Settlement Systems Act, 2007 to non-banks issuing Prepaid Payment Instruments (PPIs), operating White Label ATMs (WLAs) or the Trade Receivables Discounting Systems (TReDS), or participating as Bharat Bill Payment Operating Units (BBPOUs). Authorisation (including renewal of authorisation) of such PSOs has been largely for specified periods up to five years.

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