RBI measures provide temporary relief, but fail to incentivise banks to step-up credit to India Inc.: Brickwork Ratings

Brickwork Ratings (BWR), Mumbai, 22 May 2020: The Reserve Bank of India (RBI), post its Monetary Policy Committee (MPC) meeting today, announced the second set of regulatory measures (first set announced on 17 April 2020) to safeguard India Inc. from the impact of COVID-19. BWR believes most announcements made today will largely address the working capital challenges of corporate India in the near term. It will also provide sufficient liquidity to resume operations, with the nationwide lockdown being lifted in a phased manner. However, the announcements fall short of incentivising the banks to increase the pace of domestic credit. BWR believes the reverse repo rate cut should be much higher than the repo rate cut to discourage banks from parking their excess funds with the RBI.

Some key measures that BWR believes will enable Corporate India to manage its working capital better are as follows:

- Extension of moratorium on term loan instalments by another three months until 31 August 2020
- Conversion of accumulated interest on working capital facilities (1 March – 31 August 2020) into a funded interest term loan (FITL) repayable until the end of March 2021
- Enhancing bank exposure to a group of connected counterparties from 25% to 30% of the eligible capital base of the bank applicable up to 30 June 2021

Says Mr. Vydanathan Ramaswamy, Director – Brickwork Ratings, “RBI has taken bold measures to counter the impact of COVID-19 and build enough liquidity and credit buffers for Corporate Inc. to kickstart business operations as the nationwide lockdown is being lifted in phases. However, despite concerted efforts by the RBI, banks’ high-risk perception of the current economic environment continues to be a dampener in stepping up credit to India Inc. This is clearly evident from the significant jump in excess funds parked by banks with the RBI, which nearly doubled to ~ Rs.7.2 lakh crore as on 21 May 2020 from ~Rs 3.8 lakh crore as on 31 March 2020 and from a relatively low level of ~ Rs 1.5 lakh crore as of 31 December 2019”.

BWR has carried out a comparative analysis of the return on assets for banks on funds parked with the RBI as against those deployed to corporate India. The 1-year return on credit deployed by banks is high at ~8% vis-à-vis the return that banks will earn at 3.35% from parking the excess funds with the RBI, translating to a Rs 34,000 crore additional profit on the funds currently kept with the RBI. This is even after assuming a stringent 1-year default and recovery rate in a stress scenario on the deployment of credit to companies rated in the AA to BBB categories (Please refer Annexure for detailed analysis).

Says Mr. Rajat Bahl, Chief Ratings Officer, Brickwork Ratings, “For a meaningful transmission of RBI measures into higher bank credit, the reverse repo rate has to be brought down sharply and very close to the savings deposit rates offered by banks. This will dissuade banks from parking funds with the RBI, and they will start looking out for credit deployment while pricing the risk appropriately”.

Annexure – BWR analysis on return on funds deployed for banks

As banks have been parking funds with RBI in the form of reverse repo, BWR has calculated, the difference in earnings if these funds were deployed via lending to corporates. Approx. Rs 7 lakh crore have been deployed with the RBI as on May 21, 2020 helping banks earn around Rs 23,500 crores as interest. However, if these were deployed via lending to corporates (AA to BBB rating category) the earning for banks would have been around Rs 57,500 crore in a year.

<table>
<thead>
<tr>
<th>Option A (Funds deployed in reverse repo)</th>
<th>As on May 21, 2020 (Rs crore)</th>
<th>Option B (Funds deployed via lending to corporates)</th>
<th>As on May 21, 2020 (Rs crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds (Rs crore)</td>
<td>~700,000</td>
<td>Funds (Rs crore)</td>
<td>~700,000</td>
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<tr>
<td>Reverse repo rate</td>
<td>3.35%</td>
<td>Assumptions *</td>
<td></td>
</tr>
<tr>
<td>Banks earning from deployed funds</td>
<td>23,450</td>
<td>Wtd avg lending rate</td>
<td>12%</td>
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<td></td>
<td></td>
<td>Wtd avg Default rate</td>
<td>5%</td>
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<td></td>
<td></td>
<td>Recovery rate</td>
<td>33%</td>
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<tr>
<td></td>
<td></td>
<td>Interest earned</td>
<td>82,343</td>
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<td></td>
<td></td>
<td>Credit cost based on defaults &amp; recovery</td>
<td>24,898</td>
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<td></td>
<td>Banks earning from deployed funds</td>
<td>57,445</td>
</tr>
</tbody>
</table>

*Assumptions:*

- This assumes funds deployment in companies: 50% with AA rating, 25% with A rating and 25% with BBB rating.
- Lending rate: Weighted average lending rate based on FIMMDA benchmarks of AA to BBB rating categories and after pricing in credit and market risk.
- Default rate: Weighted average default rate of 5% in a high risk scenario has been considered based on the default rate of AA to BBB rating categories.
- Recovery rate: Assuming to be around one third recovery rate in the portfolio.
Contacts:

**Rajat Bahl**
Chief Ratings Officer
+91 22 67456634
rajat.b@brickworkratings.com

**Vydanathan Ramaswamy**
Director & Head - Financial Sector Ratings
+91 22 67456660
vydianathan.r@brickworkratings.com

**Investors & Media Contact**
+91 9930319588
liena.t@brickworkratings.com
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