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RBI MONETARY POLICY

FEBRUARY 2021

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HIGHLIGHTS

MPC holds rates and guidance, acknowledging lower inflation risks in Q4 and early signs of recovery gaining momentum

RBI's Fifth Bi-monthly Monetary Policy Review: 2020-21
The MPC unanimously voted to maintain its benchmark repo rate at 4.00% and continue with an accommodative stance as long as necessary - at least through FY21 and into FY22 – to revive growth on a durable basis and mitigate the impact of the pandemic on the economy.

Policy Actions
Repo, Reverse repo, MSF & Bank rate also kept steady. CRR held constant at 3%, **but will be gradually restored in two steps towards 4% by May, 2021.**

GROWTH-INFLATION DYNAMICS

RBI lowered its inflation projection to 5.2% in Q4FY21 from 5.8% in December meeting. Also, CPI projection has been revised and is likely to ease from 5% - 5.2% in H1FY22 to 4.3% in Q3FY22. Risks were seen as broadly balanced with downside bias driven by bumper Kharif arrivals, larger winter arrivals of key vegetables, and softer egg & poultry demand on avian flu. Though exposed to upside risks from increase in crude oil and broad based increases in the prices of industrial raw materials. The RBI projections are some way lower, as compared to the Axis Bank Economic Research, which are projecting inflation to stabilize around 5.5% for the above mentioned period.

GDP growth for FY22 was projected at 10.5% in FY22, with H1FY22 projected in a broad range of 8.3% - 26.2% and Q3FY22 at 6%. The rural recovery was expected to remain resilient on good prospects of agriculture, with urban and contact-intensive services demand expected to strengthen with fall in Covid-19 cases and increase in vaccination coverage. Boost to capital expenditure in the budget is expected to revive growth momentum and it augers well for capacity creation and crowding in private investment.

LIQUIDITY AND EXTERNAL SECTOR

Domestic system liquidity remained in large surplus in December 2020 and January 2021, resulting in easy financial conditions, aided by heavy GOI month-end spending and sizeable intervention by the RBI in forex markets.

Global financial markets remained buoyant on easy monetary conditions, abundant liquidity and optimism linked to vaccine rollout. Global economic recovery had moderated in Oct-Dec 2020, weighed by second wave of infections in several countries, including more contagious strains of the virus. However, with vaccination drive underway, downside risks to the economic recovery may ease and the activity is expected to gain momentum in H2-CY 2021.

POLICY STANCE AND GUIDANCE

The MPC continued with an accommodative stance as long as it is necessary to revive growth and mitigate the impact of pandemic on the economy while ensuring inflation remains within the target.
The accommodative stance is to be held at least through FY21 and into FY22.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order since lockdown.

Date	Measures Announced
March 27, 2020	• Repo Rate cut by 75 basis points to 4.4%; • Reverse Repo Rate cut by 90 basis points to 4%; • Cash Reserve Ratio (CRR) cut by 1% to 3% for a period of 1 year. • TLTRO (Targeted Long-Term Operations) for Rs 1 tn, for upto 3 years • MSF window extended to 3% from 2% of NDTL, • 3-month moratorium on payment of interest of all term loans, • 3-months deferment of interest on working capital facilities, • NFSR implementation delayed by 6 months and banks permitted to trade in NDF from 30 June.
March 27, 2020	First TLTRO for Rs. 250 bn
April 3, 2020	Second TLTRO for Rs. 250 bn
April 7, 2020	RBI increased tenor allowed for states/UTs overdraft to 21 consecutive working days from 14 days previous, and to 50 working days in a quarter from 36 days previous
April 9, 2020	Third TLTRO for Rs. 250 bn
April 17, 2020	• Reverse repo cut by 25 bps to 3.75%; • TLTRO 2.0 of Rs 500 bn, for small and mid-sized NBFC and MFIs; • LCR requirements of SCBs cut from 100% to 80%, • Special refinance of Rs 500 bn to NABARD, SIDBI and NHB, • Hike in WMA (Ways & Means Advances) limit for states by 60% over and above the levels as on 31 Mar until 30 Sep. • NPA classification will exclude 3-month moratorium period till May end • NBFCs' loans to delayed commercial real estate projects can be extended by a year without restructuring;
April 20, 2020	RBI enhances WMA limit for remaining part of H1-FY21 to Rs 2 trillion.
April 27, 2020	Announces special 90-day repo liquidity facility for MFs up to Rs 500 bn.
May 22, 2020	• Repo Rate cut by 40 basis points to 4%; • Reverse Repo Rate cut by 40 basis points to 3.35%; • Extends moratorium on term loan repayments for 3 months. • To support exports/imports, RBI has increased pre and post-shipment credit facility and extended line of credit for Rs 150 bn to EXIM bank for 90 days. • Rs 150 bn facility created for SIDBI to be extended by another 90 days. • Permits banks to extend margins on working capital facilities to original levels by 31 March 2021 and group exposures of banks to be increased from 25% to 30% of eligible capital base by 30 June, 2021.

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Measures announced in chronological order since lockdown.

Date	Measures Announced

August 6, 2020	• Policy Rates Unchanged
	• Rs. 10,000cr at repo rate to NABARD and NHB
	  ◦ Rs. 5,000cr to NHB to support HFCs (after the Rs. 10,000cr already given),
	  ◦ Rs. 5,000cr to NABARD (after the Rs. 25,000cr already given) to refinance small NBFCs and MFIs
	• The RBI to amend priority-sector lending guidelines to remove regional disparity -- a higher weight would be accorded to districts with lower credit flows.
	• To provide a window under the 'prudential framework on resolution of stressed assets' dated 07 June 2019 to enable lenders to implement a resolution plan for eligible corporate exposures (without change in ownership) and personal loans, while classifying such loans as standard and subject to specific conditions.
	• Restructuring MSME debt so that stressed MSMEs can utilise this provided their accounts with the concerned lender were classified as standard as on 01 March 2020 but this will have to be implemented by 31 March 2021. (Already in place if account was standard as on 01 Jan 20).
	• Maximum loan-to-value of loans sanctioned by banks against gold ornaments & jewellery for non-agricultural purposes, which is currently 75%, has been increased to 90%.
	• Banks investment in debt MFs and debt ETFs will be treated consistently with direct debt investments in terms of capital allocation.

October 9, 2020	• Policy Rates Unchanged • WMA limit for the Centre has been kept at Rs.1.25 lakh crore compared to Rs.35,000 crore in H2FY20. The 60% WMA limit for states has been extended till March 31, 2021. • RBI to up the size of the OMO Purchases to Rs.20,000 crore from Rs. 10,000 crores. • To conduct on tap TLTRO with tenors upto 3 years for upto Rs.1 Lakh crore at floating rate linked to policy rate available up to March 31, 2021. • TLTRO funds availed by banks to be deployed in corporate bonds, commercial papers and non convertible debentures issued by entities in specific sectors. • To conduct OMOs in State Development Loans (SDL) to rationalize spreads over G-sec.

KEY MEASURES ANNOUNCED BY THE RBI

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Date	Measures Announced

October 9, 2020	• Enhanced SLR holdings in HTM category (increased from 19.5% to 22% in September 2020) of NDTL of banks, acquired between 1st September 2020 to 31st March 2021, will be applicable till 31st March 2022.
	• To discontinue system-based automatic caution listing of Exporters.
	• Allowed banks to increase exposure to retail individuals or small business (with turnover of upto Rs 50 crore) from Rs.5 crore to Rs.7.5 crore.
	• To rationalise the risk weights and link them to LTV ratios only for all new housing loans sanctioned up to March 31, 2022.
	• To extend scheme for Co-lending to all NBFCs including HFCs.
	• Other Measures
	  • Round-the-clock availability of RTGS on all days from December 2020.
	  • To grant authorisation for all PSOs (new applicants as well as existing PSOs) on a perpetual basis from earlier limited periods of up to five years.

December 4, 2020	• On Tap TLTRO - will be expanded to cover other stressed sectors in synergy with the credit guarantee available under the Emergency Credit Line Guarantee Scheme (ECLGS 2.0). • Regional Rural Banks (RRB) will be allowed to access the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) of the RBI; and also the Call money market. • Scheduled commercial banks & cooperative banks shall not make any dividend pay-out from the profits of FY20. • Formulate guidelines on dividend distribution policy by NBFCs. • Issue guidelines to large UCBs, NBFCs for adoption of Risk-Based Internal Audit. • Harmonise guidelines on appointment of statutory auditors for commercial banks, UCBs and NBFCs. • Proposed to issue Reserve Bank of India (Digital Payment Security Controls) Directions, 2020 for regulated entities to set up a robust governance structure and implement common minimum standards of security controls for channels like internet, mobile banking, card payments, among others. • Revised draft directions to be issued for credit default swaps. • Revides draft guidelines for derivatives to be issued. • Discussion paper on supervision of NBFCs based on size to be issued in January.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order since lockdown.

Date	Measures Announced
February 5, 2021	• TLTRO on Tap scheme extended to NBFCs for incremental lending to the specified stressed sectors. • Restoration of CRR in two phases beginning March 2021 (increase to 3.5% on March 27 and 4% on May 22, 2021) • Additional 1% of NDTL dispensation given on statutory liquidity ratio (SLR) for availing funds under the marginal standing facility (MSF) extended by 6 months to end September 30, 2021. • Extension of HTM limits (upto 22% of NDTL) upto March 31, 2023 from March 31, 2020 (to include securities acquired between April 1, 2021 and March 31, 2022). • Defer the implementation of last tranche of the Capital Conservation Buffer (CCB) of 0.625 per cent and also defer the implementation of Net Stable Funding Ratio (NSFR) by another six months from April 1 to October 1, 2021. • Retail investors are being allowed to open gilt accounts with RBI. • Encouraging foreign portfolio investments in defaulted bonds by exempting these investments from short term limit and the minimum residual maturity requirement.

IMPACT ON THE MUTUAL FUND INDUSTRY:

Liquid Funds:

These schemes will continue to generate returns around the operating rate due to their portfolio composition i.e. being invested at the shorter end of the money market segment. Liquid funds have low average maturity as they concentrate more on high quality papers including CPs, CDs and other debt securities with residual maturity of upto 3 months.

Ultra Short Term / Low Duration / Money Market Funds (Maturity Up to 1 Year):

These schemes predominantly invest in below 1 year maturity paper. The strategy adopted by these schemes is to hold the paper till maturity and capitalize on the running yield. Hence, returns in this category will continue to remain relatively attractive depending on the positioning of the fund.

Short Duration Funds:

Schemes in this category are predominantly invested in Corporate Bonds, CPs and CDs while a few of them also have some exposure to G-Secs. We continue to remain bullish at the shorter end of the curve. Investors may consider these funds (with the investment horizon commensurate with the maturity profile of such funds) and gain from current accruals.

Medium Duration & Credit Risk Funds:

We remain cautious on Medium Duration Funds (having a higher than category average allocation towards credit papers) and Credit Risk Funds going forward. We assume that there could be further erosion of NAVs and hence returns due to a mark-to-market impact (timing mismatches, further possible downgrades, etc) in the medium duration and credit funds space. It will also depend on the liquidity conditions in the market and redemption pressure on these funds. Thus, we think there is an elevated systemic risk in the market within the credit / accrual space. Hence, it makes sense for one to stay away from these funds at the current juncture till the dust settles or risks in the credit markets shows signs of waning.

IMPACT ON THE MUTUAL FUND INDUSTRY:

Long Term Income Funds / Gilt Funds / Dynamic Bond Funds:

FY21 has been a difficult year for government finances with revenue shrinking due to disruption in economic activities and the need to maintain spending momentum to cushion the impact of Covid-19 induced slowdown.

The gross market borrowings program was raised to Rs.12 trillion during the year as compared to Rs.7.8 trillion estimated in budget. While widening of deficit was a given, revised estimate of FY21 fiscal deficit at 9.5% of GDP was significantly higher than market estimates. Further, the FY22 fiscal deficit projection of 6.8% is also much higher than the market expectations. However, the government has shown intent to bring the fiscal deficit below 4.5% by FY26. The budget has given precedence to growth over fiscal consolidation.

Market borrowing has gone smoothly for most of FY2021 owing to various measures undertaken by the RBI. But the additional borrowing of Rs.80,000 crore for this fiscal year and higher borrowing for next fiscal was not expected by the bond market participants. These resulted in Gsec yields rising by 10 to 20 bps across the board on the day of the Budget.

Although, the overall borrowing numbers for FY 22 are marginally lower than FY 21, they are still at elevated levels. With the larger net borrowing number for FY22 of Rs 9.7 trillion and the requirement to ensure normal liquidity conditions to guard against financial stability risks, the RBI would need to do a delicate balancing act with respect to managing market conditions, normalizing excess liquidity, & conducting overall borrowing program in a non-disruptive manner.

RBI is expected to continue gradual normalization of liquidity management operations as the growth & economic activity picks-up. Coincidentally, the RBI had also in the beginning of the month announced the resumption of normal liquidity management operations. The RBI conducted 14-day variable rate reverse repo/ repo operations (operating instrument) to target the weighted average call rate (operating target) around the operating rate, which translated in hardening of yield across the curve by around 20-25 bps, while the benchmark remained anchored around 5.90%. This announcement was interpreted as an RBI action to normalize money market rates which had fallen below the reverse repo rates and to normalize system liquidity. However, the base of surplus liquidity is likely to broadly remain the base case for the year even as an incremental unwinding is expected on a gradual basis. The RBI stands committed to ensure the availability of ample liquidity in the system and thereby foster congenial financial conditions for the recovery to gain traction.

Over the past two months, the moderation in vegetable prices in winter has turned out on expected lines and RBI has also taken steps to normalise the

IMPACT ON THE MUTUAL FUND INDUSTRY:

liquidity management operations & in the process, attempted to align short end rates with reverse repo rate. But, RBI increasingly is running out of tools to manage its multiple objectives – inflation, growth, yields & financial stability. Going ahead, we are likely to witness further correction in the prices of vegetables as correction in vegetable prices in the past few years has been more concentrated in Jan-Feb period rather than Dec-Jan. Overall, the inflation trajectory looks much more benign than in the last policy.

Going forward, the sharp increase in budgeted fiscal deficit, relaxation in glide path of fiscal consolidation & large supply of market borrowings is expected to keep an upward pressure on yields. However, as has been the case over the past year or so, we believe RBI will continue to use conventional & unconventional tools going forward as well, thus, limiting the increase in Gsec yields. Further, we derive comfort from the fact that RBI seems to be committed towards maintaining ample liquidity within the system. The impact of large supply has kept the curve much steeper than normal. Given the context of the expected normalization of liquidity along with a massive borrowing schedule over the coming fiscal year may lead to interest rate volatility. There is limited scope of rate cuts which was the major driver for returns in the past couple of years and thus, it's important to rationalize return expectations going forward. As stated above, we believe that the process of withdrawal will be gradual & there won't be large knee jerk adjustments in yield. Post the current repricing in yields we remain constructive on the shorter end of the yield curve as surplus liquidity is expected to remain in the system and continued supply is expected on the longer end of the yield curve. We believe rates are expected to remain benign, however, volatility might continue for some time. Short Duration funds, Corporate Bond funds, Banking & PSU Debt funds, Low Duration funds, Money Market funds and Ultra Short Duration funds can be considered by investors with an investment horizon commensurate with the maturity and duration of the schemes. All said, duration funds including dynamic bond funds which are at the longer end of the yield curve, may see some volatility in returns over the near term.

(P.S.: The 10 Year g-sec is up by 20 bps since last policy. The 10 year benchmark (5.85% GS 2030) increased by 3 bps to 6.109% at the close).

Conservative Hybrid Funds-CHF *(Erstwhile: Monthly Income Plans (MIPs)*: With between 10% to 25% allocation to equity, returns of CHFs are largely determined by the vagaries of the equity markets as against the debt markets. These funds are therefore suitable for investors who have a reasonably long time horizon & are comfortable with taking exposure to equities.

OUTLOOK

IMPACT ON THE MUTUAL FUND INDUSTRY:

The MPC held rates unchanged, while acknowledging faster pace of normalization in Q3 (high frequency indicators suggesting recovery gaining traction). On the liquidity front, the stance continues to be accommodative. Further, RBI's commitment to replenish liquidity withdrawn due to phased normalization in CRR (by May 2021) through more durable market friendly form of liquidity, suggests accommodative stance well into FY22. So far, RBI has supported the government borrowing programme and kept the yields range bound through both intervention (OTs/OMOs) and by signaling through verbal communication (with statements like yield curve being a public good).

We remain constructive on the shorter end of the yield curve. **Short Duration funds, Corporate Bond funds, Banking & PSU Debt funds, Low Duration funds, Money Market funds and Ultra Short Duration funds** can be considered by investors with an investment horizon commensurate with the maturity and duration of the schemes. Having said that, one should consider aspects such as exit load, capital gains tax and asset allocation amongst others while evaluating their investment options.

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