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RBI MONETARY POLICY

JUNE 2022

HIGHLIGHTS

MPC unanimously raises repo rate by 50 bps with intensifying inflation pressures, drops reference to remain accommodative

MPC's second bi-monthly Monetary Policy Review: 2022-23

MPC unanimously increased its repo rate by 50 bps to 4.9% with immediate effect. The statement dropped previous wording of remaining accommodative, with focus now on **withdrawal of accommodative conditions** to ensure inflation is within the target going forward, while supporting growth.

Policy Actions

Repo rate hiked by 50 bps to 4.90%.
Consequently, SDF at 4.65% and MSF at 5.15%.
RBI kept CRR unchanged at 4.50%.

GROWTH-INFLATION DYNAMICS

The statement continued from May, acknowledging realization of multiple upside risks, but also began to talk more of second round impact as well as pass through of higher input costs. It also added potential risks from increases in prices of electricity. FY23 inflation projections were revised higher to 6.7% (from 5.7% as per April forecasts), with Q1 at 7.5% (previously 6.3%), Q2 at 7.4% (previously 5.8%), Q3 at 6.2% (previously 5.4%), and Q4 at 5.8% (previously 5.1%), with risk evenly balanced.

MPC's language around growth was upbeat, with reiteration of comments made in May. The governor's statement emphasized domestic activity gaining traction, with inflation pressures intensifying further. Growth projections for FY23 were maintained at 7.2%, with Q1 at 16.2%, Q2 at 6.2%, Q3 at 4.1%, and Q4 at 4%, with risks broadly balanced.

LIQUIDITY AND EXTERNAL SECTOR

Liquidity conditions have tightened on higher government balances, with multi year absorption of liquidity set to continue.

The statement acknowledged dire global outlook given global stagflation risks adding to persisting geopolitical tensions, elevated commodity prices and COVID related supply chain disruptions, with tightening of global financial conditions also weighing. However, focus was on India's resilience to these developments and buffers including FX reserves, deleveraged corporate balance sheets, and healthy bank capital ratios.

POLICY STANCE AND GUIDANCE

While the statement phased out the remaining accommodative phrasing, comments indicated that allowing overnight rates to trade below the repo rate was still consistent with the accommodative stance. Guidance indicated a calibrated move towards normal conditions where the overnight rates will gradually trade at the repo level in consonance with Feb'20 liquidity policy.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order in last 1 year.

Date	Measures Announced

August 6, 2021	• Propose to conduct fortnightly VRRR auctions of Rs.2.5 lakh crore on August 13, 2021; Rs.3.0 lakh crore on August 27, 2021; Rs.3.5 lakh crore on September 9, 2021; and Rs.4.0 lakh crore on September 24, 2021.
	• Propose to conduct two more auctions of Rs.25,000 crore each on August 12 and August 26, 2021 under G-SAP 2.0.
	• To extend the on-tap TLTRO scheme further by a period of three months, i.e. till December 31, 2021.
	• To provide comfort to banks on their liquidity requirements, including meeting their LCR requirement, relaxation which is currently available till September 30, 2021 is being extended for a further period of three months, i.e., up to December 31, 2021.
	• Deferral of Deadline for Achievement of Financial Parameters under Resolution Framework 1.0
	• RBI Amends Rules For Smoother Transition Away From Libor banks can:
	    • Extend export credit in foreign currency using any other widely accepted alternative reference rate in the currency concerned.
	    • Change in reference rate from Libor/Libor-related benchmarks to an alternative reference rate will not be treated as restructuring
	• RBI has decided to defer the deadline for achievement of four financial parameters under Resolution Framework 1.0 for Covid related stress to October 1, 2022 earlier was required to be met by March 31, 2022.

October 8, 2021	• Withdrawing secondary market G-SAP due to existing liquidity overhang. However, would step-in to undertake G-SAP as and when warranted by liquidity conditions including OTs and OMOs. • Proposed to undertake the 14-day VRRR auctions on a fortnightly basis and may also consider 28-day VRRR auctions in a similar calibrated fashion to complement the 14-day VRRR. • On Tap Special Long-Term Repo Operations (SLTRO) for Small Finance Banks (SFBs) extended to December 31, 2021. • Proposed to introduce a framework for retail digital payments in offline mode across the country • Enhancing Transaction Limit in IMPS to Rs.5 lakh from Rs.2 lakh • Ways and Means Advances (WMA) Limits and Relaxation in Overdraft (OD) Facility for the State Governments / UT extended to Mar 31, 2022 • Priority Sector Lending - Permitting Banks to On-lend through NBFCs - Continuation of Facility further extended to march 31, 2022 • Introduce the Internal Ombudsman Scheme (IOS) for certain categories of NBFCs having higher customer interface.

KEY MEASURES ANNOUNCED BY THE RBI

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December 8, 2021	• Proposed to enhance the 14-day VRRR auction amounts on a fortnightly basis : Rs.6.5 lakh crore on December 17; and further to Rs.7.5 lakh crore on December 31. January 2022 onwards, liquidity absorption will be undertaken through the auction route.
	• Banks will be able to dip up to 2% of NDTL instead of 3% for overnight borrowing under the MSF from January 1, 2022.
	• Infusion of Capital in Overseas Branches and Subsidiaries of Banks and Retention/Repatriation/Transfer of Profits by these entities
	• UPI: Simplification, Deepening and Enhancement of Limits:
	  • launch UPI-based payment products for feature phone users
	  • process flow for small value transactions simpler through a mechanism of 'on-device' wallet in UPI applications; and
	  • enhance the transaction limit for payments through UPI for the Retail Direct Scheme for investment in G-secs and IPO applications from Rs.2 lakh to Rs.5 lakh.
	• Guidelines for transition from LIBOR to Alternative Reference Rate

February 10, 2022	• Extension of On-tap Liquidity Facilities for Emergency Health Services (Rs.50,000 Cr) and Contact-intensive Sectors (Rs.15,000 Cr) from March 31, 2022 to June 30, 2022. • Proposed to enhance the Voluntary Retention Route (VRR) limit for investments under the scheme by Rs.1.0 lakh crore from Rs.1.5 lakh crore at present to Rs.2.5 lakh crore with effect from April 1, 2022. • Proposed to increase the cap of e-RUPI vouchers issued by the Central and State governments from Rs.10,000 to Rs.1,00,000 per voucher and permit such e-RUPI vouchers to be used more than once (until the amount of the voucher is completely redeemed). • Proposed to increase the NACH mandate limit from Rs.1 crore at present to Rs.3 crore for TReDS related settlements to facilitate the financing of trade receivables of MSMEs.
April 8, 2022	• RBI has decided to introduce the width of the LAF corridor to 50 bps which was the level pre-pandemic. The floor of the corridor will now be provided by the newly instituted standing deposit facility (SDF), which will be placed 25 bps below the repo rate, i.e., at 3.75% • Risk weights for housing loans which were rationalized in October 2020, has been extended to March 31, 2023 to facilitate higher credit flow. • Enhance the present limit under HTM category from 22% to 23% of NDTL till March 31, 2023. • HTM limits would be restored from 23% to 19.5% in a phased manner starting from the quarter ending June 30, 2023. • Due to the transformative change in the financial landscape, a committee will be set up to examine customer service regulations in RBI Regulated entities. • It is now proposed to make card-less cash withdrawal facility available across all banks and ATM networks using the UPI.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order in last 1 year.

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June 8, 2022	• Measures announced for the cooperative banking sector: 1. Individual housing loans limit extended by Urban Cooperative Banks (UCBs) and Rural Cooperative Banks (RCBs) and are revised upwards by over 100% taking into account increase in house prices. 2. Proposed to permit RCBs (State Cooperative Banks and District Central Cooperative Banks) to extend finance to ‘commercial real estate – residential housing’ (i.e. loans for residential housing projects), within the existing aggregate housing finance limit of 5% of their total assets. 3. UCBs to extend doorstep banking services to customers, especially senior citizens and differently abled. • To facilitate recurring payments like subscriptions, insurance premia, education fee, etc. of larger value under the framework, the limit is being enhanced from ₹5,000 to ₹15,000 per transaction. • At present, UPI facilitates transactions by linking savings/current accounts through users’ debit cards. It is now proposed to allow linking of credit cards on the UPI platform (Rupay credit cards).

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:

Given the current steepness in the curve there are reasonable opportunities in the intermediate duration (3-5 years) segment. Till the time RBI is managing the yield curve, the steepness of the curve may provide cushion even if there are mark-to-market losses. Investors may consider those funds with high quality portfolios and where the investment horizon is commensurate with the maturity profile of the fund and also gain from current accruals.

Credit Risk Funds:

We remain cautious on Credit Risk Funds as they have failed to prove their mettle in the last 2-3 years with the overhang of defaults and erosions of NAV on the back of mark-to-market impacts due to the aforementioned. The uncertainty around credit funds which are in an open ended avatar continues to pose risks to investors. Much also depends on the liquidity conditions in the market and redemption pressure on these funds. Thus, we think there is a systemic risk in the market within the credit 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:
The global backdrop continues to remain challenging with persistent geopolitical tensions, elevated crude oil and commodity prices and lingering COVID-19 related supply chain bottlenecks. Global financial markets have been roiled by turbulence amidst growing stagflation concerns, leading to a tightening of global financial conditions and risk to the growth outlook and financial stability. However, on domestic front, high frequency indicators for April-May 2022 indicated broadening of economic activity. Moreover, the RBI in its latest policy reaffirmed that economic activity is gathering strength, while rural consumption is likely to benefit from normal monsoon and a rebound in contact-intensive services is likely to bolster urban consumption, going forward.

Today's policy was broadly on expected lines and may provide a temporary breather to the bond market as RBI did not increase the CRR. Given the current inflation dynamics in India and globally, the RBI looks set to continue with frontloading more rate hikes potentially in August and October MPC meetings, to take the repo rate to 5.15%, a pre-pandemic level and thereon take calibrated measures depending on growth-inflation dynamics.

Today, inflation momentum in most emerging market economies is running at double the pace of central bank targets. There are evidences of price pressures broadening in most economies and inflation increasing as the economies are re-opening. RBI's projections indicate that inflation is likely to remain above the comfort zone of 6% throughout the year, despite supply side measures recently taken by GOI. Also the CPI ratios suggest that the pipeline price pressures are elevated. And, above all, the most notable upside risk is on food inflation. While expectations of normal monsoons augurs well for Kharif crop, the recent heatwave could impact Rabi output and hence put pressure on food prices. Crude could continue to be a deciding factor for inflation and RBI has forecasted crude at $105/brl for FY23. Any material change here could impact inflation.

With today's hike and tone, it is clear that interest rates are likely to stay higher for sometime. Though RBI has managed to calm some nerves in G-sec markets by stating their vigil, we believe absence of clear roadmap

IMPACT ON THE MUTUAL FUND INDUSTRY:

(for support measures) with persistent huge supply will continue to exert upward pressure on the longer end of the yield curve. At the shorter end, yields are expected to remain range bound with markets keeping a close eye on liquidity. Long term debt funds are likely to witness heavy volatility in a rising rate environment. On the other hand, short term debt funds may see volatility but will adjust with higher rates.

With the onset of rate as well as liquidity normalisation, combined with enhanced government borrowings in FY23, bond yields are expected to harden across the curve. The bigger challenge for the RBI, post this policy action, will be to manage the government's borrowing programme in a non-disruptive manner. We assume RBI is maintaining a close vigil on G-Sec markets and is likely to take steps to ensure smooth government borrowings / avoid disruption. The near-term direction would be dictated by inflation evolution and high frequency data including commodity prices and the ongoing Russia-Ukraine war, China's stringent zero-covid policy, and the increased likelihood of aggressive monetary policy tightening by the major central banks. A stagflation environment and tightening of global monetary conditions is expected to create challenges for asset prices and induce higher market volatility. With the surge in global bond yields, debt returns have been heading south. This trend may continue if inflationary risk persists for long. Given the high uncertainty over the interest rate trajectory, it would be prudent for investors to be conservative. It is expected that the RBI shall take requisite measures going forward to support growth and ensure liquidity in the banking system, with a dual objective of improving the financial conditions and managing the yield curve.

(PS: Today, 10 year benchmark closed at 7.4939%, lower by 2 bps, while during the day it made a low of 7.4308% down by ~9bps.)

Conservative Hybrid Funds *(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 overall tone was in line with continuation of calibrated normalisation to restore pre-covid levels on interest rates. This was intended to push back against second round effects of higher commodity prices on inflation expectations - given greater confidence in the growth trajectory.

We remain constructive on the short to medium end of the yield curve; **Short Duration funds, Banking & PSU Debt funds, Corporate Bond funds, Debt Index funds (Target Maturities), Floating Rate funds, Money Market funds, Low Duration 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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