Students' ECONOMIC FORUM

A monthly publication from South Indian Bank

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To empower the student community...

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Theme : 341

RBI & THE LIQUIDITY TAP

29th Year of Publication

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STUDENTS' ECONOMIC FORUM

APRIL 2020

Theme No: 341: RBI & the Liquidity Tap

"When learning is purposeful, creativity blossoms. When creativity blossoms, thinking emanates. When thinking emanates, knowledge is fully lit. When knowledge is lit, economy flourishes." - A.P.J. Abdul Kalam

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is "**RBI & the Liquidity Tap".**

India's economy was reeling under pressure due to a slew of factors including a slump in demand due to lower consumption. In the calendar year 2019, RBI had reduced the repo rate by 135 basis points (bps) in five successive rate cuts starting from February 2019 but had achieved little in terms of boosting demand. It was mostly because Indian banks had not succeeded in passing on lower interest rates to borrowers despite RBI's mandate to link lending rates with its external benchmark.

Against this backdrop, the Reserve Bank continued to manage liquidity using a combination of instruments consisting of repo and reverse repo operations under the Liquidity Adjustment Facility (LAF), Open Market Operations (OMOs), operations under the Marginal Standing Facility (MSF) and interest rate signals through the reverse repo/repo rates. **Let's discuss some of the liquidity management tools used by the RBI recently.**

I. OPERATION TWIST

On December 19, 2019, The Reserve Bank of India (RBI) announced a unique policy that would have a bearing on interest rates. Operation Twist was the name given to a monetary policy tool that the US Federal Reserve had initiated to influence the prevailing rate of interest in the markets. The tool essentially aims at changing the shape of the yield curve (hence the name - twist) through simultaneous buying and selling of long and short-term government bonds. In India, the RBI put through its version of Operation Twist by buying ₹ 10,000 crore worth of 10-year government bonds while selling four shorter-term government bonds maturing in 2020 adding up to the same value. The intent was to moderate high long-term interest rates in the market and bring them closer to the repo rate.

In India's context, Operation Twist was a bid to bring down interest rates on long-term loans—something that it had failed despite five rate cuts by RBI that year. It may be noted that high market yields on long-term government securities often send interest rates on long-term loans soaring. This can affect customers seeking long term loans for vehicles, real estate, and other long-term borrowings. As the central bank buys more long-term security and sells off short term bonds, the bond yield - the return an investor gets on his holding comes down significantly. Since long-term bond yield (10-year government securities) is a key market interest rate, lower rates can help people avail more long-term loans. It also helps in bringing down overall borrowing costs for the government.

In a nutshell, Operation Twist is an RBI initiative that aims to control long-term bond yields and bring down interest rates on long-term borrowing.

II. LTRO (Long Term Repo Operations)

In the 6th bi monthly policy on 6th February 2020, RBI had announced its first ever- long term repo operations (LTRO), a tool that lets banks borrow one and three-year funds from the central bank at the repo rate, by providing government securities with similar or higher tenure as collateral. LTRO was first introduced by the European Central Bank during its sovereign debt crisis that began in 2008. The new policy tool comes in the context of the RBI's limitations in cutting its policy rate as well as its desire to enhance liquidity in the banking system and promote lending activities of banks. It is supposed to increase the money supply in the economy without affecting the interest rates or the repo rate.

What are the Features?

- Maturity period (tenor): One-year and three-year tenor
- Total funds injected: Rs 1,00,000 crores + Rs. 25000 crore additional
- Interest rate: at the prevailing policy rate (Repo rate).
- Banks would be required to place their requests for the amount sought under LTRO during the window timing at the prevailing policy repo rate. Bids below or above policy rate will be rejected.
- If there is over-subscription of the notified amount, the allotment will be done on pro-rata basis. RBI will, however, reserve the right to inject marginally higher amount than the notified amount due to rounding effects.
- The minimum bid amount would be Rupees one crore and multiples thereof. There will be no restriction on the maximum amount of bidding by individual bidders.

What are the Potential effects?

Since, under LTRO, funds are provided at low interest rate (the repo rate), the overall short-term interest rate may come under pressure to register a decline. Similarly, the short-term yield also may fall. Altogether, there will be pressure on the banking system to reduce their lending rates.

III. TLTRO (Targeted Long Term Repo Operations)

As the name suggests, it targets certain category of borrowers. In this case, it is the fund starved companies. The central bank wants banks opting for funds under this option to be specifically invested in investment-grade corporate debt. This was launched to fight the covid-19 economic shock on Indian economy. This helps banks get funds for a longer duration as compared to the short-term (up to 28 days) liquidity provided by the RBI through other tools such as liquidity adjustment facility (LAF) and marginal standing facility (MSF).

Liquidity availed under the scheme by banks has to be deployed in investment grade corporate bonds, commercial paper and non-convertible debentures over and above the outstanding level of their investments in these bonds as on March 25, 2020. Eligible instruments comprise both primary market issuances and secondary market purchases, including from mutual funds and non-banking finance companies. Investments made by banks under this facility will be classified as held to maturity (HTM) even in excess of 25 per cent of total investment permitted to be included in the HTM portfolio. Exposures under this facility will also not be reckoned under the large exposure framework.

How does the TLTRO process works?

- RBI lends to banks in 4 tranches of Rs 25,000 Cr each (total Rs 1 lakh Cr in TLTRO).
- Once the banks bid for an amount, they will get it at the repo rate (the interest rate will change for subsequent periods as repo changes) for a tenure of 3 years.
- Banks need to deploy this amount in fresh acquisition of bonds (meaning, they have to buy bonds) in the next 30 days. Failing which they pay 2% higher interest.
- Bonds need to be investment grade (BBB or better).
- A bank can buy a maximum of 10% of allocated amount to one entity or group.
- Also, 50% of the allocated fund should be used for fresh issues and another 50% towards secondary market.
- There is no criterion for duration. Banks can buy bonds of any duration. Only criterion is that once the bond matures, banks need to redeploy the money in some other bonds until the TLTRO expires (three years later).
- Banks need to return the money availed from RBI after 3 years with the interest (no intermediate repayments).

IV. TLTRO 2.0

The TLTRO funds were used by the Banks to buy high rated bonds of Corporates (which have otherwise very little trouble raising money anyhow). They were actually meant to be deployed for firms which are facing severe liquidity issues and are unable to raise cash (primarily to NBFCs). Hence RBI came up with a TLTRO version 2.0 and instructed the banks to specifically allocate funds to NBFCs. Under Version 2.0, RBI will extend an additional Rs 50,000 Cr towards NBFCs only. Banks cannot use the version 2.0 money to lend to Corporates – only NBFCs. The first tranche of Rs. 25,000 Cr was extended on April 23rd 2020.

RBI has laid the following conditions in version 2.0.

- Minimum time to deploy the allocated funds has been extended from 30 days to 45 days.
- Rs. 50,000 Cr should be used to buy bonds of NBFCs only, including housing finance companies.
- 10% of the allocated fund (Rs. 5,000 Cr) should be used for Micro financiers (MFIs).
- 15% of the allocated fund should be used for NBFCs with asset size of Rs. 500 Cr and below.
- 25% of the allocated funds should be used for NBFCs with asset size of Rs. 500 Cr – Rs. 5,000 Cr.
- The rest 50% can be deployed in any way they choose.
- No criterion for primary or secondary market. Banks could buy as much as they wished directly from companies (primary) or from the secondary market.
- The maximum 10% allocation for individual company rule did not hold good.
- The rest of TLTRO guidelines remain same.

V. Ways and Means Advances

As a part of its Stimulus 2.0 to deepen the availability of credit, The Reserve Bank of India (RBI), announced an increase in the Ways and Means Advances (WMA) limits to States. For the first half of FY21, WMA limit of States has been increased by 60 per cent over the level as on March 31, 2020, with a view to enable them "to undertake COVID-19 containment and mitigation efforts" and "to better plan their market borrowings".

What is Ways and Means Advances (WMA)?

The Ways and Means Advances scheme was introduced in 1997. It is a mechanism used by the RBI to fund States to help them tide over temporary mismatches in cash flows. Borrowings through WMA are to be repaid within three months and usually offered at the repo rate. The governments are, however, allowed to draw amounts in excess of their WMA limits. The interest on such overdraft is 2 percentage points above the repo rate, which now works out to 6.4%. Further, no state can run an overdraft with the RBI for more than a certain period. Section 17(5) of the RBI Act, 1934 authorises the central bank to lend to the Centre and State governments subject to their being repayable "not later than three months from the date of the making of the advance".

There are two types of WMAs - normal Ways and Means Advances; and Special Drawing Facilities against government securities held by States as collateral. Any amount drawn by a State in excess of the normal WMA is an overdraft. There is a State-wise limit for the funds that can be availed via WMA. These limits depend on many factors, including total expenditure, revenue deficit and fiscal position of the State. WMA limits are revised periodically and the previous utilisation rates are considered while determining revised limits.

What are the existing WMA limits and overdraft conditions?

For the Centre, the WMA limit during the first half of 2020-21 (April-September) has been fixed at Rs 120,000 crore. This is 60% higher than the Rs 75,000 crore limit for the same period of 2019-20. The limit for the second half of the last fiscal (October-March) is Rs 35,000 crore. For the states, the aggregate WMA limit was Rs 32,225 crore till March 31, 2020. On April 1, the RBI announced a 30% hike in this limit, which has now been enhanced to 60%, taking it to Rs 51,560 crore. The higher limit will be valid till September 30, 2020. The Central Bank, on April 7, also increased the number of days States can be in continuous overdraft to 21 days from 14, and the number of days in total that states can be in overdraft in a quarter was raised from 32 to 50 days.

Why is it important?

Increased WMA limit for States to borrow short-term funds from the RBI provides a financial cushion when there's uncertainty in revenue collections due to stressed economic conditions. WMA can be an alternative to raising longer-tenure funds from the markets, issue of State government securities (State development loans) or borrowing from financial institutions for short-term funding. WMA funding is much cheaper than borrowing from markets.

VI. Special Liquidity Window for Mutual Funds

Heightened volatility in capital markets as reaction to COVID-19 has imposed liquidity strains on Mutual Funds. This has intensified in the wake of redemption pressures related to closure of some debt MFs and potential contagious effects there from. The Reserve Bank of India (RBI) announced a special liquidity window of ₹ 50,000 crore for Mutual Funds. Similar windows were opened in 2008 and 2013, when credit markets were under stress. Under the scheme, the RBI will conduct repo (repurchase agreement) operations of 90-day tenor at a fixed repo rate for banks.

According to the RBI, Banks can draw funds under the Special Liquidity Facility-Mutual Fund (SLF) exclusively for meeting the liquidity requirements of MFs by extending loans. Bank could also make outright purchase of investment-grade corporate bonds, commercial papers (CPs), debentures and certificates of Deposit (CDs) held by MFs.

In view of the COVID-19 pandemic, Reserve Bank of India announced several additional measures aimed at maintaining adequate liquidity in the system and its constituents in the face of COVID-19 related dislocations; facilitating and incentivising bank credit flows; easing financial stress and enabling markets to function normally. All these measures are aimed at boosting the confidence among the financial sector players to wake up and regain the pace of economic growth.

Source: RBI

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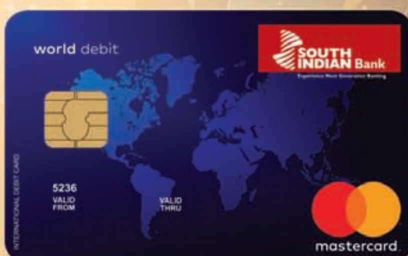

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