Rising yields a worry; RBI should act: Bond dealers

Rise in interest rates could hit corporate earnings, hinder economic recovery

ANUP ROY & KRISHNA KANT
Mumbai, 3 February

The post-Budget rise in bond yields could hinder the fledgling growth impulses, and the central bank may have to once again assure the market that yields would be kept under check by providing ample support, say experts.

Much of those assurances can be expected on Friday, when the Monetary Policy Committee (MPC) announces its decision on policy rates, which are likely to be on hold for an extended period. The bond yields have moved up at least 15 basis points after the Budget, closing at 6.10 per cent on Wednesday. The mood in the market has soured after the government said it would borrow ₹12 trillion for the next fiscal year and an extra ₹80,000 crore this fiscal year.

For the better part of 2020, the yields have remained below 6 per cent. If the yields close the financial year at a substantially higher level, there would be heavy losses in the books. The Reserve Bank of India (RBI) has run a negative interest rate in the economy, and let the three-month borrowing cost dip to 3 per cent, far below the overnight policy rates. If the yields rise, much of those would be undone.

That won't be good for the economic recovery.

"The larger-than-expected borrowing will put pressure on the yields and will eventually hinder transmission and crowd out private borrowing," said Ashhish Vaidya, head of treasury at DBS Bank.

Still, mopping up of excess liquidity would continue as the market can function well with even ₹2 trillion of surplus liquidity, against more than ₹6 trillion now.

The rise in interest rates could also hit the corporate earnings. Most companies, including banks and non-banking finance companies, reported a decline in their interest burden in the first nine months of FY21 (April-December 2020) following a sharp fall in bond yields.

For example, the lenders' (banks plus non-bank) combined interest cost was up just 1.4 per cent year-on-year (YoY) during the nine months in fiscal 20-21 (9MFY21), compared to a 17.1 per cent rise for the same period a year ago. The lenders' interest cost in the December 20 quarter was the lowest in the last seven quarters even as the industry revenue reached a new high in the third quarter, a *Business Standard* analysis shows. This resulted in a sharp rise in lenders' interest margins and profits, going up nearly 27 per cent YoY (excluding YES Bank numbers).

Low interest rates also boosted the bottom line of mainline manufacturing and service sector companies. The combined interest cost of companies, excluding financial companies, was down 4.9 YoY during 9MFY21. This cushioned the blow from 15.5 per cent y-o-y decline in net sales during the period. This, in combination with a dip in raw material cost, allowed companies to report 9.2 per cent YoY growth in net profit in the April-December 2020 period.

"India is trying to build a manufacturing base. A higher manufacturing cost because of higher interest components will make us uncompetitive," said Debendra Dash, head of asset liability management at AU SFB. "Global interest rates are low and any rise in interest rates will attract more capital, which will make the rupee appreciate and impact our exports."

According to Gopal Tripathi, head of treasury at Jana SFB, interest rates would naturally rise with growth, and everyone would be prepared for that in the next year. "Given the economic recovery and that normalcy is returning, the RBI's tolerance level to keep the 10-year yield in check can go up by 40-50 basis points," said Tripathi.

But the central bank probably won't let rates rise in this current fiscal year. The RBI gave some of these indications by cancelling the primary auction on January 22.

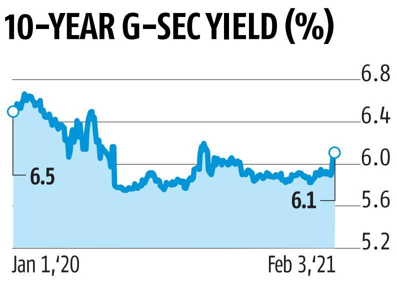
"The market will be looking for the tone and guidance from the MPC and RBI, and how the central bank strikes a balance between keeping liquidity and managing inflation expectations along with the oversupply of government bonds," Vaidya said.

The RBI can technically increase the reverse repo rate from its current 3.35 per cent and at the same time give a larger amount through long-term repo operations (say, for one or three years) along with some periodic open market operations (OMO) calendar, Vaidya said. OMO is used to buy bonds from the secondary market to keep demand robust.

These measures can flatten the yield curve with the long end remaining well anchored and, thereby, not materially altering the borrowing cost for the government.

ILLUSTRATION: BINAY SINHA

10-YEAR G-SEC YIELD (%)



COMMENT

Monetary policy will continue to have role in supporting fiscal stimulus

SAUGATA BHATTACHARYA

The FY22 Budget has definitively shifted the fulcrum of recovery away from the earlier dominant monetary stimulus, manifest in the ostensible Survive, Revive and Thrive strategy, to fiscal policy. Yet monetary policy will play not just a supporting, but an equal, flanking role in reinforcing the government's expenditure boost *inter alia* by anchoring interest rates. This will need to be accompanied by managing a gradual, calibrated normalisation of the accommodative stance in order to reduce potential financial stability risks.

The MPC will keep the policy repo rate on hold, unanimously, despite the prospect of a drop in CPI inflation to 5 per cent in Q4 and then likely to average 4.5 per cent in FY22. The accommodative stance will be maintained.

Not only are there continuing risks from higher global inflation (metals consumption ex-China was very strong in Q4 '20), a quicker and seemingly more broad-based recovery in India might push inflation. Consensus forecasts on crude in 2021 remain in the $60/ barrel range. The effects of the higher government spending envisaged in Q4 of FY21 also need to be monitored.

Having said this, initial readings of the set of leading and concurrent indicators we track suggest a slight tick down of economic activity in January. Sustaining the recovery deep into FY22, and then pushing up India's potential growth upwards of 7 per cent will not be easy.

Increasing credit, more broadly the total flow of funds, to borrowers will need to complement the fiscal measures to sustain the recovery momentum. We had expected the Budget to have expanded the scope of credit guarantees following the template of the fairly successful ECLGS model for MSMEs, particularly for farm loans. While this did not happen, details of operationalising the new institutions and mechanisms which have been proposed will need to be monitored, to gauge their likely impact on credit flows in the medium term. As the forbearance measures are gradually rolled back, the resulting stress on loan portfolios will also be a decision factor.

Even if inflation stabilises at around 4.5 per cent, there is virtually no space for any cut in the repo rate. As recovery progresses, policy and short-term rates will need to be taken up into positive real territory, reversing the deep negative real rates we have had for most of 2020.

The US Fed is likely to start tapering sometime later this year, and will contribute to increasing global volatility with spillovers to EMs, although probably weaker than the 2013 episode. Hence, policy statement and communication will be about keeping markets stable while the normalisation process is taken forward in baby steps.

RUN-UP TO MONETARY POLICY REVIEW

Although the time for initiating normalisation is still distant, markets will gradually need to be prepared for tightening financial conditions. Yet, we expect the autonomous drivers of liquidity to add to the current surplus in FY22. Hence, the design of the normalisation process, including the timing of the expected hikes in the reverse repo accompanying liquidity management, will be crucial.

Forward guidance plus signaling through OMOs, twists, auction yield cut-offs, variable rate reverse repo auctions, forex market interventions, etc, will be part of communication strategy.

The author is executive vice-president and chief economist, Axis Bank

Sticking points in India-US mini trade deal fixed: Commerce secy

INDIVJAL DHASMANA
New Delhi, 3 February

Commerce Secretary Anup Wadhawan on Wednesday said the negotiations over India-US mini trade deal are ongoing and that the contentious points have largely been addressed. "There are no sticking points. Bilateral discussions never end," said Wadhawan.

The two countries are negotiating a trade package to iron out the chinks and promote two-way commerce.

India has demanded resumption of export benefits to certain domestic products under the Generalised System of Preferences, and greater market access for its products from sectors like agriculture, automobile, auto components, and engineering.

Equalisation levy

Wadhawan reiterated the country's stand that it does not agree with the United States Trade Representative (USTR) report that New Delhi's move to impose 2-per cent equalisation levy on foreign e-commerce firms discriminates against American companies.

"We do not agree with that conclusion," said Wadhawan.

Budget & exports

Wadhawan said exports are picking up and will soon reach pre-Covid levels.

He said the Budget measures, such as provisions relating to countervailing duties and anti-dumping duty, a scheme for mega investment textile parks, substantial investments in the development of modern fishing harbours an fish landing centres, Operation Green scheme for the agriculture sector, will enable growth, diversification, and technological enhancement of India's exports.

Customs duties

Wadhawan said the broad principle is that it should do away with the inverted duty structure and increase competitiveness of exports. He said all Customs duties are within the bound duty rates committed by India in the World Trade Organization.

On RCEP

"Our stance is clear," he said.

India had opted out of the deal in 2019. The Regional Comprehensive Economic Partnership (RCEP) says its doors to India are open.

Services PMI rises for 4th month

Inflation a concern; firms confident of a rise in output

DILASHA SETH
New Delhi, 3 February

Activity in the services sector expanded for the fourth straight month in January as the Covid-19 vaccination roll-out drove business optimism, a private survey showed on Wednesday.

The IHS Markit India Services Business Activity Index rose to 52.8 in January, from 52.3 in December, suggesting the pace of growth was moderate. The 50-point mark separates expansion from contraction.

"The service sector enjoyed good levels of activity in January, with new business volumes rising for the fourth successive month and growth rates for both measures picking up from December," said Pollyanna De Lima, Economics Associate Director at IHS Markit. "The sector looks set to sustain growth and confidence towards hiring may improve as Covid-19 concerns diminish."

Though the pace of growth accelerated from December, the headline figure remained below its long-term average of 53.3 and was consistent with a moderate pace of growth, the survey said.

The rise in new business continued to be driven by the domestic market even as new export work dropped further as travel restrictions and the pandemic dampened international demand for services.

Price discounting strategies helped total new orders. Marketing efforts, the reopening of some establishments and strengthening demand supported the increase in sales. The goods and services tax collection touched a record high of ₹1.19 trillion in January.

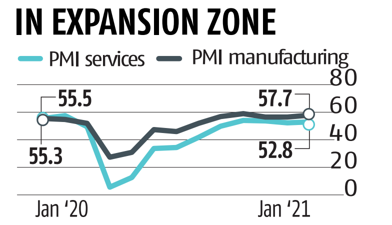
On the inflation front, input costs increased for the seventh straight month, with monitored companies reporting higher prices for fuel and a wide range of materials. "The main area of concern is the extent to which costs are rising across the services economy, with the rate of inflation remaining above trend despite easing from December," Lima said.

Besides, higher costs have prevented firms from taking on additional staff, with the PMI survey showing a second successive fall in employment.

Firms were confident of a rise in output in the next 12 months. Positive sentiment was supported by beliefs that the roll-out of vaccines would underpin demand growth and improvements in the wider economy. The overall degree of optimism was at an 11-month high.

The composite index, including manufacturing and services, edged up to 55.8 in January, from 54.9 in December.

IN EXPANSION ZONE



Note : A figure above 50 means expansion while below that means contraction
Source : IHS Markit

RBI makes risk-based internal audit mandatory for select NBFCs, UCBs

SUBRATA PANDA
Mumbai, 3 February

The Reserve Bank of India (RBI) on Wednesday introduced a risk-based internal audit (RBIA) system for select non-bank lenders and urban co-operative banks (UCBs).

All deposit-taking non-banking financial companies (NBFCs), NBFCs with an asset size of ₹5,000 crore, and UCBs with an asset size of ₹500 crore will have to implement the system by March 31, 2022.

This, the RBI said, will enhance the efficacy of internal audit systems and processes followed by NBFCs and UCBs. The central bank had introduced RBIA for scheduled commercial banks (SCBs) in 2002.

These entities already have internal audit systems, but by and large they have focused on transaction testing, checking accuracy and reliability of accounting records and financial reports, adherence to legal and regulatory requirements, etc.

As these entities have grown in size and become systemically important, the central bank felt different audit systems for lending entities, engaged in financial intermediation of similar nature, has created inconsistencies, risks and gaps.

The RBI has been focusing on bringing the supervisory regulations of NBFCs, UCBs on a par with banks after some recent defaults. These firms, especially NBFCs, have enjoyed light-touch regulation from the RBI which has enabled them to grow at a faster rate.

"As SCBs, NBFCs and UCBs face similar risks by virtue of being engaged in similar financial intermediation activities, their internal audit systems also need to broadly align while keeping in mind the principle of proportionality," the RBI said.

RBIA is an audit methodology that links an organisation's overall risk management framework and provides an assurance to the board of directors and the senior management on the quality and effectiveness of internal controls, risk management, and governance-related systems and processes.

For NBFCs and UCBs, the internal audit system will evaluate the risk management systems and control procedures in various aspects of operations, in addition to transaction testing, which is expected to help the entities to anticipate risks and mitigate it too.

According to the RBI guidelines, the board of the entity or its audit committee — which anyway is responsible for overseeing the internal audit function of the organisation — will be responsible for reviewing the performance of RBIA. The RBIA system should be consistent with the entity's goal so that it adds value to the organisation.

The RBI has suggested the entities prepare a risk audit matrix based on the magnitude and frequency of risks.

WHAT CHANGES

- All deposit-taking NBFCs & those with asset size of ₹5,000 cr have to implement the audit system
- UCBs with asset size of ₹500 cr, too, need to implement it
- RBI has asked the entities concerned to implement it by March 31, 2022
- These have to form a committee of senior executive to transition into this system
- This committee will formulate an action plan and report to the board

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