RBI Fights Economic Stress

Restructuring Package dated 6th August 2020

Published on 26-08-2020

Effect of COVID 19 on Indian Economy

Real GDP Growth Rate, India, FY14 to FY21

Real GDP Growth Rate (%)

	Q1	Q2	Q3	Q4
FY14	6.4	7.3	6.5	5.3
FY15	8.0	8.7	5.9	7.1
FY16	7.7	8.2	7.3	9.3
FY17	9.2	8.7	7.4	6.1
FY18	6.0	6.8	7.7	7.7
FY19	8.0	7.0	6.6	5.8
FY20	5.0	4.5	4.7	3.1
FY21	-5.0	-4.8	-4.3	-4.2

Denotes India’s Economic Slowdown

Denotes LSI Estimates

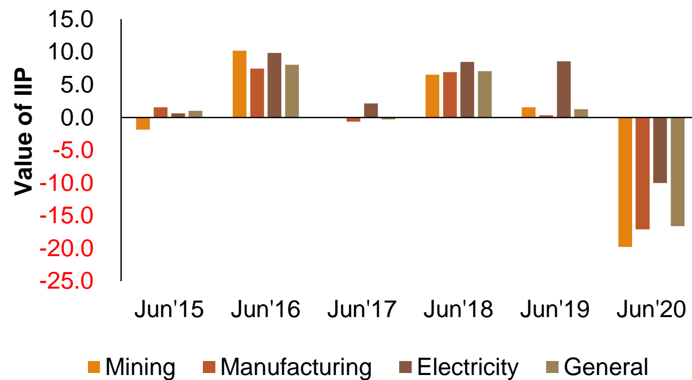
- India’s real GDP decelerated to its lowest in over six years in 4Q 2019-2020, and the outbreak of the COVID-19 posed fresh challenges. Steps taken to contain its spread, such as nationwide restrictions due to complete lockdown of states, had brought economic activity to a near standstill and it impacted both demand and supply, as well as investment.

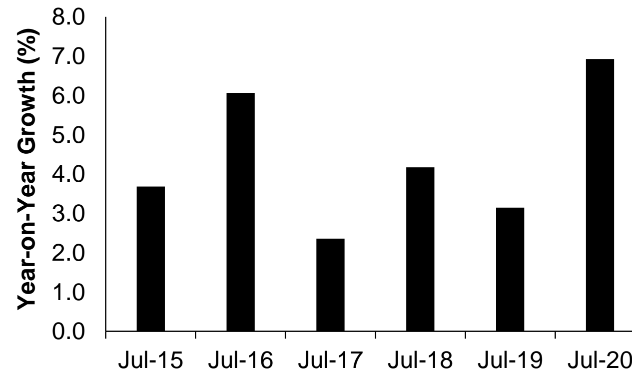
- While Indian businesses, barring a few sectors, can possibly insulate themselves from the global supply chain disruption caused by the outbreak due to relatively lower reliance on intermediate imports, their exports to COVID-19 infected nations has taken a toll already. In sum, the three major contributors to GDP -- private consumption, investment and external trade – have got affected.

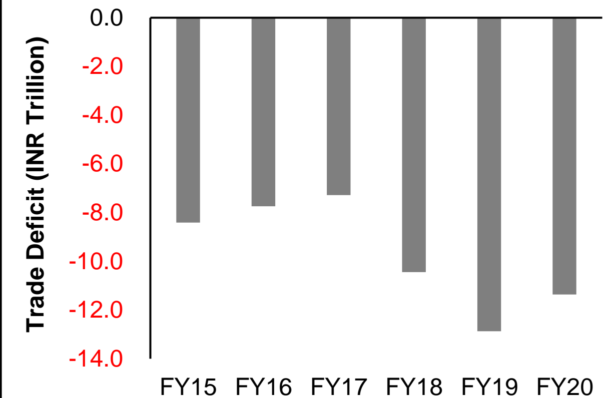
- Covid-19 battered India's economy is projected to contract by **(-)4.5%** this fiscal (FY21), as projected by the International Monetary Fund (IMF). As per IMF, India's economy is expected to contract on the back of a longer lockdown and a slower recovery than anticipated in April 2020. Accordingly, the country's economy will contract in FY21 from an expansion of **4.2%** in FY20. In terms of calendar year 2020, the economy is expected to contract by **(-)4.9%.**

Source: MoSPI, LSI Research

Important Economic Indicators Depicting India's Slowdown







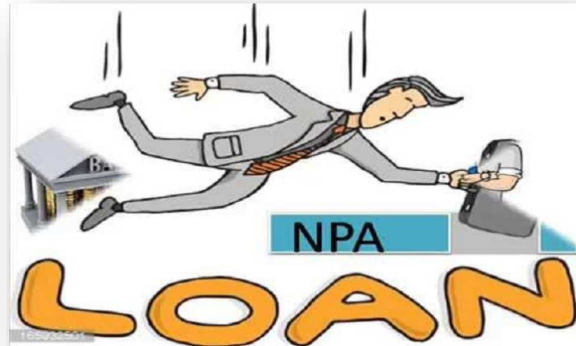
- According to the recently released data by government, India's core sector, which consists of eight crucial segments of infrastructure, contracted to **15%** in June'20 compared to **1.2%** in June'19. These core sectors account for **40.27%** in the total industrial output. Hence, a contraction like this indicates nothing but a downturn in the production of overall industrial goods. Only the fertilisers industry has shown positive growth owing to a growth in the Agriculture sector.

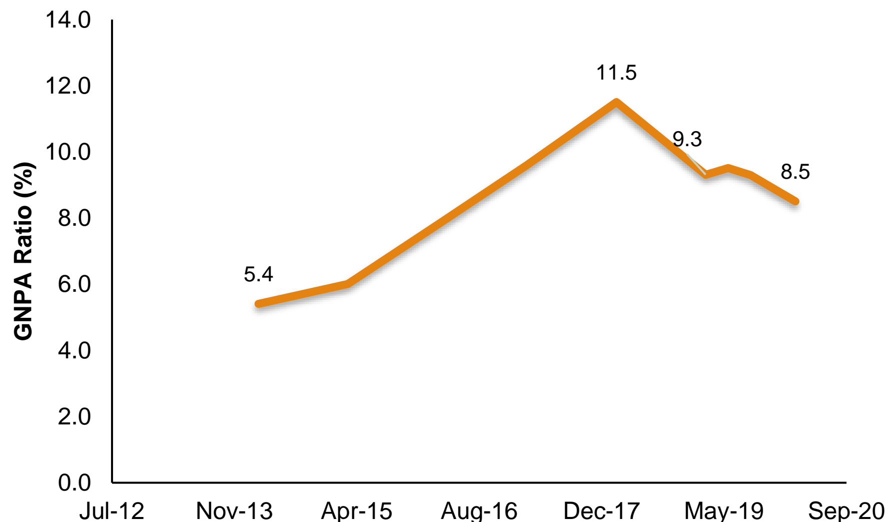
- The country's retail inflation spiked to **6.93%** in the month of July mainly on account of higher food price. Food prices, which account for nearly half the inflation basket, have soared since April due to supply-side disruptions caused by a nationwide lockdown. The falling demand in the economy due to the pandemic has caused the Wholesale Price Index (WPI) to enter the deflationary zone when it reduced by **3.21%** in May 2020 after 4.5 years. The falling demand for fuel, manufactured products, food articles like pulses, meat, fish, oils and fats is one of the crucial reasons behind it. However, the rising petrol and diesel prices might push the retail inflation higher in the coming days.

- Despite the lockdown, India's trade balance in April and May turned positive. This has been achieved by a sharper decline in imports, pointing towards a contraction of demand in the real economy. Between, FY19 and FY20, the trade deficit of the country has reduced by **11.66%.** India's trade deficit with its biggest trading partner China got also reduced by **9.15% .**

Source: MoSPI, Reserve Bank of India

Crisis Created Out of Non-Performing Assets





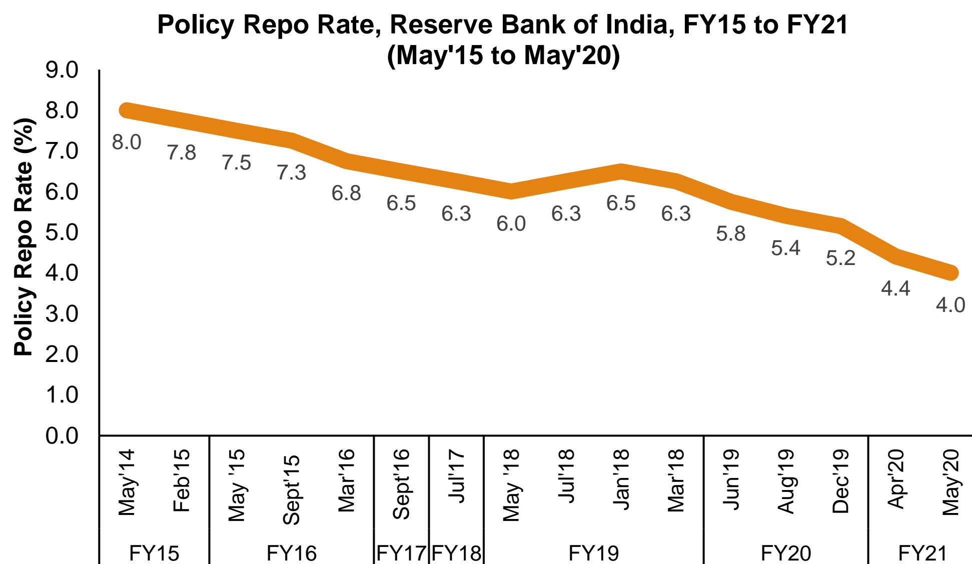
Source: Reserve Bank of India, LSI Research

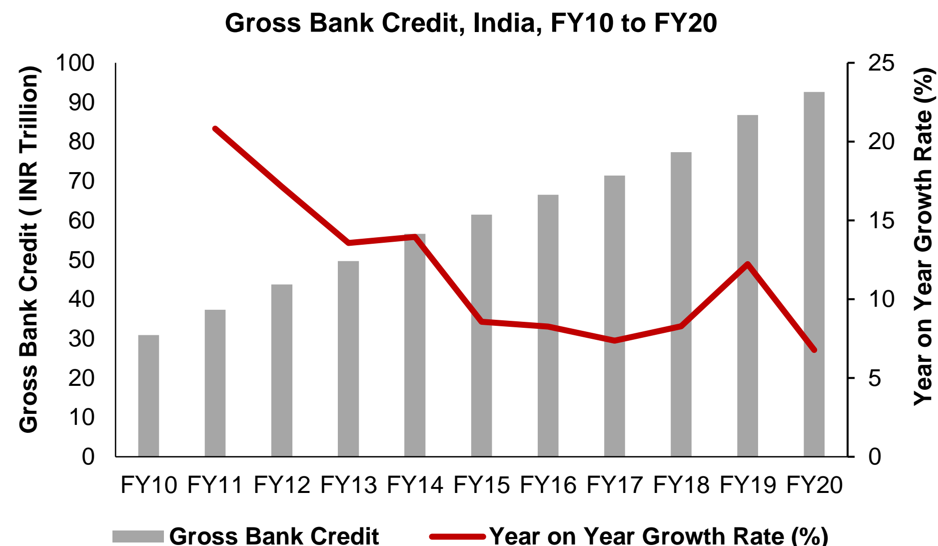
- According to a report of the government in Feb'20, the Non Performing Assets (NPAs) of Public Sector Banks (PSBs) stood at **₹ 7.27 lakh crores** as on Sept'19.
- The process of Asset Quality Review aimed at recognizing the stressed assets of banks, mandated by the RBI in 2016 had brought out the slippages in bank credit and had initiated the process of de-clogging the banking system.
- The Return on Assets (RoA) has decreased for all Scheduled Commercial Banks from **0.81% to -0.09%** between **FY14 to FY19**. The role of Public sector banks have been major in it whose share of RoA reduced from **0.5% to -0.65%** in the same time period.
- The introduction of the Insolvency and Bankruptcy Code (IBC) in the same year further enhanced the market's confidence in the banking system, as it is expected to provide a path of time bound resolution for companies that faced solvency issues.
- Though after 3 years hence, the level of GNPA started easing but the outbreak of COVID-19 is halting further improvement.

Impact of COVID-19 Stress on Bad Loans

- After facing elevated provisions resulting from the corporate stress cycle over FY16 - FY20, banks were progressing towards a more moderated credit cost cycle. However, the COVID-19 related situations are likely to result in another cycle of stress.
- With slumped economic activity due to the COVID-19 crisis, total slippages in the banking system may rise up **to ₹ 5.5 lakh crores** in the current fiscal.
- While slippages from the corporate sector may rise by **₹ 3.4 lakh crores**, for non-corporate segments it may increase by **₹ 2.1 lakh crores** in FY21.
- The total standard-but-stressed corporate pool may increase from **3.8%** of the total bank credit as of **December 2019** to up to **6.6%** in this fiscal. Out of this, the corporates exposures is up to **3.2%** of total bank credit are at a high risk of slippage.
- The gross non-performing assets (GNPA) ratio which was **9.3%** in **Sep'19** is now expected to rise up to or more than **9.9%** in **Sep'20** given the impact of the Covid-19 outbreak, exposures to certain stressed sectors, moderation in the bank credit growth and muted demand scenario. RBI has projected that the **GNPA ratio** in **FY21** will be recorded at **12.5%**.
- The growth slowdown due to the COVID-19 outbreak will aggravate the stress and slippages in the non-corporate segments - retail, agriculture and micro, small and medium enterprises. About **40%** of the incremental slippages could come from the **non-corporate segments**.
- In some relief for the real estate sector during the covid-19 pandemic, alternative asset manager SBICAP Ventures Ltd has decided to reduce its internal rate of return (IRR) on funding of stalled affordable housing projects by 300 basis points to **12%**.

RBI Reducing Policy Repo Rate





- The Reserve Bank of India (RBI) is cutting the repo rate in each quarter continuously. The agenda is to deal with the economic slowdown and maintain an accommodative monetary policy.
- Whenever the rate is lowered, it is expected that the banks would lower the lending rate which will help borrowers and enhance further lending and hence assist growth. However the impact is not immediate. The lending rate which is defined by the Marginal cost of funds-based lending rate (MCLR), is also linked to the deposit rate which has to be altered first as it goes into the cost of funds. As loans get re-priced immediately while only new and renewed deposits go at the new rate, the impact on average cost of deposits would come with a lag. There is a reason for the transmission to be slow which can take a period of over six months provided banks lower the deposit rates —which may not happen across the board depending on the funds situation of various banks.
- Even though the lending rate cut has been ongoing for sometime, the growth in credit off-take has not been that much significant. The gross bank credit grew by **6.78%** in **FY20** after growing by **12.22%** in **FY19**.

Source: Reserve Bank of India

What led to the RBI Restructuring Announcement?

- The COVID 19 pandemic and resultant 6 month (3+3) moratorium granted to borrowers (individual and Corporate) by Reserve Bank of India is effective till 31st August'20. Statistics released by Banks indicate moratorium on loans ranging from ~25% (as is the case with large banks) to 70% (in the case of few Small Finance Banks) out of their lending book.
- There was a general feedback from banks and lending institutions that a blanket moratorium is leading to a situation, where even borrowers with means to pay continue to seek moratorium to conserve liquidity.
- Based on this feedback, RBI came up with guidelines for Restructuring of Loans within the Prudential Framework for Resolution of Stressed Assets, dated 7th June'19.
- This guideline is addressed to all banks (scheduled and co-operative). All India Financial institutions and NBFCs but not to Debt Mutual Funds and Asset Restructuring Companies.
- The intent is to facilitate revival of the real sector as well as to give borrowers with good track record but impacted by COVID-19 pandemic with the time required to improve their cash flow generation relative to their debt size.
- The current window is also applicable for Retail or personal loans. This may create the first set of Restructured retail loans in the country since Settlements, Asset sales or Legal recovery have largely been the routes for resolution of Retail loan NPAs till date.

RBI Prescriptions for Reducing the Financial Distress

- Relaxation on payment of EMIs' by providing moratorium
- Reduction in the repo and reverse repo rates
- Measures to increase liquidity
  - ✓ Reduced Cash Reserve Ratio.
  - ✓ Marginal Standing Facility: Increases the amount borrowed by banks against govt. bonds from **₹ 1.36 lakh crores** to **₹ 2.8 lakh crores**
  - ✓ Long term Repo rate: Allowed all banks to borrow money at the rate of **4.4%** against corporate bonds
  - ✓ The liquidity adjustment facility (LAF) has been reduced by 25 basis points (bps) from **4%** to **3.75%**
  - ✓ The LCR requirement for Scheduled Commercial Banks is being brought down from **100%** to **80%**
- Conduct Targeted Long-Term Repo Operations (TLTRO) 2.0 at the policy repo rate for tenors up to three years for a total amount of up to **₹ 50,000 crores**.
- Increase in advances for states
- Restrictions on dividend distribution
- An assistance of **₹15,000 crores** was announced to refinance small firms. Emphasis is given on ensuring adequate funds flow to non-banking financial companies (NBFCs) and microfinance institutions (MFIs).
- It has been decided to provide special refinance for an amount of **₹50,000 crores** to the National Bank for Agriculture & Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), and National Housing Bank to enable them to meet sectoral credit needs.
- Moratorium to MSMEs; MSME definition redefined; CGTSME guarantee to stressed MSME.

Key Highlights (1/2)

- Framework enables lenders to implement a resolution plan for eligible corporate exposures (without change in ownership) and personal loans continue to be classified as Standard assets subject to specific conditions
- Resolution under this framework extended only to borrowers having stress on account of Covid-19
- Reference date for outstanding debt to be considered for resolution is **1st March'20.**
- Board approved policies of Lending Institutions (LI) to be in place detailing (i) Eligibility of borrowers and (ii) Due diligence considerations
- Major thrust on signing of ICA by LIs through incentives related to provisioning (highlighted in relevant sections herein)
- All norms applicable to implementation of resolution plan, including mandatory requirement of ICA and specific implementation conditions, as per Prudential Framework for Resolution of Stressed Assets, dated 7th June'19, to be applicable to all lending institutions for any resolution plan implemented under this framework
- Borrowers/ credit facilities not eligible under this framework
  - ✓ MSME borrowers with aggregate exposure **₹ 25 Crores** to all LIs as on 1st March'20.
  - ✓ Farm credit
  - ✓ Loans to PACS, FSS and LAMPS for on lending to agriculture
  - ✓ Exposures to financial service providers
  - ✓ Exposures to Central and State Governments Local Government bodies and body corporates established by an Act of Parliament or State Legislature
  - ✓ Exposures of housing finance companies where account is rescheduled after 1st March'20 unless a resolution plan under this framework has been invoked by other LIs

ICA: Inter Creditor Agreement; MSME: Micro, Small, and Medium Enterprises; PACS: Primary Agricultural Credit Societies; FSS: Farmers' Service Societies; LAMPS Large sized Adivasi Multi Purpose Societies

Key Highlights (2/2)

- Eligibility: Borrower accounts classified as Standard, but not in default for more than 30 days with any LI as on 1st March'20
- Account should continue to remain standard till the date of invocation
- Invocation Date: Resolution may be invoked not later than 31st December'20
- For Sole LI: Date on which both the borrower & LI agree to proceed with resolution plan
- Multiple LIs: LIs representing 75% by value of total outstanding (FB&NFB) & 60% by number agree to invoke
- Implementation: Within 180 days from the date of invocation
- RBI has formed a 5-member Expert Committee under Chairmanship of Mr KV Kamath which shall recommend:
  - ✓ List of financial parameters to be factored in to assumptions for each resolution plan
  - ✓ Sector specific benchmark ranges for such parameters
  - ✓ Parameters shall cover aspects related to leverage, liquidity, debt serviceability, etc
- For accounts with aggregate exposure
  - ✓ **>= ₹ 1500 Crs** : Expert Committee shall do vetting of the resolution plans with only purpose to verify that all the processes have been followed
  - ✓ **>= ₹ 100 Crs** : Independent Credit Evaluation from one Credit Rating Agency (authorized by RBI) is required
- Conversion of loans in to equity or other marketable non convertible debt securities permitted
- On any timelines breach, the resolution process ceases to apply immediately

Effects of the announcement on Banks and Borrowers

Lending Institutions

- If resolution plan is implemented within the timelines as mentioned above, asset classification of the loan may be retained as Standard; if the account has slipped to NPA during the interim, it can be upgraded as Standard on successful implementation.
- Lending institutions which signed the ICA and implemented the plan as per timelines, must set aside **10%** of their exposure post restructuring as Provisions.
- Lending institutions which do not sign the ICA within 30 days of Invocation have to set aside provisions equivalent to 20% of their exposure, immediately upon completion of 30 days post Invocation.
- Half of the Provisions made as above, can be written back on repayment of **20%** of the restructured debt, while the balance half can be written back on repayment of additional **10%** of the restructured debt.
- Lending institutions such as Small finance banks and Housing Finance Companies which have a large retail book and high percentage of loans under moratorium **(60% - 70%)** will be better off since it is expected that restructuring is likely to be a lesser probable outcome in Retail loans than Corporate debt.

Corporates

- A loan restructuring scheme helps borrowers to the extent that they can delay repayment of interest and principal amount, or repay loans at easy terms and conditions. These measures help address their immediate revenue losses.
- Corporate Borrowers in 'Consumer discretionary' (Hospitality, Auto, Retail, Entertainment, Building Material etc), Real Estate (Commercial as well as Residential) and 'Export' (due to global recession) sectors where recovery is likely to be long drawn, say over 15 to 18 months will be benefitted.
- However, consumers are not expected to increase non-essential spending in the coming year as well. This shows that the recovery prospects of these sectors are bleak in the next few months. Unless demand picks up, their ability to repay loans would remain impaired. A loan recast scheme would not be enough for them.
- The government now needs to prepare a plan on how to address the issue of their loans and defaults in the coming months.

Key Takeaways

As an impact of Covid-19 outbreak, India's economy is projected to contract by **(-)4.5%** this fiscal (FY21), as projected by the International Monetary Fund (IMF). As per IMF, India's economy is expected to contract on the back of a longer lockdown and a slower recovery than anticipated in April 2020.

The gross non-performing assets (GNPA) ratio which was **9.3%** in **Sep'19** is now expected to rise up to or more than **9.9%** in **Sep'20** given the impact of the Covid-19 outbreak, exposures to certain stressed sectors, moderation in the bank credit growth and muted demand scenario. RBI has projected that the **GNPA ratio** in **FY21** will be recorded at **12.5%**.

RBI is cutting the repo rate in each quarter continuously. The agenda is to deal with the economic slowdown and maintain an accommodative monetary policy. Even though the lending rate cut has been ongoing for sometime, the growth in credit off-take has not been that much significant. The gross bank credit grew by **6.78%** in **FY20** after growing by **12.22%** in **FY19**.

There was a general feedback from banks and lending institutions that a blanket moratorium offered on account of Covid-19 related stress, is leading to a situation, where even borrowers with means to pay continue to seek moratorium to conserve liquidity. Based on this feedback, on 6th August'20, RBI came up with guidelines for Restructuring of Loans within the Prudential Framework for Resolution of Stressed Assets, dated 7th June'19.

This framework enables lenders to implement a resolution plan for eligible corporate exposures (without change in ownership) and personal loans continue to be classified as Standard assets subject to specific conditions. Resolution under this framework extended only to borrowers having stress on account of Covid-19. Reference date for outstanding debt to be considered for resolution is 1st March'20.

A loan restructuring scheme helps borrowers to the extent that they can delay repayment of interest and principal amount, or repay loans at easy terms and conditions. These measures help address their immediate revenue losses. However, the government now needs to prepare a plan on how to address the issue of their loans and defaults in the coming months.

LSI Presence

Delhi Office
"Chiranjiv Tower" 1206, 12th Floor,
43, Nehru Place,
New Delhi 110 019, India

T: +91 (11) 4662 8852-56.

E: *corporate@lsimails.com*

Mumbai Office
710, 7th Floor, Madhava E Block,
Bandra Kurla Complex,
Bandra East,
Mumbai 400 051

T: +91 (22) 2659 4803 /
+91 98333 89402

E: *corporate@lsimails.com*

Kolkata Office
Sagar Trade Cube, 5th Floor,
104 S P Mukherjee Road,
Kolkata 700 026, India

T: +91 (33) 2486 3815 / 17 / 3362 /3485

E: *corporate@lsimails.com*

We are also present in Bengaluru, Bhubaneshwar, Hyderabad, Nagpur, Raipur, Rajasthan and Haryana

For Research Reports and Infographics: http://www.lsifinance.com/lsi-reserch.php

For Research Articles: http://blog.lsifinance.com/

Follow us on Linkedin.com at https://www.linkedin.com/company/lsi-financial-services-pvt-ltd1/?viewAsMember=true

Our Group Companies

L S I Financial Services | **L S I Engineering & Consultants** | **Resolute Valuers**