REXIT IMPACT: FLIPPING THE COIN

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IPCS ISSUE BRIEF #263

AUGUST 2016
On 18 June, 2016, the 23rd Governor of Reserve Bank of India (RBI), Raghuram Govind Rajan announced his exit (popularly referred to by the acronym Rexit). This announcement was received negatively by most of the country’s financial community. However a closer reading of the governor’s tenure does not lend itself to such a uniformly negative interpretation, being as it was - a mixed bag.

With impressive and global credentials under his belt, Rajan on September 5, 2013 took charge as the successor of Duvvuri Subbarao. When he took over, the Indian economy was labelled as one of the Fragile Five economies in 2013 with interest rates (repo rate) at 7.5 per cent, inflation at an average of 10.92 per cent and the Rupee (INR) valued at INR 63.79 to the US Dollar (USD). All these factors were keeping economy under stress.

On the path to resuscitate the economy, the RBI under Rajan took some important decisions. However, some of his decisions turned out to be double edged swords.

INFLATION OVER GROWTH

Right after taking over as the governor, Rajan focused on taming inflation. In order to curb this, the RBI hiked the repo rate (repo rate is the rate at which the RBI lends money to the commercial banks in the event of shortfall of funds) which in turn acted as a disincentive for banks to borrow from the central bank. This ultimately reduced the money supply in the economy and thus helped in arresting inflation.

However, in pursuit of this goal of controlling inflation, the focus on economic growth and employment appears to have weakened. His refusal to cut interest rates has impacted the growth of the Small and Medium Enterprise (SME) sector. Union Minister, Nirmala Sitharaman has also stated that high interest rates are impacting the cost competitiveness of industry, especially SMEs. High interest rates are deterring businesses from increasing investment and have made it

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1 Fragile Five economies represent emerging market economies that have become too dependent on unreliable foreign investments to finance their growth ambitions.
costlier for consumers to borrow. This coupled with extremely uneven industrial growth have pushed up the unemployment. The graph below illustrates the pattern of industrial growth:

![India Industrial Production Graph]

Large manufacturers are trimming operations, throwing many jobs into jeopardy. Sunil Kanoria, President The Associated Chambers of Commerce of India (ASSOCHAM), said that the company has been downsizing in the last few years especially in infrastructure because of the bad financial situation which has made it difficult to get more resources. Ajit Gulabchand, chairman of the Hindustan Construction Company, said that new job creation is poor as the investment cycle has not kick started due to a slowing Indian economy. However, there are other reasons also attached to unemployment. The agriculture sector is struggling with the effects of widespread drought, and the knock-on effects of a global slowdown and increasing mechanisation of operations has also attributed to downward movement in job creation. As economist and Nobel Laureate Joseph Stiglitz recently suggested “excessive focus on inflation could hurt growth leading to unemployment and inequality” and this seems to be the case at least partially under Rajan.

The graph below clearly shows that even though RBI had achieved his objective of keeping the inflation below 6 per cent in mid-2014, he declined to cut down the interest rates and brought the first rate cut in January 15, 2015.

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4 Ibid
5 Ibid
SHIFT FROM WPI TO CPI

Under Rajan’s tenure, the RBI shifted from Wholesale Price Index (WPI)\textsuperscript{6} to Consumer Price Index (CPI)\textsuperscript{7} as the nominal anchor of monetary policy conduct in the country. The differences between the WPI and CPI are a result of the different items that are included in each measure and the weights. The need for CPI was felt because WPI was not effectively representing the impact of price change on the population at large. Under CPI, an important factor “miscellaneous” (includes education, healthcare, transport, personal care, entertainment etc.) is covered with a weightage of 28.32 per cent. The measurement of price change of these items (that were not included in WPI) will reflect ground reality better.

The divergence between the CPI and WPI shown in the graph below validates that basing the monetary policy on WPI could prove to be ineffective or counterproductive. With continued higher levels of inflation measured by CPI, any ease in the interest rates basis WPI (not impacting the population at large has shown negative trend in inflation rate suggesting the rate cut) will result in further northward price pressure on daily consumed items.

\textsuperscript{6}WPI is calculated by monitoring the prices of certain goods that are traded at the Wholesale Market. Components of WPI: (i) Manufactured products – 64.97 % (ii) Fuel and Power -14.91 % and (iii) primary articles-20.12%

\textsuperscript{7}CPI is calculated by collecting the Retail Cost of representative products or Services for Urban Non-Manual Employees. Components of CPI: (i) food and beverages-45.86% (ii) housing-10.07 % (iii) Fuel and light-6.84 % (iv) clothing and footwear-6.53%, (v) pan, tobacco and intoxicants-2.38 % and (vi) miscellaneous-28.32 %
Here, it would also be interesting to look into food inflation which impacts the end consumer the most. This high food inflation is attributable to its higher weightage in calculating CPI. It is to be noted that food inflation in the last few years is being spurred more by items such as vegetables, pulses, eggs, meat and fish than cereals. Tables below give the justification of high food inflation.

Source: http://www.thehindubusinessline.com/opinion/understanding-the-cpiwpi-divergence/article7924096.ece
BANK CLEAN UP

One of Rajan’s biggest policy initiatives has been cleaning the banks' books, Public Sector Banks (PSBs) in particular, which have been sitting on a pile of undisclosed bad loans for years. RBI made banks report all loans over INR 5 crore and create an electronic database showing if the loan was a sound or Non-Performing Asset (NPA)\(^8\). The next step was to get all lenders to the troubled borrower on a single platform and decide on future course of action. The RBI also took away powers of a bank to restructure projects without designating them as NPAs. Banks have taken recourse to the Strategic Debt Restructuring (SDR) scheme, put together by the RBI wherein a consortium of lenders converts a part of their loan in an ailing company into equity, with the consortium owning at least 51 per cent stake. It also allows banks to overrule the management of the company should the lenders need to. Another new initiative to sort the problem of NPAs was: Declaration of 'Special Mention Accounts'. This means that if the loan behaviour of a client does not seem appropriate (in terms of recovery of instalments and interest on loans and advances and other aspects as per RBI norms), the bank can declare the account Special Mention Account and report it to RBI before it is declared an NPA account. Usually, NPA is an account whose loan is overdue by more than 90 days (3 months). Special mention accounts are in that sense 'prospective NPAs' and can be reported in the 2\(^{nd}\) or 3\(^{rd}\) month so that corrective action can be taken ahead of time in order to save resources (financial and administrative) of the bank.

However, despite all these, under-recognition of the NPAs is still significantly high. For example “House of Debt” is a Credit Suisse report where it evaluated the top 10 Indian corporate houses and found that a steep growth in borrowings had stretched the financials of these companies. Still many of those loans are yet to be restructured or declared as NPAs. This means that a significant portion of “under stress” borrowings, neither show up under NPAs nor have they been restructured. Also, high provisioning\(^9\) has increased the capital needs\(^10\) at banks. The provisioning laws\(^11\) have made banks conservative and infused in them a fear to lend money. Consequently we find that on one hand a reluctance to lend has increased, while the RBI has come up with innovative solutions, which do not seem to be translating into workable solutions on the ground.

Clearly, the objective of the clean-up by RBI should be to fix the financial rot, not to incapacitate banks because the banking sector cannot afford its earnings to be under pressure for a long duration of time.

SWAP WINDOW TO ATTRACT DOLLAR FUNDS

In order to stabilise the Rupee, which was trending at close to record lows against the USD, RBI on 4\(^{th}\) September 2013 opened a window to the banks to swap the fresh Foreign Currency Non Resident Deposit (FCNR) type B\(^12\) dollar funds. These funds were to be mobilised for a minimum tenor of three years with a swap facility with RBI fixed at an attractive

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\(^8\)A Non-performing asset (NPA) is defined as a credit facility in respect of which the interest and/or installment of principal has remained ‘past due’ for a specified period of time. In simple terms, an asset is tagged as non performing when it ceases to generate income for the lender

\(^9\)Loan loss/NPA provisioning is an expense set aside as an allowance for uncollected loans and loan payments

\(^10\)It is the amount of capital a bank or other financial institution has to hold as required by its financial regulator

\(^11\)http://iibf.org.in/documents/IRAC.pdf

\(^12\)An FCNR account is a term deposit account that can be maintained by NRIs and PIOs in foreign currency.
rate of 3.5 per cent per annum for the tenor of the deposit. The swap window was opened until the 30th of November 2013. But since banks have always had the option of raising FCNR (B) deposits, it would be engaging to know what made it such an attractive proposition for the banks. The low cost of this option was the major reason. Usually, an interest rate of 400 basis points over Libor is paid on dollar deposits to NRIs. To service the deposit, the bank would have to buy a currency hedge, paying about 7 per cent a year. Effectively the bank ended up footing an interest cost upwards of 12 per cent on each deposit. But with the RBI subsidising the hedging cost at a fixed 3.5 per cent, the effective cost of funds for FCNR deposits has plummeted to 8.75-9 per cent. This made it an attractive option, similar to raising domestic deposits. With lower swap rate and high INR interest rate for domestic lending, FCNR deposits suddenly became attractive for banks. Banks sold dollars mobilised through FCNR deposits to RBI for rupees (at the time of deposit) and simultaneously entered into an agreement to buy dollars at a future date (maturity of loan) at a low premium of 3.5 per cent significantly reducing the cost of funds for the banks. Banks have managed to mobilise USD 34 billion in foreign currency deposits since the special swap scheme was flagged off.

These forex reserves defend us from the volatility in the currency market providing adequate cushion to take appropriate measures in times of crisis. Buying dollars from the foreign exchange market is not just a tool to keep the currency volatility in check; it can also perform the important task of influencing liquidity in the system.

The graph below shows the trend of foreign exchange reserves and the INR-USD exchange value. The low of INR/USD represented by peak in graph in the year 2013 was that trigger which led to the decision to raise forex through FCNR deposits. Although current INR/USD is lower than its 2013 levels, it is important to note that rupee has stabilised at this level.
NARROWING DOWN OF CURRENT ACCOUNT DEFICIT (CAD)

Current account deficit (as a per cent age) to GDP under his tenure was largely contained and brought down to around 1.25 per cent in 2015 against a high of 4.82 per cent in 2013. CAD is a situation when import of goods, services and capital by government, businesses and individuals is more than the total exports. It is the sum of the balance of trade (exports minus imports of goods and services), net factor income (such as interest and dividends) and net transfer payments (such as foreign aid).

Gold import duty enhanced: In order to narrow down the CAD, he favoured and maintained the hike (which was initiated by his predecessor) in import duty on gold, silver, oil and non-essential items such as consumer durables. Since gold imports amount to 1/3rd of the total import bill of India, it brought down the imports effectively. While the increased import duty on gold resulted in lowering of gold imports, a parallel market was developed where the traders explored the alternative routes for procurement of gold, leading to its import through unofficial channel or smuggling.

However, there were other factors also that led to narrowing down of CAD such as:

FDI policy modified: Foreign Direct Investment (FDI) also narrowed down India’s external financing needs and mitigate the risk of a potential widening of the current account deficit related to weakening remittances, which is a credit positive. The Government of India amended FDI policy to increase FDI inflow. Increased FDI in insurance sector, Make in India initiative and liberalisation of FDI policy for 25 sectors made India a top destination for FDI in 2015. In a statement Moody recently said it does not expect widening of India's current account deficit based on its assumptions that commodity prices will remain low in 2016 and 2017.

Oil Prices: From a high of USD 108.76 per barrel in September 2013, the cost of crude imported by Indian refiners has come down to USD 45.51 in May, 2016. It also witnessed surprising lows of under USD 27 a barrel in Jan 2016, a level that was seen first time after 2003. The low levels of crude price helped halve the value of India’s oil imports from USD 164.77 billion in 2013-14 to USD 82.66 billion in 2015-16 and, in turn, reduce its current account deficit from a peak of USD 88.16 billion in 2012-13 to an estimated USD 20 billion in the last fiscal. Apart from the two obvious benefits, there is a third one that cheap crude has conferred in the form of a fiscal windfall for the government. The government, wisely perhaps, did not fully pass on the gains from lower international oil prices to consumers. Instead, in the last two years, it has raised the specific excise duty on diesel from INR 3.56 to INR 17.33 a litre and that on petrol from INR 9.48 to INR 21.48 a litre. The additional revenues from this alone, taking annual consumption of 8.8 crore kilo-litres of diesel and 3 crore kilo-litres of petrol, works out to over INR 157,000 crore. Also previously, oil marketing companies were

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13 Foreign companies invest directly in fast growing private Indian businesses to take benefits of cheaper wages and changing business environment of India. And https://en.wikipedia.org/wiki/Foreign_direct_investment_in_India
14“FDI to reduce India’s current account deficit: Moody’s”, The Times of India, April 7, 2016 (http://timesofindia.indiatimes.com/business/india-business/FDI-to-reduce-Indias-current-account-deficit-Moodys/articleshow/51726726.cms)
losing money on sales of most petro-products. The “under-recoveries\(^{15}\)” from these which is borne by the Central Government either directly as subsidy or as lower dividends from national oil companies reduced to a mere INR 27,571 crore in last fiscal as compared to INR 143,738 crore in 2013-14. The Centre’s overall yearly fiscal windfall from the global oil crash would, thus, be upwards of INR 250,000 crore.

**Introduction of MCLR:** The RBI under Rajan’s tenure introduced Marginal Cost of Funds based Lending Rate\(^{16}\) (MCLR) which replaced existing base rate system of setting lending rate. Under Base rate system, banks did not consider “repo rate” in their calculations. So any change in repo rate by RBI was not getting transmitted to the bank customers immediately. In contrast to base rate, calculation of MCLR would mandatorily consider repo rate, thus the effect of change in repo rate can be passed on to the customers. It will be an immediate development for the new borrowers as they will benefit in a declining interest rate scenario and take a dent when interest rates are rising.

When RBI planned to introduce a new formula for pricing loans it has taken into account what impact it would have on banks’ balance sheet in the short term. Sudden change to a new method of pricing loans would affect the Net Interest Margin (NIM) of the banks. The deposits banks have already taken would be of longer duration and interest rates on them fixed till maturity. So if the rates banks can charge on the loans drops suddenly we would see the banks NIM reduce and increase its interest rate risk. RBI has taken care of this problem by making the new rates applicable only to new loans after 1\(^{st}\) April 2016.

However, the problem would arise in case of floating rate loans and hybrid loans (where the interest rates are partly fixed and partly floating). According to guidelines of RBI these loans have to adjust to MCLR. This would create pressures on Net Interest Margin\(^{17}\) of the banks, as the deposits funding these loans would have fixed rates and would take longer to re-price. This will result in a huge dent in the profitability of the banks as the margins kept by the banks for providing loans are really thin and barely even covers the operational costs of the banks.

**New Bank Licensing:** In his approach to cater the needs of small borrowers and to increase the penetration of financial services in the hinterlands, RBI gave in principle-licences to 11 payment banks and 10 small finance banks. Payment Banks are based on the concept of Pre-Paid Instruments\(^{18}\) commonly used to load cash into mobile, transferring money from mobile to - another mobile phone, bank account or point-of-sale. The payment banks could be supermarket chain, mobile service provider, non-banking financial companies, post offices, agriculture/dairy type cooperatives etc. Small

\(^{15}\) Under recovery: It is the gap between the local price of fuel and what would have been the price if the fuel were imported. The government fixes the price of fuel at a subsidised rate. It then compensates companies for any loss from selling fuel products at lower rates. These losses are called under-recoveries

\(^{16}\) The main Components of MCLR are: (i) Operating Expenses (ii) Cost of maintaining Cash reserve ratio (iii) Marginal Cost of funds (includes interest rates offered on savings/current/term deposit accounts. It is based on cost of borrowings which is repo rate and also on long term borrowing rates and Return on Net worth) and (iv) Tenor Premium (an additional slab of interest over the base rate, based on the loan tenure and commitments)

\(^{17}\) Net Interest Margin= (Investment Returns – Interest Expenses) / Average Earning Assets

\(^{18}\) Prepaid payment instruments are those which facilitate purchase of goods and services against the value stored on such instruments. The value stored on such instruments represents the value paid for by the holder, by cash, by debit to a bank account, or by credit card. The Prepaid instruments can be issued as smart cards, magnetic stripe cards, internet accounts, online wallets, mobile accounts, mobile wallets, paper vouchers and any such instruments which can be used to access the prepaid amount
Finance Banks with a small finance bank licence can provide basic banking service of acceptance of and lending. They will provide banking products to the unserved and undeserved sections of the country, which includes small and marginal farmers, micro and small industries, and other organised sector entities, at an affordable cost.

In case of Payment Banks, while the scope of business is limited, tough restrictions, cost of adhering to compliance (almost equal to a full commercial bank), make it a financially unviable option leaving very little on the table for the promoters. Recently three out of 11 licensees have already opted out from payment banks. Although, RBI stated that it can be seen as a reflection of companies not doing proper assessment while applying for the licence, but on the other hand it also suggests that RBI did not craft the licensing policy well.

RBI also put out a draft framework for on-tap universal bank licensing. The proposed licensing policy is a change from the current stop-start policy where RBI opens the window for bank licences periodically but rarely. The new licensing policy allows flexibility in timing an application; still financial experts do not expect any scramble for a bank licence or a long queue of aspirants. It will not be easy to get a licence. The conditions are daunting. The policy clearly prevents large industrial houses from entering the sector. Challenges on the transition especially on Cash Reserve Ratio, statutory liquidity ratio and priority sector lending will prove to be a costly affair for Non-Banking Financial Company (NBFC-best suited for bank licence) and there are no special benefits given to NBFC for this transition management. With greater competition from existing private players, it will be challenging as unlike existing players; new players will not enjoy the benefit of economies of scale. Further, the requirement to comply with the priority sector lending targets and sub-targets (similar to those of the existing banks) that too from the commencement of its operations will be tough condition to meet.

**BOARD ROOM MAN OR A FIELD MAN**

Discarding the system of disposing confidential bank reports for sanctioning loans and relying heavily on credit information companies (CICs) for getting the track record of the borrowers had done more damage than good. The CICs doesn’t have much penetration and many defaulters are not captured in their database, particularly in semi urban and rural areas where personal interaction (PI) and inspection by bank official is extremely critical. While PI has its own flaw as it does not bring complete clarity on the bad debt condition of the company/individual, score retrieved from CICs can be flawed due to delay in sending the latest information by the banks/credit agencies resulting in non-update of the database. However, the combination of PI and CICs would be a better method to have a comprehensive analysis of the creditworthiness.

Lastly, his approaches and decisions reflect that he is not a “field man” and rather a “board room man”. He is a knowledgeable man but controlling the Indian banking industry requires ground level knowledge in dealing with credit decisions and other big decisions. A small error that he committed was to equate our semi-urban economy to the developed urban economies of the west without considering the fact that nearly 60 per cent of our economy is dependent on semi-urban and rural areas. Expanding the bank network in these areas alone will not help, until the recovery laws is brought forth and technology is upgraded in these areas. His resistance to PM Modi’s Mudra Bank
project\(^{19}\) (to fund 60 million unorganised businesses with a capital requirement of INR 12 trillion) was due to his being out of sync with the concept of India’s unique unorganised economy represented by the likes of Tirupur, Sivakasi, Rajkot or Bhatala—entrepreneurship models based on community conglomerations almost fully disconnected from the formal banking system and funded mainly by cash with interest as high as 30-120 per cent.

Although, Rajan’s policy decisions have met with praises and criticism, his successor will still find the economy in a much better shape.

**PATH AHEAD**

Even in this relatively stable environment, the new governor will face a number of short- and medium-term challenges.

To begin with, the new governor will have to strike a balance between inflation and growth. In the process to tame inflation, growth cannot be neglected. The fight against bad loans needs to be taken a logical conclusion to further empower banks in dealing with bad assets and bring in changes so that similar situation can be avoided in the future. While cleaning the banks, the RBI should also work in tandem with the legal system to punish the wilful defaulters. Also it is important that a Bankruptcy Code be formulated to ensure that large business houses are no longer able to take banking system for a ride and help tackle the NPA problem in a more meaningful way. Regulation of payment banks and small finance banks will be an important and critical task. RBI will have to effectively manage the outflow of USD 20 billion on account of FCNR (B) deposits maturing in September 2016. RBI will have to work towards mitigation of the risk that can arise with the rollover of the tenor of FCNR (B). Once the Monetary Policy Committee (mandated with the task of guiding interest rates in the economy) comes into effect, the development and implementation of the formal migration to a new monetary policy framework will have to be ensured.

The biggest challenge for the new governor will be to protect the hard won credibility of the RBI along with having a healthy difference in opinion with the central government as this may not be easy in the evolving circumstances. In the end, it would be appropriate to say that economy is a perception game. At the announcement of Rexit, against the expected pessimism, both Dalal Street and bond market exhibited immense maturity. It is indicative of the acceptance of change and preparedness to carry the good work forward and make the necessary amendments wherever required.

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\(^{19}\)Micro Units Development and Refinance Agency Bank (MUDRA Bank), is a new institution setup by the Government of India for development of micro units and refinance of MFIs to encourage entrepreneurship in India & provide the funding to the non-corporate small business sector.