



EXPERT
VIEW

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REGULATOR NEEDS TO ADDRESS RISKS TO FINANCIAL STABILITY



**Brahmos
cruise
missile with
major
indigenous
systems
test-fired
successfully**

bit.ly/2n7pjw6

The Reserve Bank of India's (RBI's) accelerated monetary policy response since February, no doubt, has provided the first line of defence to India's acute growth slowdown. Yet the pace of policy rate transmission and investment revival is very slow, given the magnitude of disruption in India's real and financial sectors.

Monetary policy easing has impacted government bonds more favourably than corporate bonds. During February-September, the benchmark government bond yield fell by 62 basis points (net), but corporate yields did not fall the same way largely because of high credit risk perception. Corporate yield spreads over gilts stayed elevated, reflecting higher risk premia. Transmission through the banking channel was very slow. Leading banks lowered the one-year marginal cost of funds based lending rate (MCLR) by 25-40 basis points (bps) against the policy rate reduction of 110 bps. Low investment confidence was also visible in the 67% year-on-year plunge in non-convertible debentures (NCDs) raised in April-August. The investment momentum was weak during H1FY20 because of several factors such as downgrades, unsustainable borrowings by some large companies, a continued funding crunch for non-banking financial companies (NBFCs)/ housing finance companies (HFCs) and low capital adequacy of public sector banks. Global headwinds and domestic policy flip flops further weakened the investment sentiment.

Given the subdued growth-inflation dynamics, there is scope for further reduction in the repo rate by 35-40 bps in H2FY20 besides having an accommodative stance. However, we wonder whether this will have any material impact on improving investment spending, given the obstacles to monetary transmission. As the weight of structural factors has increased in the slowdown, cyclical stimulus measures may not be enough to restore investment confidence.

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Monetary policy is too blunt a tool to take care of sector-specific issues, as it simultaneously affects all sectors of the economy. What India needs today in addition to "easy monetary conditions" is targeted interventions and

sector-specific corrective measures for its ailing sectors such as infrastructure, real estate, micro, small and medium enterprises, export industries, and highly interconnected but vulnerable financial intermediaries such as public sector banks (PSBs), NBFCs/HFCs and mutual funds.

With the Centre taking a big step to provide fiscal stimulus worth ₹1.45 trillion through corporate tax reduction, and RBI creating easy money conditions, the focus of the monetary policy should shift to financial stability issues such as restoring confidence in financial intermediaries and getting credit flowing again at a reasonable price. This has to be done in conjunction with corrective measures from other policymakers aimed at removing structural constraints for various productive sectors.

In particular, RBI's policy emphasis should be on strengthening the NBFC sector, a dominant lender to retail, rural, housing and micro, small and medium enterprises, which contributes more than 20% of the total credit.

In this context, we see two policy priorities for RBI. First, it should set up a "lender of last resort" facility for NBFCs. This should be seen in the context of the huge increase of 41.4% in their asset size from FY15 to FY18. For systemic stability, we need an institution that can undertake repo of securities, backed by NBFCs' loan portfolio. To begin with, it can be restricted to NBFCs that are more bank-like in nature, adequately capitalised and have top ratings. Such an open-ended backstop facility has to be always available to avoid "illiquidity" of solvent institutions.

Second, there should be an effort to facilitate long-term funding for NBFCs. There are various ways to achieve this. At present, PSBs cannot lend to NBFCs because of capital shortage. Hence, RBI may advise the government to extend special dispensations/bank guarantees to PSBs, which can be treated as "capital" for taking additional exposure to well-governed, top-rated NBFCs. This will have no fiscal implications, as guarantees are non-fund based. Long-term tax saving bonds may be reintroduced for infrastructure financiers. Listed NBFCs, which are part of large conglomerates, may be kept out of the group exposure limit to improve their access to bank funds. Innovative instruments, such as covered bonds, may be promoted to make available enhanced funding from insurance/pension funds to NBFCs, apart from banks and mutual funds. RBI may also allow systemically important, well-governed, top-rated NBFCs to raise public deposits. A roadmap for this could be defined and linked to increasing degree of financial regulation of NBFCs.

Unless the regulator addresses growing risks to financial stability, monetary policy will not be effective beyond a certain limit.

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