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Monetary management and financial intermediation

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The central issue addressed by this article pertains to monetary management and financial information. It begins with monetary policy, and the liquidity management by the RBI so far starting from the pandemic. It will also address the monetary policy transmission, banking sector development and development of credit growth. Finally it touches upon Insolvency and Bankruptcy Code (IBC).

Monetary developments during 2020-21

In the wake of the COVID-19 pandemic monetary policy was significantly eased starting from March 2020 onwards, and thereafter it remained accommodative. After the pandemic hit the Indian economy, the monetary policy committee (MPC) acted swiftly and drastically reduced the repo rate from 5.51% to 4.4% in its March 27, 2020 meeting. In the next subsequent MPC meetings, the MPC maintained the status quo with respect to the repo rate, but then on May 22, 2020, they brought down the repo rate from 4.4% to 4% since the economy contracted more than what the committee had expected. The objective was to stimulate more lending activity by the banks. Simultaneously, the reverse repo rate was also reduced with the objective that the commercial banks would be forced not to park their surplus money with the RBI.

Liquidity conditions and its management

With regard to monetary growth, let us see the evolution of reserve money (M0), narrow money (M1), and broad money (M3). During 2020-21, the growth of monetary aggregates witnessed higher growth as compared to the previous few years on account of higher liquidity

in the economy. M1 grew from 9.4% in 2019-20 to 15.2% in January 2021. However, M3 grew from 8.9% in 2019-20 to 12.5% in December 2020. This shows that the monetary transmission has not been that effective. The reserve money started growing significantly starting from April 10, 2020, onwards. But we did not see a commensurate increase in cash-in-circulation (CIC). Thus, the significant rise in M0 did not translate into a commensurate increase in money supply due to a subdued money multiplier and higher money parked at RBI under the reverse repo window. Because of the pandemic-induced lockdown, most of the industries did not operate and hence they did not borrow much money from the banks. So, banks parked the surplus money in the RBI.

The liquidity in 2020-21 has been consistently in a surplus condition because of RBI intervention in the financial market in various ways such as several conventional and unconventional monetary policies. RBI initiated open market operation, Long Term Repo Operations (LTROs), Targeted Long Term Repo Operations (TLTROs), Special Liquidity Facility for mutual funds, and Refinance facility for all Indian financial institutions. These measures amounted to Rs 8.87 Lakh Crores liquidity inclusion to the system.

Banking sector

In the banking sector, the gross non-performing assets (GNPA) ratio of the scheduled commercial banks (SCBs) reduced from 8.2% at the end of March 2022 to 7.5% by the end-September 2020. During this period, the GNPA of public sector banks declined from 10.25% at the end-March 2020 to 9.4% at the end-September 2020. The Stressed Advances ratio, which is the sum of NPAs, restructured loans and written-off assets, of SCBs declined from 8.6% to 7.9% in the same period. As a result of this, the capital to risk-weighted asset ratio (CRAR) of SCBs increased from 14.7% to 15.8% between March 2020 and September 2020.

This reduction in NPA and the resultant improvement in CRAR can be attributed to RBI's loan moratorium and freezing of the asset classification dispensation and special resolution framework due to Covid-19 by the Supreme Court. Other factors such as low lending during the lockdown period, and the suspension of the Insolvency & Bankruptcy Code (IBC) helped the banks improve their balance sheet and reduce GNPA.

Monetary policy transmission

Since March 2020 there has been a noticeable improvement in the transmission of policy repo rate changes to deposit and lending rates of SCBs. This can be due to policy rate cuts, a large liquidity surplus with accommodative policy stance, and the introduction of external benchmark-based pricing of loans. The Survey finds that Private Sector Banks exhibited greater transmission in terms of fresh loans, whereas Public Sector Banks exhibited greater transmission on outstanding loans for the entire easing cycle.

The Survey reports that the reduction in policy rate has been 250 bps since February 2019. This was accompanied by a decline in credit growth. The Year-on-Year (YoY) Credit growth stood at 14.8% in February 2019 and declined to 5.1% in October 2020. Thereafter, credit growth picked up, and it stands at 6.7% as of January 1, 2021. The non-food credit growth (YoY) declined from 7.2% in November 2019 to 6.0% in November 2020. Except for services, this decline in credit offtake was noticed across all sectors in 2020-21. While credit growth to agriculture & allied activities moderated in the first quarter of 2019-20, it increased to 8.5% in November 2020. Credit growth to the industry contracted by 1.7% in October 2020. The services sector however grew at 9.5% in October 2020 and 8.8% in November 2020.

Non-banking financial companies (NBFC) sector

NBFC sector plays a critical role in India's growth story. Most of the micro, small and medium enterprises which do not get formal or banking sector loans are served by the NBFC sector. The YoY credit growth of the NBFC sector was close to 3% in June 2020 but decelerated to -6.6% in September 2020. The Survey notes that the NBFCs saw growth slowdown in 2019-20, mainly because of isolated credit events in a few large NBFCs and challenges in accessing funds growth. Following the COVID-19 pandemic, NBFCs faced a severe credit crunch. Banks extended support to this critical sector. Various measures taken by the RBI during the pandemic time such as Targeted Long-Term Repo (TLTRO) Operations helped the NBFCs sector. As a result of the prompt actions taken by the Government of India, banks, and the RBI, the GNPA ratio of NBFCs deteriorated moderately from 6.30% at the end-March 2020 to 6.44% at the end-June 2020.

Insolvency and bankruptcy code

The enactment of the Insolvency and Bankruptcy Code (IBC) in December 2016 has been a major milestone in the history of corporate legislation in India. This is codified overarching legislation designed to deal with multiple aspects of a company. IBC since its inception has admitted 4,117 applications as of December 31, 2020. The Survey mentions that nearly 23% of the cases admitted were settled or withdrawn after the commencement of the Corporate Insolvency Resolution Process (CIRP). Out of the 1420 cases for which the CIRP process has been completed, liquidation has been commenced for 1112 cases whereas resolution has been approved for 308 cases.

The Code has facilitated the recovery of NPAs by banks. The recovery rate for the Scheduled Commercial Banks through IBC (since its inception) has been over 45%. The IBC has resulted in significant behavioral changes among the creditors and debtors. The fear of a resolution process (that is the original promotors and managers lose control and management of the firm) deters the management and promoter of the firm from operating below the optimum level of efficiency.

Union budget and financial reforms

There was a huge expectation that the Union government in the Union Budget would announce some kind of like big bang reforms to give stimulus to the economy that has been badly affected by the COVID-19 pandemic.

Among the major reforms, the Union government proposed to create an asset reconstruction and asset management company (ARC-AMC) which is kind of a 'Bad Bank'. This may be a win-win for lenders. A 'bad bank' is a bank that buys the bad loans of banks and financial institutions that will clear their balance sheets. The bad bank then resolves these bad assets over a period of time. The idea is that banks freed of the NPA burden can start at fresh loans. This measure is expected boost banks' liquidity position and their rating as well. While this appears to cure the ailing banking sector, how much it will be successful depends upon the detailed code and structure of a bad bank and its implementation.

For the first time in the history of Union Budgets, the Union government announced that it intends to privatize two public sector banks in the coming financial year. This disinvestment

move is aimed at shoring up the government revenues by selling state assets and freeing the state from the burden of recapitalization of weak banks due to high NPA.

Similarly, the finance minister announced in her budget speech that the government would privatize one general insurance company in the coming financial year. The government is trying to monetize state assets by doing disinvestment and simultaneously vacating the space for the private sector.

The Union Budget 2021-22 has proposed setting up a Development Finance Institution with a capital of Rs 20,000 crore. The government has also set an ambitious lending target of Rs 5 lakh crore in the first three years. This may give a big boost to the Infrastructure sector financing.

The Government plans to open up both the insurance and pension sectors by increasing the FDI limit to 74% from 49%, at par with private banks. The finance minister also announced that the disinvestment process of the IDBI Bank will also be completed in the next fiscal.