

Economy & Gilt Watch

RBI Embarks on New Path in Regulation

In an important discussion paper recently released by RBI, the central bank has proposed a major regulatory overhaul for the NBFC sector, which till now has enjoyed significant “regulatory arbitrage” over their banking counterparts. The proposed regulatory framework comes in the aftermath of the 2018 IL&FS debacle, which had a ripple effect across the NBFC sector leading to series of defaults (Dewan Housing Finance Ltd, Reliance Home Finance Ltd.) and a severe crunch of confidence in the shadow-banking sector. Through the proposed regulatory framework, RBI moots to curb the systemic risk engendered through the growing linkages of the NBFC sector with the rest of the financial system. In the paper, RBI has suggested a “**scale based**” approach, which comprises of a four-tiered structure, to cater to different categories of NBFCs and aims at striking a balance between regulation and operational flexibility.

Scale Based Approach: Nuances

NBFCs play a crucial role in deepening of the financial services, providing additional support to the real economy by complementing the credit intermediation function of banks, while also facilitating competition in the financial system. The sector has undergone sharp growth over the years and now is deeply interconnected with the rest of the financial system. While the sector has grown rapidly, the regulatory framework remained less rigorous. In order to address the same, RBI has suggested a more stringent and a graded approach to regulation of the sector. **As per RBI, a scale-based approach is necessitated by difference in systemic risk posed by various categories of NBFCs and the degree of regulation should be commensurate with this perception of risk that the entity poses to the financial system and the scale of its operations.** The degree of regulation would in direction proportion to the following three fundamental factors, **i) Risk perception:** higher the risk perception higher the regulation, **ii) Size of operations:** bigger sized NBFCs having greater systemic significance, **iii) Activity:** For eg, heavier regulations for deposit taking NBFCs and lighter regulations for those who do not have access to public funds.

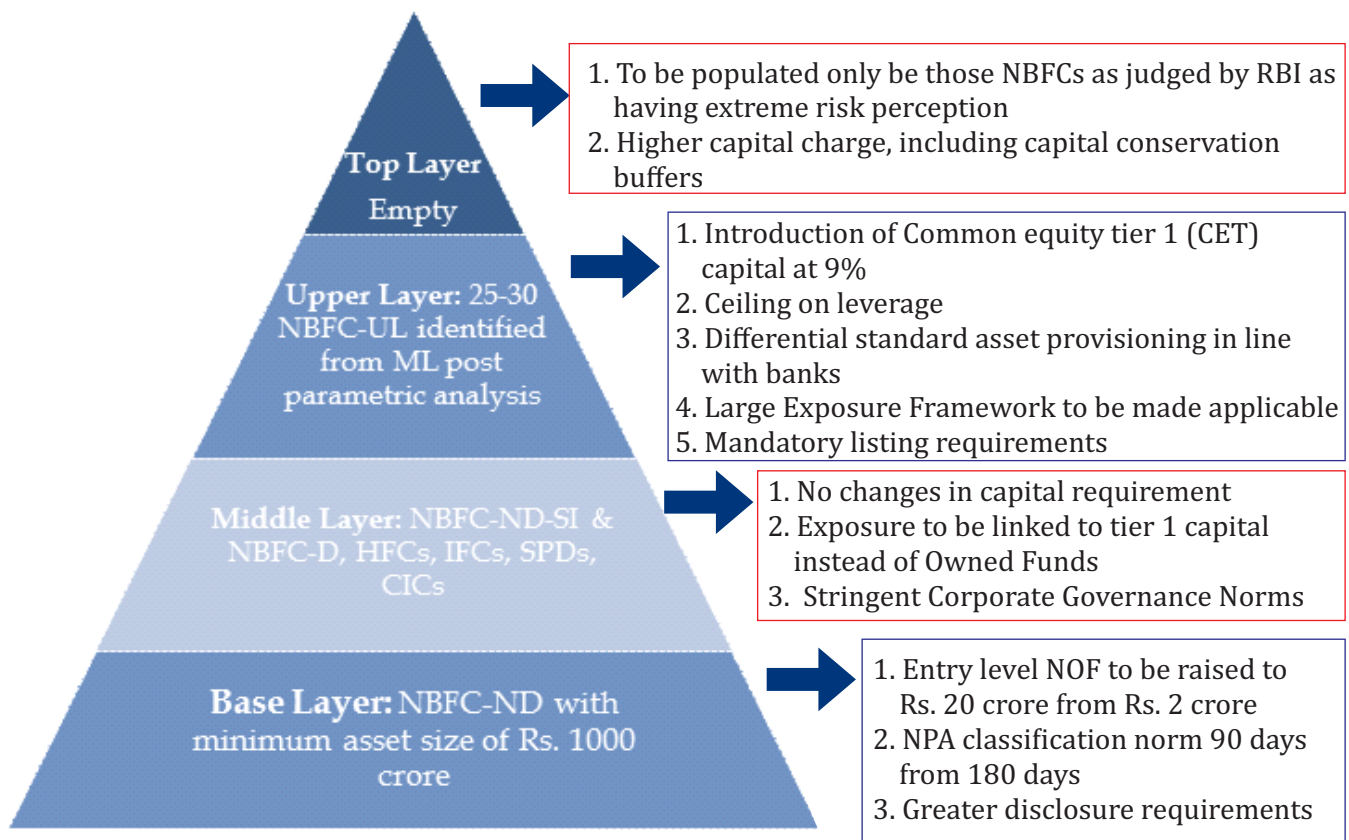
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The Four Tiers

For the purpose of regulation, NBFCs have been categorized into four types, viz, base layer (BL), middle layer (ML), upper layer (UL) and top layer (TL). The regulation is progressive in nature and increases as we move from base layer to the top layer. All the existing NBFCs can be categorized in the base layer and the middle layer, while the upper layer is a new category being introduced by RBI, which will be populated by NBFCs identified as having large potential of systemic spillover of risks and bearing on the stability of the overall financial system. The regulatory framework for upper layer would be most stringent with NBFCs falling in this category to be subjected to “bank like” regulations. The top 10 NBFCs (as per asset size would by default form a part of the upper layer, while more NBFCs would be identified from a sample to be a part of the UL based on a parametric analysis. The top layer of the regulatory pyramid will remain empty and would be occupied by those NBFCs that are pushed out of the upper layer based on supervisory judgment and will face significantly higher regulatory requirements.

The Four Tiered Regulatory Framework for NBFCs



Bottom-line

Through the proposed guidelines, RBI aims to address the problem of NBFCs posing significant systemic risk to the financial system and endangering the stability of the financial system and therefore the overall economic stability. From the perspective of maintaining financial sector stability, tighter regulations on otherwise hitherto lightly regulated NBFC sector are a welcome move. However, the issue of interconnectedness between banks and NBFCs remains the biggest risk to the financial system and it needs to be seen how the proposed framework would work in addressing this key risk.

Fixed Income Outlook

Fundamental View

The previous fortnight proved to be quite action oriented for the bond markets beginning with the reaction to the announcement of the variable rate reverse repo auction (amounting to Rs. 2 trillion), which RBI announced on 8th Jan'21. Market participants interpreted this announcement as the "beginning of the end" of easy liquidity conditions. Though it was argued that this seemed to be an action to bring the overnight money market rates within the LAF corridor, as rates ruling outside of the corridor would defeat the purpose of rate setting by RBI. Nonetheless, the confidence of the market regarding the future of the liquidity environment was shaken a bit at this seemingly innocuous announcement, which was amidst liquidity in excess of Rs. 8 trillion. The result of the variable rate reverse repo auction further spooked the market, especially the short end of the curve as RBI announced a worse than expected cut off of 3.55% with the weighted average of 3.46%, which gave further ammunition to the bearish camp. As a result of all this, the short term rates have moved up rather sharply by 25-40 bps in upto 5 year segment. Though the short end of the curve was adversely impacted, the longer end of the curve was well anchored the whole time. Another important development was the devolvement of the 5-yr paper in the Rs. 27,000 crore auction conducted by RBI last Friday. Giving a strong signal to the market this time RBI refused to settle for higher yields and devolved the whole of 5-yr paper on Primary Dealers and also cancelled the auction of the entire 10-yr paper. This is indeed a very strong signal by RBI which has clearly indicated its non-tolerance for higher yields.

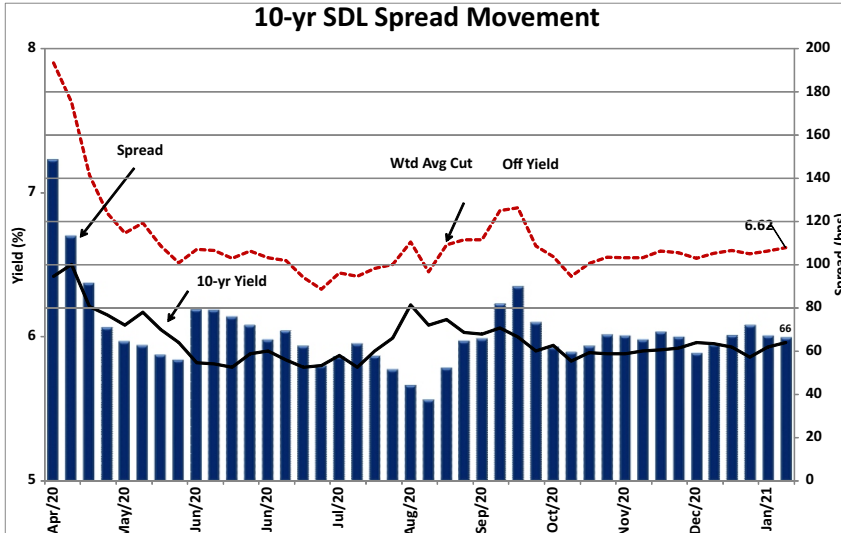
All these important signals of the last fortnight would again reinforce the trading range that has been discussed in the past few issuances, i.e. 5.85% to 5.95% on the 10-yr yield. The range may hold good till the next big event, which is the Budget (to be announced on 1st Feb'21). Further move in yields will be strongly dependent on the gross/net government borrowings for the upcoming FY 2021-22. A gross borrowing number of Rs. 10-11 lakh crore is widely expected and any number adverse than this may push the yields northward. Markets would also keenly watch for the fiscal normalization path that the Budget would envisage for better visibility on overall debt dynamics going forward.

Technical View

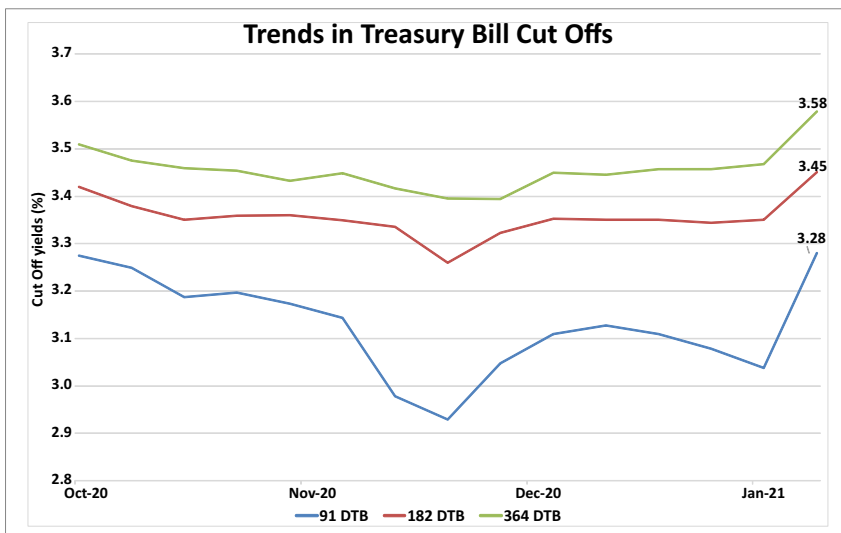
Analyst 1: 5.77% G Sec 2030 Yield settled at 5.94% on Friday's session. Last fortnight, benchmark Yield traded range bound between 5.92%/5.99% zone. Momentum indicator RSI is trading in 30-60 range from past three months, indicating lack of momentum either side in the benchmark. Last week 5.93% act as a strong support for the 10yr, with major resistance placed around 5.99% level, which coincide with upper Bollinger band indicating crucial rest level on higher side. From here on, any closing above 5.99% may lead yield to touch 6.05% level, till then benchmark may trade sideways in the range of 5.90% to 5.99% zone



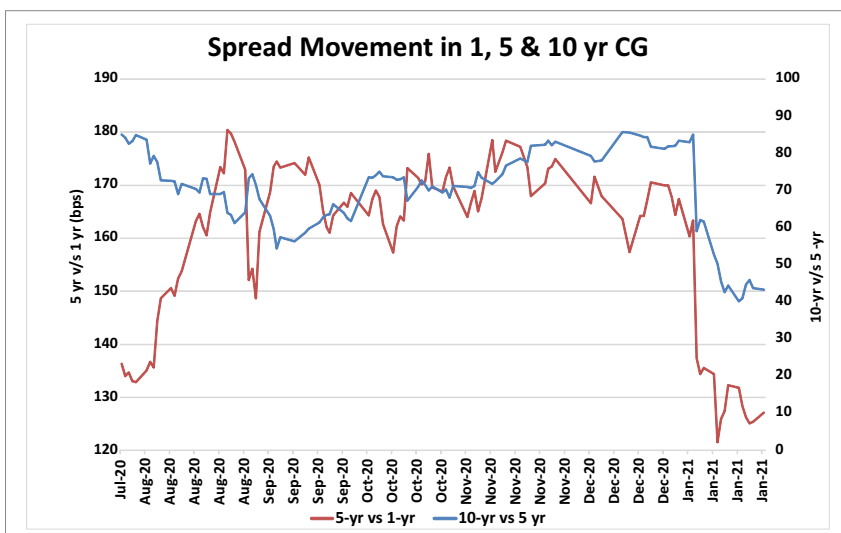
Analyst 2: 5.77 GS 2030 has significantly broken above 5.93% and hence, in line with our previous fortnight view, the long view has hit its stop loss. Hence, going forward, the market is expected to hover in a range of 5.98% to 5.90%. This range is seen as a no trade zone. Any breakdown below 5.87% shall be treated as a bullish signal.



SDL spreads continue to remain stable on prospects of better State finances



Cut off yields on treasury bills recalibrate to higher levels post conduct of variable rate reverse repo auction of Rs. 2 trillion



While short end of the curve was adversely impacted during the fortnight, the longer end of the curve remained well anchored

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