

## **Usha Thorat: Impact of global financial crisis on Reserve Bank of India (RBI) as a national regulator**

Presentation by Ms Usha Thorat, Deputy Governor of the Reserve Bank of India, at the 56th EXCOM Meeting and FinPower CEO Forum organised by APRACA, Seoul, 29 June 2009.

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I am delighted to be here in Seoul, participating in this 56th EXCOM Meeting and FinPower CEO Forum – my thanks to Secretary General Bayaua for inviting me to make this presentation on the “impact of the global financial crisis on RBI as a national regulator”.

In order to understand the impact of the global crisis on India and the manner in which the Reserve Bank of India (RBI) responded, it is important to realise that the RBI is a central bank that is entrusted with multi-dimensional roles and hence in this talk I propose to analyse how the RBI responded with respect to several of these roles.

### **Multi-dimensional roles of the RBI**

The RBI is entrusted with several functions, one of the most important one being the monetary authority of the country. As monetary authority, the RBI has as its objectives price stability, growth and financial stability. The weight and emphasis accorded to each of these objectives would vary depending on the overall macro economic conditions. In addition to its role as monetary authority, the RBI has responsibilities for forex management and government domestic debt management – both national and sub national. It is also the banking regulator – it regulates commercial banks, cooperative banks (both rural and urban), financial institutions and non banking financial companies. It has a developmental role to ensure inclusive growth – thus, policies on rural credit, SME and financial inclusion are an integral part of its functions.

### **Impact of the global crisis on India**

The direct effect of the global financial crisis on the Indian banking and financial system was almost negligible, thanks to the limited exposure to riskier assets and derivatives. The relatively low presence of foreign banks also minimised the impact on the domestic economy.

However, the crisis did have knock on effects on the country, broadly, in three ways. First, the reduction in foreign equity flows – especially FII flows – impacted the capital and forex markets and the availability of funds from these markets to domestic businesses; second, the shrinking of credit markets overseas had the impact of tightening access to overseas lines of credit including trade credit for banks and corporates. Both these factors led to pressure on credit and liquidity in the domestic markets with the knock on effects, and third, the fall in global trade and output had impact on consumption and investment demand. The cumulative impact of all this was a slowing down of output and employment. Despite the slowing down, India is still the second fastest growing economy in the world.

### **Moderation in growth**

After clocking an average of 9.4 per cent during three successive years from 2005-06 to 2007-08, the growth rate of real GDP slowed down to 6.7 per cent (revised estimates) in 2008-09. Industrial production grew by 2.6 per cent as compared to 7.4 per cent in the previous year. In the half year ended March 2009, imports fell by 12.2 per cent and exports fell by 20.0 per cent. The trade deficit widened from \$88.5 billion in 2007-08 to \$119.1 billion

in 2008-09. Current account deficit increased from \$17.0 billion in 2007-08 to \$29.8 billion in 2008-09. Net capital inflows at US\$ 9.1 billion (0.8 per cent of GDP) were much lower in 2008-09 as compared with US\$ 108.0 billion (9.2 per cent of GDP) during the previous year mainly due to net outflows under portfolio investment, banking capital and short-term trade credit. As per the estimate made by the RBI in its Annual Policy announced on April 21, 2009, GDP is expected to grow by 6 per cent in 2009-10.

### **RBI's response as monetary authority**

Till August 2008, the RBI followed a tight monetary stance in view of the inflationary pressures arising from crude, commodity and food prices. In mid-September 2008, severe disruptions of international money markets, sharp declines in stock markets across the globe and extreme investor aversion brought pressures on the domestic money and forex markets. The RBI responded by selling dollars consistent with its policy objective of maintaining orderly conditions in the foreign exchange market. Simultaneously, it started addressing the liquidity pressures through a variety of measures. A second repo auction in the day under the Liquidity Adjustment Facility (LAF) was also re-introduced in September 2008. The repo rate was cut in stages from 9 per cent in October 2008 to the current rate of 4.75 per cent. The reverse repo rate was brought down from 6 per cent to 3.25 per cent. The cash reserve ratio which was 9 per cent in October 2008 has been brought down to 5 per cent. To overcome the problem of availability of collateral of government securities for availing of LAF, a special refinance facility was introduced in October 2008 to enable banks to get refinance from the RBI against a declaration of having extended bona fide commercial loans, under a pre-existing provision of the RBI Act for a maximum period of 90 days. The statutory liquidity ratio requiring banks to keep 25 per cent of their liabilities in government securities was reduced to 24 per cent. These actions of the RBI since mid-September 2008 resulted in augmentation of actual/potential liquidity of nearly \$50 billion.

### **Financial stability objective – RBI's response**

The immediate result of tightening of the money and credit markets in October 2008 created demands on banks that were already expanding credit well beyond the resources raised from the public by way of deposits. Companies which were substituting overseas credit and capital market sources with bank funds started withdrawing funds parked with mutual funds and utilising their undrawn limits with banks. Some of the companies that had issued commercial paper in the market – especially the real estate companies and the non banking companies – found it difficult to roll over the maturing paper. The Commercial Paper and Certificates of Deposit markets became illiquid and mutual funds started facing severe redemption pressures. Hence, in the interest of maintaining financial stability, the RBI instituted a 14-day special repo facility for a notified amount of about \$ 4 billion to alleviate liquidity stress faced by mutual funds, and banks were allowed temporary use of Statutory Liquidity Ratio (SLR) securities for collateral purposes for an additional 0.5 per cent of Net Demand and Time Liabilities exclusively for this. Subsequently, this facility was extended for Non Banking Finance Companies (NBFCs) and later to housing finance companies as well. The relaxation in the maintenance of the SLR was enhanced to the extent of up to 1.5 per cent of their NDTL.

In order to curtail leveraging, commercial banks, all-India term lending and refinancing institutions were not allowed to lend against or buy back CDs held by mutual funds. This restriction was relaxed in the context of the drying up of liquidity for CDs and CPs.

Considering the systemic importance of the NBFC sector, the Government in consultation with the RBI announced the setting up of a special purpose vehicle (SPV) that could raise funds from the RBI against government-guaranteed bonds to meet the temporary liquidity

constraints of systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI).

### **RBI's response as forex manager**

The RBI assured the markets that it would continue to sell foreign exchange (US dollar) through agent banks to augment supply in the domestic foreign exchange market or intervene directly to meet any demand-supply gaps, and did so, especially in October 2008. It also provided forex swap facility with a three month tenor, to Indian public and private sector banks having overseas branches or subsidiaries – this acted as a strong comfort to such banks in the context of the drying up of the overseas money markets. Further, for funding the swap facility, banks were allowed to borrow under the LAF for the corresponding tenor at the prevailing repo rate. The forex swap facility of tenor up to three months was extended up to March 31, 2010. The prudential limit on overseas borrowing by banks has been doubled.

Taking into account the difficulties faced by exporters, as orders got cancelled and receivables mounted, the RBI extended the period of concessional pre-shipment and post-shipment export credit. The export credit refinance available to banks from the RBI was also increased.

Interest rates on dollar and rupee deposits kept in Indian banks by non resident Indians are capped by the RBI in order to prevent hot money flows. In order to address the impact of slow down in capital flows, the ceiling rates on these deposits were raised.

The ceiling on the interest rates at which companies could raise funds from abroad were increased and the end use restrictions that were placed on the deployment of such funds, to deal with the huge inflows in 2007-08, were restored to the status quo position.

Systemically important NBFCs that were not otherwise permitted to resort to overseas borrowing were allowed to raise short term foreign borrowings; housing finance companies were also allowed to access External Commercial Borrowings (ECBs) subject to RBI approval.

Taking advantage of the discount on Foreign Currency Convertible Bonds (FCCBs) issued by Indian companies in overseas markets, they were allowed to prematurely buy back their FCCBs at prevailing discounted rates.

### **Regulator of banks and NBFCs – RBI's response**

As indicated earlier, the Indian banking system was not affected by the global crisis and all financial parameters have remained strong with capital adequacy ratio for the system at 13.65 per cent (tier I ratio at 8.95 per cent), return on assets over 1 per cent, non-performing loans around 2 per cent as of March 2009. All commercial banks meet the minimum capital adequacy norm of 9 per cent and throughout the crisis period, inter-bank markets for money, forex and debt have been functioning smoothly.

The impact of the crisis in India, as in many Emerging Market Economies (EMEs), spilled over from the real sector to the financial sector. Industry and businesses especially the Small and Medium Enterprises (SME) sector had to grapple with a host of problems such as delay in payments of bills from overseas buyers as also domestic buyers affected by the global slowdown; increase in stocks of finished goods; fall in value of inventories, especially raw material, which in many cases were acquired at higher prices such as metal and crude oil based products; slowing down of capacity expansion due to fall in investment demand; demand compression for employment intensive industries, such as, gems and jewellery, construction and allied activities, textiles, auto and auto components and other export

oriented industries. Hotels and airlines apart from IT also saw fall in demand due to global downturn.

Recognising that the unexpected and swift turn of events could lead to problems of a spiralling downturn, the RBI took a series of regulatory measures in addition to providing liquidity and special refinance.

During the years from 2005-6 onwards, in the context of high growth in bank credit to certain sectors, the RBI had raised in stages the risk weights for these sectors and had also increased the provisioning requirements for standard assets. In November 2008, as a countercyclical measure, the additional risk weights and provisions were withdrawn and restored to previous levels.

The prudential regulations for restructured accounts were modified, as a one-time measure and for a limited period of time in view of the extraordinary external factors, for preserving the economic and productive value of assets which were otherwise viable. The modified regulations were in operation for applications for re-structuring received up to March 31, 2009 and restructured packages implemented within 120 days of receipt of application or by June 30, 2009, whichever was earlier. Banks were, therefore, required to take swift action for detecting weaknesses and putting in place the re-structured packages in order to avail of the benefits in assets classification under the modified prudential regulations. The modifications permitted the restructured accounts to be treated as standard assets provided they were standard on the eve of the crisis, viz., September 1, 2008, even if they had turned non-performing when restructuring had been taken up. This special regulatory treatment for restructured accounts was extended to most cases of second restructuring and for first restructuring of exposures to commercial real estate in view of the sudden downturn. To take care of the problem of restructured accounts that had become unsecured due to loss in the value of inventories, special regulatory treatment for asset classification was permitted if additional provisions were made as prescribed for the unsecured portion.

In the case of NBFCs, having regard to their need to raise capital, they were allowed to issue perpetual debt instruments qualifying for capital. They were also allowed further time of one more year to comply with the increased Capital to Risk-Weighted Asset Ratio (CRAR) stipulation of 15 per cent as against the existing requirement of 12 per cent. Risk weight on banks' exposures to NBFCs which had been increased earlier was brought down.

The impact of liquidity easing and prudential measures is reflected in the credit growth in the year ended June 2009 at 15.8 per cent against 26.3 per cent in the previous year. Though there was slowing down in the period after October 2008, the credit growth in the period October 2008 to June 2009 clocked annualised rate of 8.9 per cent. The credit growth during November 2008 – May 2009 was higher than average for sectors such as infrastructure, real estate, NBFCs, SME, agriculture and certain industries like iron and steel.

### **Employment intensive sectors – RBI's response**

Following the announcement in the Union Budget 2008 in February 2008, the commercial banks, cooperative banks and regional rural banks implemented in the period till June 2008, the debt waiver (100 per cent waiver) program for small and marginal farmers and debt relief (25 per cent relief) program for other farmers, covering an estimated 40 million farmers to the extent of nearly Rs. 71,000 crore or \$14.5 billion. The RBI took sector-specific measures to alleviate the stress faced by employment intensive sectors such as SME, export and housing. In order to address the problems faced by the MSEs, meetings of the State Level Bankers Committee were convened almost on a monthly basis in the first half of this year. During these meetings, State governments and banks were sensitised about the need to respond promptly to the credit needs of the sector to ensure that units do not get into distress. The RBI guidelines on restructuring were disseminated at such meetings.

The RBI extended special refinance of \$1.4 billion to Small Industries Development Bank of India (SIDBI) to enable it to on-lend to banks and financial institutions towards incremental SME loans. Banks were advised to carve out and monitor separate sub-limits of large companies to meet payment obligations to micro and small enterprises. MSME (Refinance) Fund of Rs. 2000 crore (\$400 million) was instituted and banks were asked to contribute towards this fund against their shortfall in their lending to the weaker sections as low interest deposits with SIDBI to be used by the latter for providing assistance to the MSME sector.

Considering the knock on effects on the housing sector, and the role of housing finance companies (HFCs) in providing housing loans, the National Housing Bank (NHB) was made available a refinance limit of \$800 million to assist the sector. As in case of SIDBI, banks were asked to deposit specified amount against the shortfall in their lending to the weaker sections with NHB. Loans to HFCs were made eligible for the special repo window opened for bank lending to mutual funds. HFCs were also allowed to borrow abroad from bilateral and multilateral agencies with prior approval from the RBI.

The period of concessional export credit was extended and the entitlement of banks under the export refinance facility from the RBI was enhanced. Export-Import Bank of India (EXIM Bank) was given a special refinance limit of \$1 billion as also extended a special forex swap facility as in case of banks with overseas branches.

### **RBI's response as debt manager**

To contain the knock on effects of the global slowdown, the Government of India announced three fiscal stimulus packages during December 2008-February 2009. These stimulus packages were in addition to the already announced post-budget expenditure towards farm loan waiver, rural employment guarantee and other social security programs, enhanced pay structure arising from the sixth pay commission, etc. As a result, the net borrowing requirement for 2008-09 increased by nearly 2.5 times the original projection in 2008-09 from 2.08 per cent of GDP to 5.89 per cent of GDP.

The RBI managed the additional borrowings in a non-disruptive manner through a combination of measures including unwinding under the market stabilisation scheme (MSS), open market operations and easing of monetary conditions.

The MSS was introduced in 2004 to help the RBI sterilise the impact of capital flows when huge accretion to reserves added primary liquidity to the system. Under an agreement entered into between the Government of India (GOI) and RBI, GOI agreed to issue bills and bonds the proceeds of which were immobilised with the RBI and thereby the liquidity impact of forex purchase by the RBI was neutralised. The MSS operates symmetrically, and acts as a store of liquidity and hence has the flexibility to smoothen liquidity in the banking system both during episodes of capital inflows and outflows. When capital outflows were experienced in 2008, and the borrowing requirement of government increased, it was decided to buy back MSS securities while simultaneously issuing new securities under the borrowing program. The agreement between RBI and GOI alluded to earlier was amended in February 2009 to allow the funds immobilised under the MSS to be de-sequestered instead of going in for fresh borrowing. So far between March and May this year, cash balances of nearly \$8 billion have been de-sequestered.

Keeping in view the government market borrowing in 2009-10 as provided in the interim budget, coming on top of a substantial expansion in market borrowing in 2008-09, it was important for the RBI to provide comfort to the market so that the borrowing programme is conducted in a non-disruptive manner. Accordingly, the RBI simultaneously indicated its intention to purchase government securities under open market operations (OMO) for an indicative amount of Rs.80,000 crore (\$16 billion) during the first half of 2009-10.

The distribution method for the primary issuances was also shifted to uniform price auction in view of the uncertain market conditions. Offers of shorter term bonds and benchmark securities have also helped meet investor preference and stabilise yields.

The general easing of monetary conditions, in addition to the above measures have also ensured that the additional borrowing needs of the government do not result in crowding out of credit to the private sector and helped in maintaining stable conditions in the government securities markets.

### **Factors that helped in responding swiftly and effectively**

In concluding my presentation on the impact of the global crisis on the RBI, I would like to briefly touch upon the factors that enabled the RBI to respond swiftly and effectively to the unfolding crisis.

The single most important concern that needed to be addressed in the global crisis was the liquidity issue. The RBI had in its arsenal a variety of instruments to manage liquidity, viz., CRR, SLR, LAF, Refinance, OMO and MSS. Through a judicious combination of all these instruments, the RBI was able to ensure more than adequate liquidity in the system. At the same time it was ensured that the growth in primary liquidity was not excessive.

The inherent synergies in its multiple roles enabled the RBI to ensure orderly functioning of money, forex and government securities markets while dealing with capital flows, managing additional government market borrowing and ensuring adequate credit to restore growth momentum.

As regulator and forex manager, the RBI was able to build reserves, calibrate capital controls and take prudential countercyclical measures which could be reversed when the need arose.

Both, macro prudential and micro prudential policies adopted by the RBI have ensured financial stability and resilience of the banking system. The timely prudential measures instituted during the high growth period especially in regard to securitisation, additional risk weights and provisioning for specific sectors, measures to curb dependence on borrowed funds, and leveraging by systemically important NBFCs have stood us in good stead. The reserve requirements – both cash and liquidity – acted as natural buffers preventing excessive leverage.

While credit expansion by private sector and foreign banks was significantly lower during 2008-09 especially to retail and SME borrowers, public sector banks (covering nearly 70 per cent of banking assets) maintained their credit growth to employment impacting sectors such as SME, agriculture, real estate and infrastructure, even as regulatory policies have ensured that prudential norms and financial soundness were not compromised.

Finally, the close coordination and interaction between the Government and the RBI ensured that appropriate package of measures were put in place promptly to deal with the crisis and restore the growth momentum. Thank you.