*SBI RESEARCH*

# ECOWRAP

## GEO POLITICAL CHALLENGES POSING ASYMMETRIC WORKING CAPITAL UTILISATION ACROSS SECTORS: THE CLEAR TRADE-OFF BETWEEN RISK BASED PRICING & EXUBERANT PRICING

Issue No. 19, FY23
Date: 07 Jul 2022

Global economy continues to be characterised by significant volatility. On an average, Energy, Base Metals, Precious Metals and Agricultural prices are now down 25% from 52 week highs as markets are anticipating a global slowdown morphing into a full blown global recession. However, it is not clear whether such decline is the result of synchronized global rate actions or genuine fears of a recession looming large.

In India, such global developments could have a direct bearing on the inflation trajectory in the second half of the current fiscal. The RBI has been on course in normalising liquidity and net LAF is now close to the 1.5% threshold non inflationary level of liquidity. However, the problem is unspent Government cash balances that has now jumped to Rs 3.1 trillion. This effectively implies that core liquidity is still at Rs 6.2 trillion as against Rs 8.3 trillion in beginning of April. Additionally, RBI has also announced a slew of measures to augment capital inflows by making NRI deposits more attractive.

The cumulative impact of all these measures will be beneficial for the external sector given the fact that total NRI deposits exhibited an inflow of $3.2 billion in FY22 as against the inflows of $7.4 billion in FY21. The FCNR (B) swap scheme in 2013 was extremely successful helping raise around $34billion of inflows, though the RBI had taken up the foreign exchange risk at that time to make the scheme successful. The RBI should make conscious effort to internationalise the rupee. The Russia-Ukraine war and the disruptions to payments caused by it, is a good opportunity to insist on export settlement in rupee, beginning with some of the smaller export partners.

Coming back, to credit growth, it expanded at Rs 2.6 lakh crores far outstripping bank deposit growth at Rs 1.04 lakh crore in current year. The continued growth in bank credit is a matter of comfort and indicates that Indian economy is still navigating through the turmoil rather well. There are several aspects of this credit growth.

**First, the incremental credit to Micro, Small and Medium enterprises since March 2020 has been on an upswing**. Around 74% of such is purely because of the credit guarantee scheme, and the remaining 26% is because of other schemes including the definitional change in MSME sector. In terms of overall credit growth, the ECLG Scheme has contributed 15% of the expansion.

**Second, our analysis however shows that utilisation of working capital by various sectors has been impacted adversely across sectors that are specifically linked to the geo-political tensions**. These sectors include Petroleum, Power, Engineering and also Cement (possibly because of monsoon, construction activities take a backseat). **The good thing** is that some of the consumer facing sectors like Leather, Food Processing did not witness a material decline in working capital utilisation. Even sectors like Pharmaceuticals and new age sectors like Healthcare did witness holding on to higher working capital utilisation limits.

**Third**, **banks continue to be judicious in term of credit disbursements**. A decline in risk-weighted assets (RWA) continues, from around 65% in June'19 to below 58% as on March'22, indicate that banks are still careful about the risk profile of borrowers in an environment characterised by considerable uncertainty.

**Fourth and most importantly**, the spread between AAA corporate bond and 10 year risk free G-sec rates have though started moving upward, since April'2022, still significantly less than half of the average spread at pre pandemic level i.e. in FY20. The average spread of a AAA 10-year paper was 117 bps in pre pandemic levels over similar tenor G-Sec., which is now only 36 bps. This indicates that risk pricing of corporate loans has not moved up in tandem. Market sources point out that some of the entities are not completely factoring the inherent credit risk in their pricing. For example, 5year loans are being priced at even lower than 6%, linking with Repo / T-Bill rates. It is to be noted that 10-Yr G Sec is currently trading at 7.3%. **Tenor premium apart, the practice may create a material risk with regards to sustainability of such rates and long-term effects of this practice on the ecosystem in a rising interest rate scenario.**

**We expect sectors such as Infrastructure including Power, Renewable Energy, Petroleum, Mining Road, NBFCs, Cement, Aviation, Electric Vehicles, Electronics, Commercial Real Estate, Food Processing etc. will drive credit growth in coming quarters. RBI's recent measures on ECB/FPI inflows in debt segment are a welcome step in widening the market.**

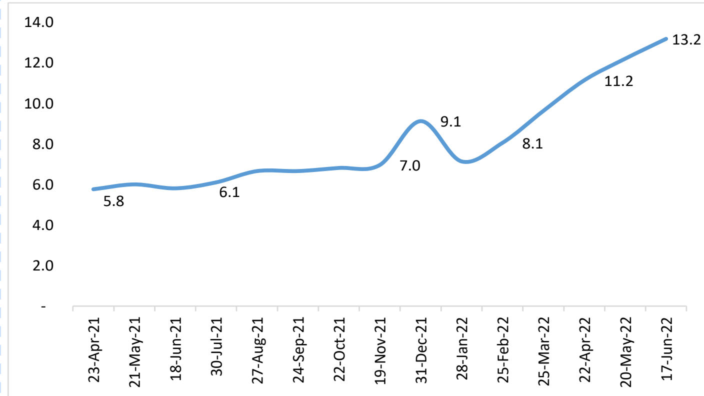
## ROBUST CREDIT GROWTH ACROSS SECTORS, INDUSTRY THOUGH IS IN SINGLE DIGIT

- As per the provisional data of ASCBs for the fortnight ending 17th June'22, credit growth crossed 13% to touch Rs 121 lakh crore. Robust credit growth was reported across sectors including, Industry, Services and Personal segment, which grew by 16.4% YoY, as per the sectoral deployment as of May'2022.
- Service sector reported YoY growth of 12.9% driven by 20.6% growth in NBFC sector and 13.4% in Trade segment. Industry credit grew by 8.1% driven by Micro & Small and Medium Enterprises.
- The most interesting trend is that incremental credit to Micro, Small and Medium enterprises since March 2020 has seen a significant jump of Rs 2.7 lakh crores, of which ECLG disbursements was around Rs 2.36 lakh crores. For a like to like comparison, **If we factor in the interest payments to incremental credit, the growth in pure credit disbursements to MSME sector could be around Rs 3.2 lakh crores since the beginning of pandemic, of which Rs 2.36 lakh crores /74% is purely because of the credit guarantee scheme, and the remaining 25% is because of other schemes including the definitional change in MSME sector. In terms of overall credit growth, the ECLG scheme has contributed 15% of the expansion.**
- Industry credit growth of 8.1% was contributed by infrastructure sector including Power, Road, Telecom. Other sector reported double digit growth includes Food Processing, Chemical and Chemical Products, Vehicle, Vehicle Parts and Transport Equipment etc.

## DEEP DIVE INTO CREDIT GROWTH

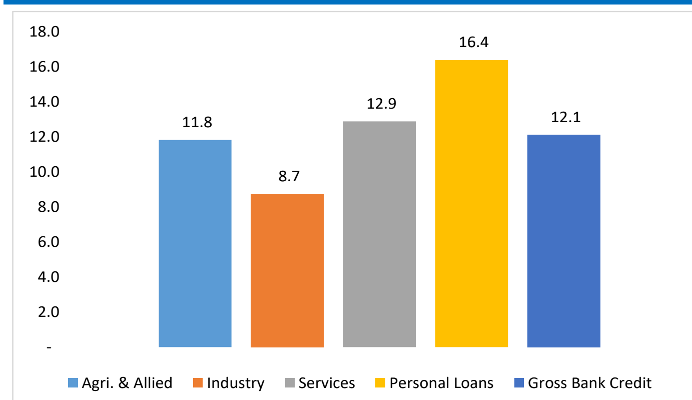
- Deeper profiling of bank credit indicates that most of the revival was in the second half of FY22, and it has continued during the current financial year so far.
- While personal loans remained a dominant component, credit demand from the industrial sector revived strongly after collapsing in FY21 as well as in the first half of FY22. A significant portion of new industrial loans was extended as working capital loans.
- **Our analysis however shows that utilisation of working capital by various sectors has been impacted adversely across sectors/companies that are specifically linked to the geo-political tensions. These sectors include Petroleum, Power, Engineering and also Cement (possibly because of monsoon, construction activities takes a backseat).**

**ASCB Credit growth (YoY) %**




Source: RBI; SBI Research

**Sector wise credit growth as of May'2022 (YoY) %**




Source: RBI; SBI Research

**Incremental Growth in Credit by SCBs (excl. RRBs)**

| Description | FY20 | FY21 | FY22 * | |
|---|---|---|---|---|
| | Full year | Full year | Full year | Second half |
| **Economic Sector (major)** | | | | |
| i) Industry | 280 | -1150 | 1490 | 2340 |
| ii) Personal Loans | 3880 | 3350 | 4660 | 3380 |
| of which, Housing Loan | 1820 | 1620 | 2010 | 1450 |
| **Organisational Sector (major)** | | | | |
| i) Public Sector | 1370 | 580 | 2280 | 2440 |
| ii) Private Corporate Sector | -710 | -950 | 1700 | 2880 |
| iii) Households Sector – Individuals | 5110 | 4330 | 6550 | 4700 |
| **Type of Loan (major)** | | | | |
| i) Working capital loans | 320 | -880 | 2220 | 2780 |
| ii) Term loans | 5690 | 5880 | 8230 | 7510 |
| **Total credit** | **6050** | **5210** | **11480** | **11160** |

Source: RBI; SBI Research; * provisional; Rs Billion

- **The good thing is that in some of the consumer facing sectors like Leather, Food Processing did not witness a material decline in working capital utilisation. Even sectors like Pharmaceuticals and new age sectors like Healthcare did witness holding on to higher working capital utilisation limits.**

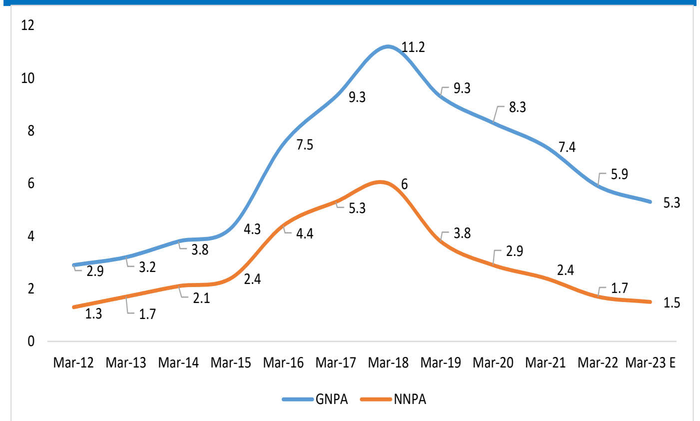
## ASSET QUALITY OF BANKS IMPROVED EVEN FURTHER

- Asset quality of ASCBs has improved, as GNPA declined by 150 bps to 5.9% as on March'2022 from 7.4% a year ago. Further, under RBI baseline scenario, the ratio is expected at a reduced level of 5.3% as of March'2023, which was at 11.2% as of March'2018.
- Banks' balance sheets remain robust, with non-performing assets (NPAs) on a decline for both wholesale and retail loans. GNPA for retail loan (less than Rs 5 crore) stands at 4.1% while for wholesale loan (above Rs 5 crore) the ratio is at 7.7% as of March'2022.
- **Similarly, on the back of strong provisioning, net NPA of SCBs also reduced to 1.7% as on March'2022** which was 2.4% a year ago and as high as 6% as on March'2018. **We expect the ratio to further reduce to 1.5% and even lower by March'23.**
- However, sector wise GNPA as of March'2022 reflects stress in certain sectors. Sectors such as Constructions, Gems and Jewellery, Engineering, Mining and quarrying, Food Processing etc., GNPA ratios is high.

## ADEQUATELY CAPITALISED, DECLINE IN RISK WEIGHTED ASSET (RWA) DENSITY

- Capital buffers remain adequate with Capital to Risk Weighted Assets Ratio (CRAR) and Common Equity Tier 1 (CET-1) ratio of SCBs as high as 16.7 per cent and 13.6 per cent respectively, as of March 2022.
- Moreover, the provisioning coverage ratio (PCR) increased to 70.9 per cent in March 2022 from 67.6 per cent in March 2021.
- **Further, decline in risk-weighted assets (RWA) continues, from around 65% in June'19 to below 58% as on March'22, indicate that banks are still careful about the risk profile of borrowers in a dynamic environment characterised by considerable uncertainty.**

**Asset Quality**



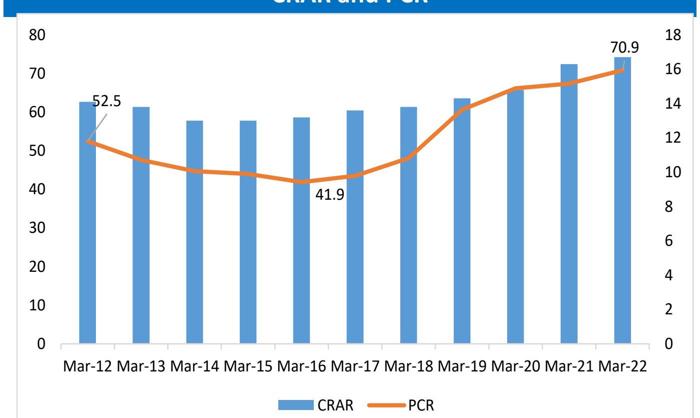

Source: RBI; SBI Research

**Sector wise GNPA as on March'2022**

| Sector | NPA % |
|---|---|
| Mining and quarrying | 12 |
| Food Processing | 11 |
| Textiles | 9 |
| Paper and other Products | 8 |
| Chemical and other products | 4 |
| Rubber,plastic and other products | 7 |
| Cement & other products | 7 |
| Basic metals and other products | 7 |
| Engineering | 13 |
| Vehicle parts and transport equipments | 5 |
| Gems and jewellary | 18 |
| Construction | 19 |
| Infrastructure | 8 |

Source: RBI; SBI Research

**CRAR and PCR**




Source: RBI; SBI Research

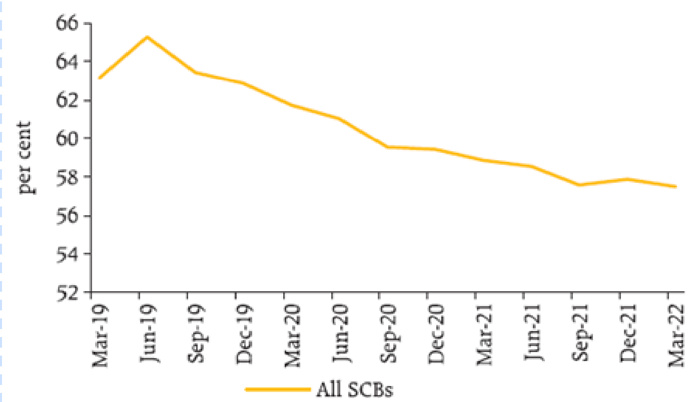
## BUT DOES CURRENT PRICING CAPTURE THE RISK ADEQUATELY?

- During and after pandemic, RBI has taken several measures to stabilise the financial system including keeping liquidity in surplus mode that is now being adjusted in sync with the current inflation scenario.
- Core liquidity injected into banking system in Apr'21 was at Rs 8.3 lakh crore and is currently at Rs 6.22 lakh crores. Net LAF is currently at Rs 2.88 lakh crores, very close to the 1.5% NDTL non inflationary threshold. However, Government cash balances is still at Rs 3.2 lakh crores, that is unspent and once the Government starts spending and could disturb the liquidity normalisation applecart.
- Importantly, the spread between AAA corporate bond and 10 year risk free G-sec rates have started moving upward, since April'2022 though still significantly less than half of the average spread at pre pandemic level i.e. in FY20. The average spread of a AAA 10-year paper was 117 bps in pre pandemic levels over similar tenor G-Sec., which is now only 36 bps. Similarly for a five-year paper the present spread is only 30 bps which was 93 bps pre-pandemic. This indicates that risk pricing of corporate loans has not moved up in tandem.
- Market sources point out that some of the entities are not fairly factoring the inherent credit risk in their pricing. For example, 5 year loans are being priced at even lower than 6%, linking with Repo / T-Bill rates. It is to be noted that 10-Yr G Sec is currently trading at 7.3%. **Tenor premium apart, the practice is creating a material risk with regards to sustainability of such rates and long-term effects of this practice on the ecosystem in a rising interest rate scenario.**

## COMMERCIAL PAPER RATES INCHING UP SINCE APRIL'22, BOND ISSUANCES DECLINE TOO

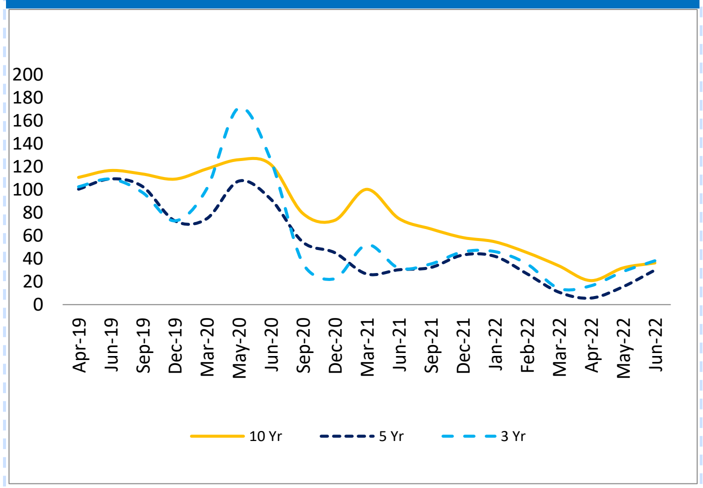
- In Commercial Paper (CP) market, Weighted Average Yield (WAY) started inching up since April'22. With WAY moving northwards, the primary issuances of the short term paper has stabilised around Rs 1 lakh crore after touching a high of around Rs 2.9 lakh crore during Nov'2021.
- The WAY has increased by 117 bps since April'2022 and is at 5.54% in June'2022. Last time the WAY level was seen in excess of 5% was during April-May 2020. With various measures taken by Government as well as RBI during pandemic the WAY had declined to 3.45% in Nov'2020.

**Risk Weighted Asset (RWA) Density**



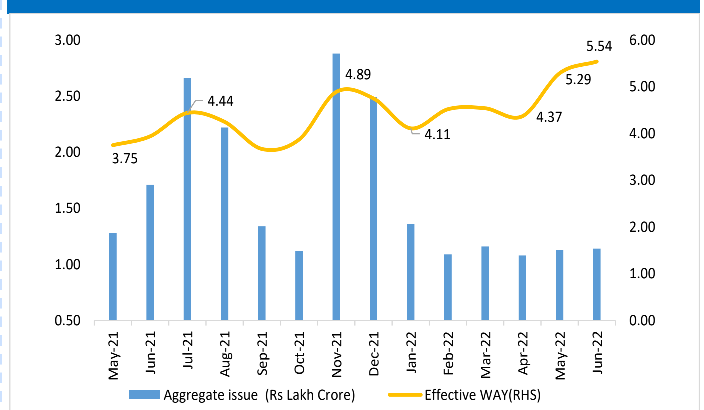

Source: RBI; SBI Research

**AAA Corporate Bond Spread (bps)**




Source: Bloomberg; SBI Research

**CP issuances and WAY**




Source: CCIL; RBI; SBI Research

- Primary bond issuances too declined to a six year low at Rs 5.97 lakh crore in FY22, with low demand and rising yield and attractive deals from banks.

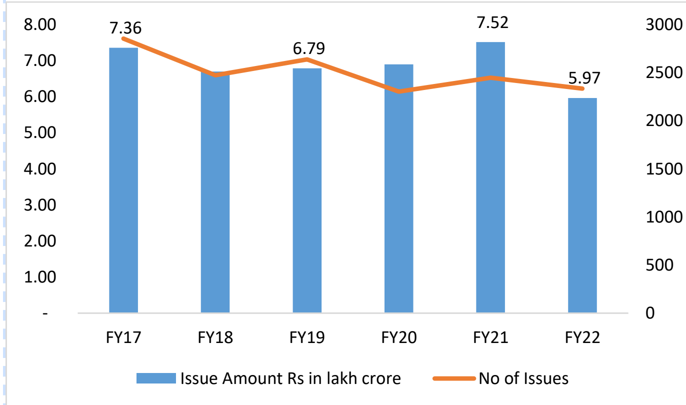
## CREDIT GROWTH OUTLOOK

- Capacity utilisation in the manufacturing sector nearing 75 per cent in Q4FY22, investment activities driven by Government's capex push at all-time high.
- With deleveraged corporate balance sheets, we expect the industry credit demand to pick up gradually.
- Even as the announcement of the projects is at a high, the implementation come with a lag and is a gradual process. So once the implementation starts, we can see disbursements in term loan first before we see a fresh cycle of working capital demand, which is usually required once the commercial operation starts.
- Indian Banks are in a better shape than ever before, with CRAR of 16.7%, PCR of 70.9% and NNPA 1.7%. Further, with RWA below 58%, the risk profiling is also strong and Banks are ready to support the next growth trajectory to fund the $ 5 trillion economy.
- However, as a sustainable lending practice, Banks should properly price their risk and tenor premium adequately .
- **We expect sectors such as Infrastructure including Power, Renewable Energy, Petroleum, Mining Road, NBFCs, Cement, Aviation, Electric Vehicles, Electronics, Commercial Real Estate, Food Processing etc. will drive credit growth in coming quarters.**

## SBI COMPOSITE INDEX: JUNE 2022

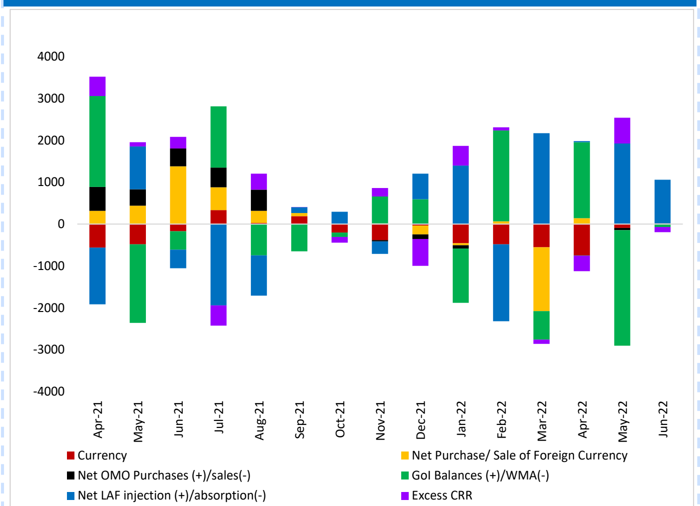
- The yearly SBI Composite Index continue to decline and is at 56.4 (High Growth) in June 2022, compared to 57.4 (High Growth) in May 2022. While, the monthly index continued to increase at 55.8 (Moderate Growth) in June from 54.5 (Moderate Growth) in May 2022. The rise in monthly index due to the continued upturn in business activities.
- Based on the SBI index, we believe IIP and IIP manufacturing may grow around 5-6% in May & June 2022.

**Bond Issuances lowest in six years**



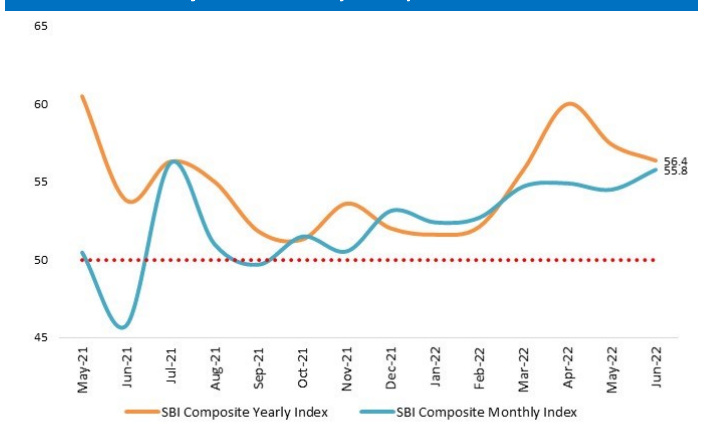

Source: Primedatabase; SBI Research

**Liquidity Management (Rs billion)**




Source: RBI; SBI Research; Net sale and purchase of foreign currency is till Apr22 and GOV cash balance for Jun'22 is provisional

**SBI Yearly and Monthly Composite Index Trend**




Source: SBI Research

******

**Contact Details:**
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in,
gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya