Current Credit Contagion and Imperative Measures to Address the Crisis

By Binyam Taddese & Karan Jhaveri

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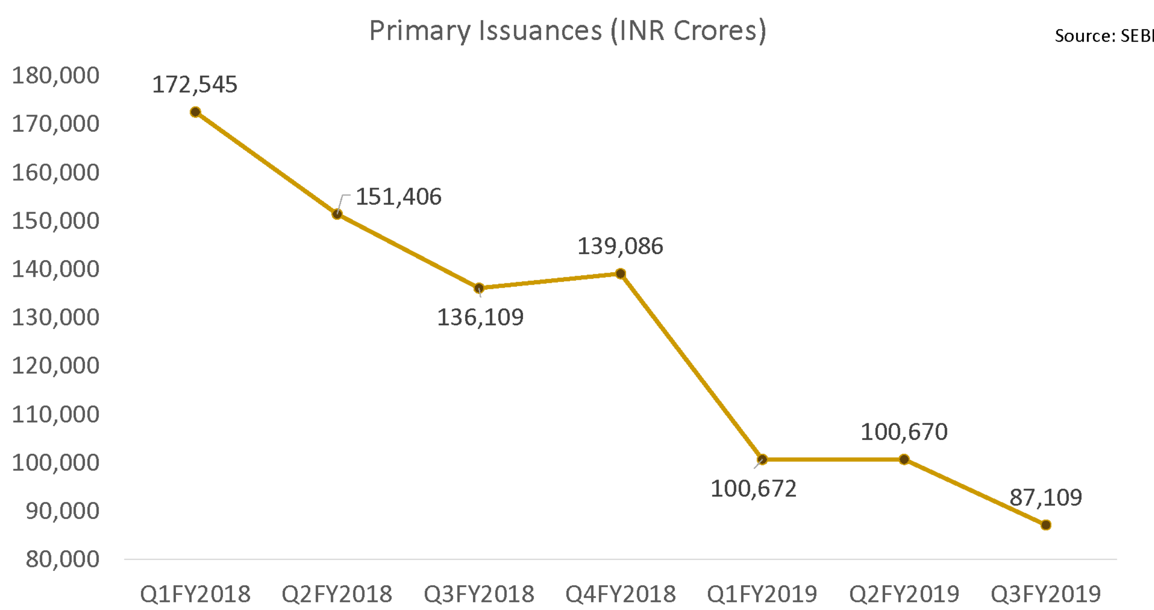
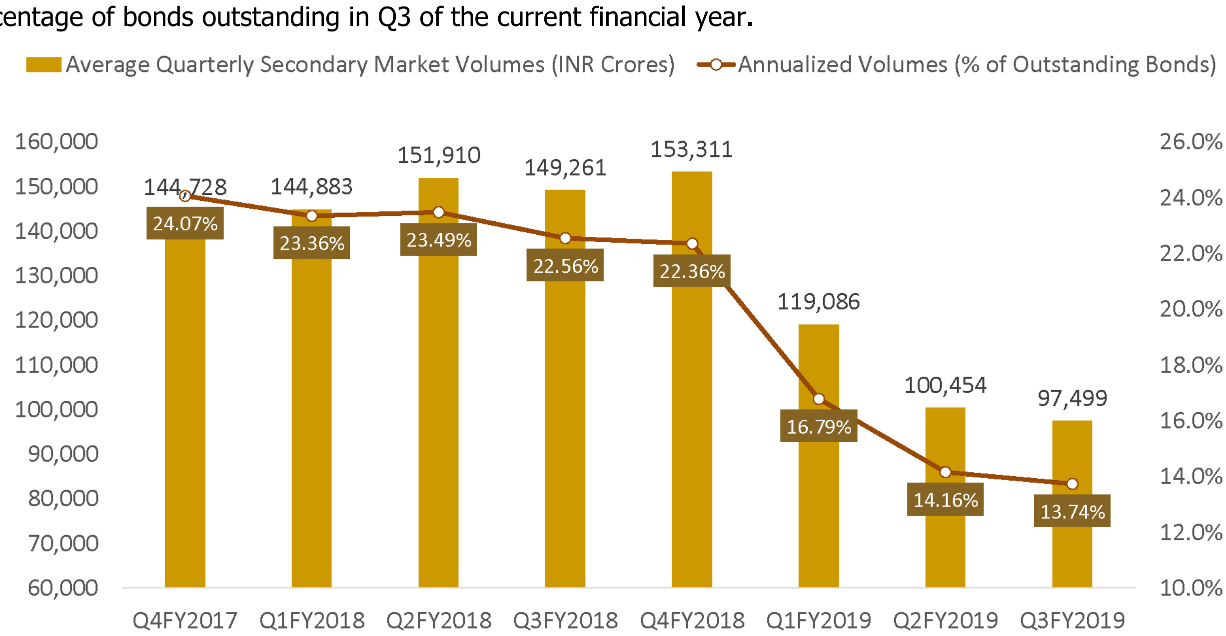
Ever since the ILFS crisis came to light in September 2018, the Indian fixed income market, especially corporate bonds have continued to exhibit stress. Spreads across sectors and maturities have expanded considerably. Generally, a sudden reduction in availability of credit may be due to increased perception of risk, change in monetary conditions or imposition of credit controls. In this case, the market dislocation was triggered by the ILFS defaults leading to an increased perception of risk, however, it is also important to note that conditions were already unfavorable setting the stage for what has unfolded since.

A key theme that has impacted global markets is the change in global central bank policies leading to cheap money being no longer available. After a decade of massive stimulus, the liquidity tide is turning with central banks tightening their monetary policies. Higher yields abroad have led to flight of foreign capital to the tune of about INR 80,000 crores. Furthermore, there were many other developments that were challenging for the market namely, fiscal and CAD concerns, lower systemic liquidity, the emerging market currency crisis and rising protectionism. All these factors have contributed to eroding market confidence making it more likely that a trigger event has a wider impact than it would otherwise have.

The liquidity squeeze triggered by IL&FS has had significant implications on the corporate bond market namely higher corporate spreads, subdued primary issuances and reduced secondary volumes. Primary issuances of corporate bonds which were already under pressure after the revised EBP guidelines kicked in, went on to shrink further to just about INR 87,000 crores during Q3FY2019.



Secondary market volumes too have dropped substantially this fiscal both in absolute terms and as a percentage of bonds outstanding in Q3 of the current financial year.

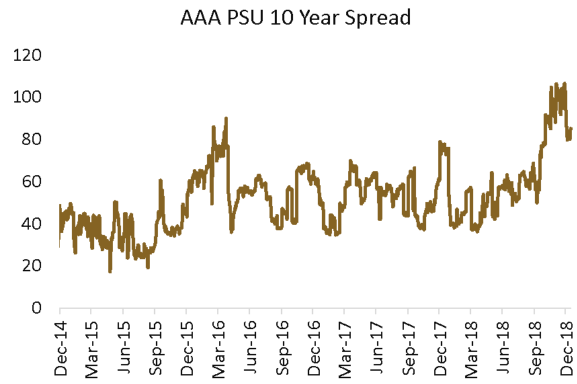


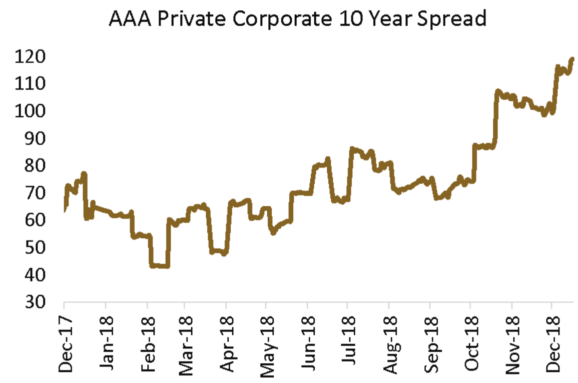
Source: SEBI, CBRICS

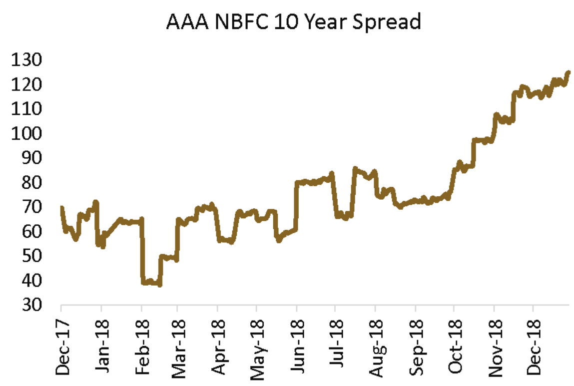
Systemic liquidity has shrunk drastically over the last year from over INR 4 lac crores & has slipped into a deficit, aggravating pain in the bond & money markets. Thus, overall the ability of corporates to access bond markets has been severely crippled over the last few months.

The intensity of recent expansion in credit spreads remains unprecedented. For example, the spread of ten year AA+ NBFC bond yields over ten year GOI bonds has moved up to 202 bps from a four year average of 121 bps, representing a move of more than three standard deviations from the average. Such instances are extremely rare with the very little probability of occurrence. While it is typical that financial markets exhibit contagion across similar businesses when under stress, the current crisis has spread across sectors. Spreads have widened for even for private corporates, PSU's and SDLs.

Corporate Bond Spreads Flare Up







Markets are experiencing a **3 sigma event**

as corporate bond spreads remain multiple standard deviations above their long term averages

Source: Bloomberg

Typically during a crisis, a central bank's standard tool kit can include flooding the system with liquidity, bringing down short and long term interest rates, and providing confidence building measures such as backstop facilities, guarantee mechanisms, etc. Historically central banks have also acted as lenders of last resort, provided liquidity directly to borrowers and lenders in key credit markets and have conducted non-traditional open market operations.

NBFC and HFC sectors are an integral part of the economy. They made up 23% of total credit and 37% of incremental credit extended in FY2018. They are also highly interconnected with the banking system and a key enabler of the government's affordable housing and priority sector lending goals. Recognizing their importance, RBI for now has eased liquidity and lending limits for banks to enhance lending to NBFCs and HFCs, in the form of higher SLR carve outs for LCR calculation and higher single borrower limits.

While these steps are significant, it is yet not clear whether they are sufficient to calm the market. Given the current NPA problems the banks face and their already large exposure to NBFC's, it is not clear how much of the extra liquidity banks will on-lend to NBFCs. The current measures will probably have to be supplemented with additional measures that address the specific funding needs of the NBFC/HFC sectors, possibly through the use special facilities targeted at these sectors. These can include:

- Bringing down real interest rates
- Larger OMO purchases
- Allowing higher percentage of net liabilities in RBI's repo window
- A temporary unconditional corporate bond repo facility to all eligible participants
- Market making responsibility to top institutions for AA and higher rated bonds with a refinancing mechanism from the RBI

Some of these measures may have to be implemented sooner rather than later to ensure that the risk of a system wide contagion is contained at the earliest and investor confidence recovers.

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