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ARE WE READY FOR YET ANOTHER CRISIS: INSTITUTIONAL LIQUIDITY VIABILITY?

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ABSTRACT

The current liquidity fiasco is not anymore, a confidential matter. In view of the same, the current study is an attempt to investigate deeper in order to gain insights of the so-called liquidity crunch on key sectors in India such as Mutual Fund, Microfinance institution, Banking and the Corporate. The analysis indicates towards the grim fundamentals in the upcoming year(s). The silver lining shall be a combination of efforts from the central bank along with a fiscal boost in order to make the desired dent to a shiny future.

Keywords: Liquidity Crisis, COVID-19, Mutual Fund, MFIs, Banking, Corporate

INTRODUCTION

Undoubtedly, the world is not immune to fight COVID-19 but the key question is, “does our 'Institutions' carry that potential”? Think of the last few decades, one can think only of epidemics and pandemics such as Zika, Ebola, H1NI, SARS, Covid-19; but what has happened, and what could be the impact of these uncontrollable events on the efficacy of not just the nations' global positioning rather at the verge of complete collapse of the 'Financial Institutions' that serves the foundation for a healthy beginning and sustenance. Unfortunately, the recent fiasco due to the impending failure to sustain by many of the institutions such as NBFCs, Banks, Asset Management Companies (AMCs), Microfinance institutions (MFIs), Lenders, Borrowers raises a big question on the entire *credit-risk* management. Additionally,

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one has to realise that its root lies in the last sovereign credit rating for India as BBB- by S&P and Baa2 (with negative outlook) by Moody's, which has further intensified the concern to worse (to borrow at much higher cost globally). The major risk that has risen among the dark clouds in the current scenario pertains to 'credit crunch' (credit crisis/ credit squeeze). Many policymakers and bureaucrats have called it a threat that has the capacity to lodge into the situation of 'liquidity trap'. Some others have called it the upcoming fiasco in the history of financial institutions, especially for AMCs.

MUTUAL FUND (MF) INDUSTRY

Does any pandemic or epidemic end up to a fiasco like the one, which Indian fund house(s) is undergoing? The recent news by one of the leading giants in the mutual fund industry has declared its' six leading funds closure just overnight. As per AMC officials, the big decision of winding-up these fixed-income funds (in no-time) added to liquidity pressure in the fund house, primarily due to high redemption pressure in the last 2 months (Refer Table-1). This renowned mutual fund house collapse for six of its debt funds has created a situation of panic among, not just the entire Mutual Fund Industry rather shaken the investors' sentiments upside down. Every investor shall think logically and apply brain, and not just be dependent upon the money 'Gurus'.

From Table-1 and Radar graph, the following pertinent findings emerge:

1) Asset under Management (AUM) has witnessed the highest plunge in the month of March 2020 during the last financial year, owing to obvious reasons due to corona pandemic.

2) Redemptions recorded soared unexpectedly to the highest level in the month of March 2020 during the second half (H2) of last financial year due to panic and hence weak sentiments among the investors' fraternity.

3) The figure 1 indicates the percentage (%) change in the average AUM during FY 2019-20. Evidently, the month of Mar-2020 books 13.5% lower vis-a-vis Feb-2020 as indicated by the sharp kink towards the lowest slab between -10% to -15% (in red), confirms the same.

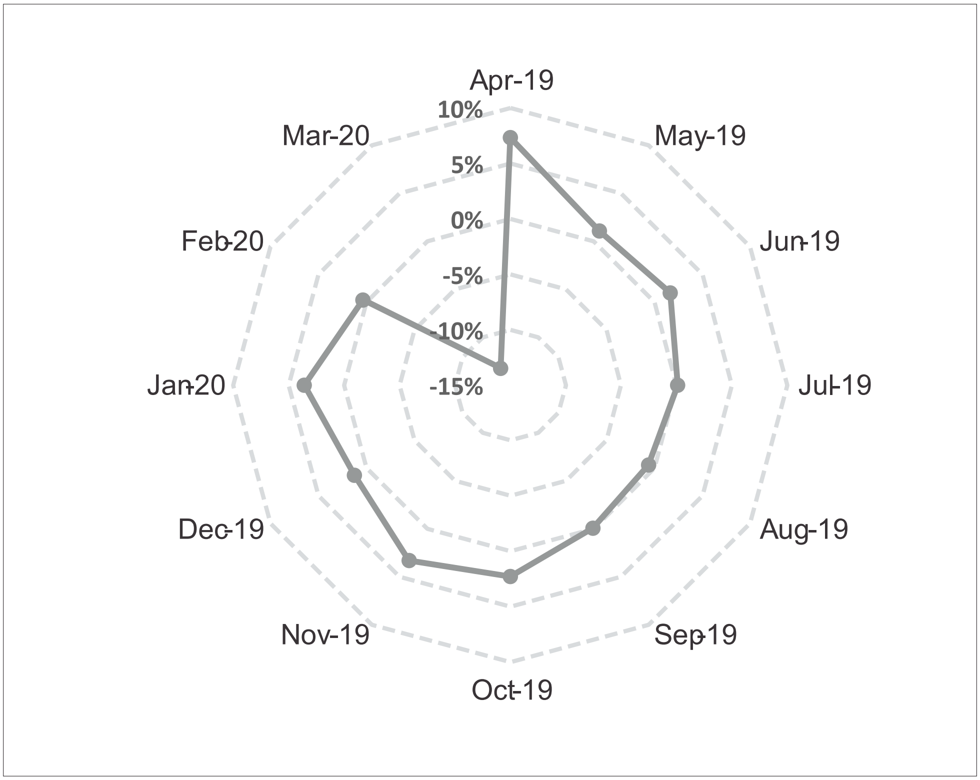
Table-1: AUM vis-à-vis Redemptions for FY 2019-20

Month	Avg. AUM for FY 2019-20 (Open Ended Funds)	Redemption for FY 2019-20 (Open Ended Funds)
Apr-19	2327025.39	1753290.38
May-19	2352016.08	2206828.97
Jun-19	2390999.05	2023991.97
Jul-19	2393301.38	2217875.18
Aug-19	2379075.59	1816077.22
Sep-19	2376752.65	1831365.60
Oct-19	2430562.30	1358618.90
Nov-19	2510043.32	826718.88
Dec-19	2541533.20	1211703.56
Jan-20	2633156.11	1030608.73
Feb-20	2642920.33	882771.90
Mar-20	**2292863.86**	**1524087.58**

Source: Authors' depiction based on data extracted from the Association of Mutual Funds in India (AMFI)[1]

1 Available at https://www.amfiindia.com/research-information/amfi-monthly [Accessed on 3rd May 2020].

Figure 1: Percentage change in AUM of MFs for FY 2019-20



Source: Authors' calculation based on Table 1

The current collapse of the giant mutual fund house has once again reinforced the fundamental belief that stories should be premised upon facts and not vice-versa. However, there is a huge risk of different biases that investors may fall an easy prey into – 1) Confirmation bias – 'follow the herd behavior', 2) Recency bias – 'everyone remembers the most recent news and try to act, thinking very short term', 3) Outcome bias – 'investors are often driven by results rather than concentrating on the process that sails through in the long run', 4) Survival bias – 'consistency prevails and diversification could be the only *sanjeevani*', 5) Framing bias – 'it is the perspective the same glass as *half full* or *half empty'*, 6) Action bias – 'it is easy to act than not to act, it takes effort *not to act* for wealth creation'.

Ironically, the time has reversed its trend where volatility in the *moderately low risky instruments* is unexpectedly high (compared to its historical usual trends) due to underlying reason of 'liquidity crunch' in financial institutions in the current scenario. If a similar sort of eventualities keeps on budding, the entire institutional framework of the nations will jeopardize and, certainly shall influence the developing nations worse. Needless to mention, the governments and central banks globally acted hawkish to avoid any future disruptions by announcing amalgamated fiscal and monetary stimulus at the beginning of Feb/ Mar 2020. The key point to ponder is that such direct liquidity infusion could really work in the Indian scenario at this juncture. Before reaching any conclusion, it is pertinent to identify the terminology in detail to evaluate the current picture lucidly.

Another dimension that needs careful vigilance under liquidity crunch, is the dampening effect on the AMCs. Standalone March 2020 has witnessed the gross redemptions of Rs 14 trillion, and the highest ever net outflows of Rs 1.94 trillion. This has created panic among many of the leading mutual fund houses, so much so, that they have approached RBI to seek liquidity support to hedge them from expected sharp redemptions, especially from liquid funds. During a pandemic, immunity against liquidity crunch for the mutual fund industry certainly could remain dubious.

Micro-Finance Institutions

Let's try and understand the impact of the current liquidity crisis for micro lenders (MFIs). Initially, in the month of March 2020, industry experts are of the opinion that COVID is an urban phenomenon and hence would be of least impact to the MFIs due to its' reach to rural and semi-urban areas. But the situation is quite the opposite. The recent relief announced by RBI to extend the moratorium till 31st May could be of little help in the current situation. Amid this liquidity tightness, MFIs are seeking fund support from the banks and other corporate giants. In such an event, MFIs are bound to take tough calls to assist their customers for suspension of payments, restructuring and ensuring liquidity in a crisis.

Indian Banking Sector

We were not completely over with the banking system concerns due to NPAs followed by 'PMC' and 'Yes Bank' collapse, that COVID-19 pandemic further intensified the global financial situation. The major concern has its root to 'credit crunch' that indicates a situation where there is a drastic drop in the lending capacity of financial institutions due to acute dearth of funds (cash inflows). Some say that it is an extension of recession cyclicity where even the leading corporates find it impossible to borrow due to higher probability of defaults that ultimately soars the interest rates artificially as an opportunity cost of undertaking higher risk. Such a situation if prevails for long may end up into a chronic phase of 'liquidity trap' (originally coined by J M Keynes) that is defined as an economic situation where consumers would prefer cash savings (instead of choosing higher-paying investments because of a negative economic view) with an expectation of a future rise in prices. Typically, it could be called as a scenario where expansionary monetary policy completely fails. Unfortunately, the liquidity trap does not confine to just the bonds rather could affect other areas of the economy due to decreased consumer spending (negative demand shock).

Let's also identify the central bank's efforts so far in India to tackle the current debacle. It started with RBI's announcement in the month of March 2020 for much-awaited and deserved relaxation on repo rate, reverse repo rate, and CRR along with moratorium period for repayments due to lockdown to as low as - 4.4% (0.75 down for repo), 3.75% (0.90 down for reverse repo) and 3% (1% down for CRR) in order to provide money infusion in the system to ease the liquidity. The second attempt to tackle the ongoing financial institutions' credit crisis, RBI has announced extended stimulus as a liquidity injection of 50k crores for standalone mutual fund industry. Some of the think-tanks have strongly recommended the only plausible option is by *monetizing the deficit* to fund government spending by printing currency in order to have the optimum money supply levels (due to monetary policy inefficacy). Some of the other western nations have already set in precedence with an early mover advantage for the same so as to maintain their current stance on the world map. The same has to be managed quite differently in case of India, where the `government essentially has to first level-up the production capacity at par so that it could deal the resulting inflation that may arise due to currency printing. Unanimously, we all would agree that it is the role of the government and central banking system in an economy to preserve financial stability.

Indian Corporate Sector

For the corporate sector, the earnings have witnessed a drastic plunge in the last quarter of FY 2018-19 (with the trail continued in 1st quarter of FY 2019-20) and the trend is not expected to reverse any soon, at least for next few quarters. To understand the trends, we have analyzed the top 4 BSE listed companies based upon their respective market capitalization quarter-wise for FY 19-20 (ending Mar-2020). Figures1 to 4 depicts the technical analysis comparison based on two parameters: Earning Per Share (EPS) and Net Profit (NP) to chalk out the pattern if any.

Figure 2: Reliance Industries Ltd. (RIL)

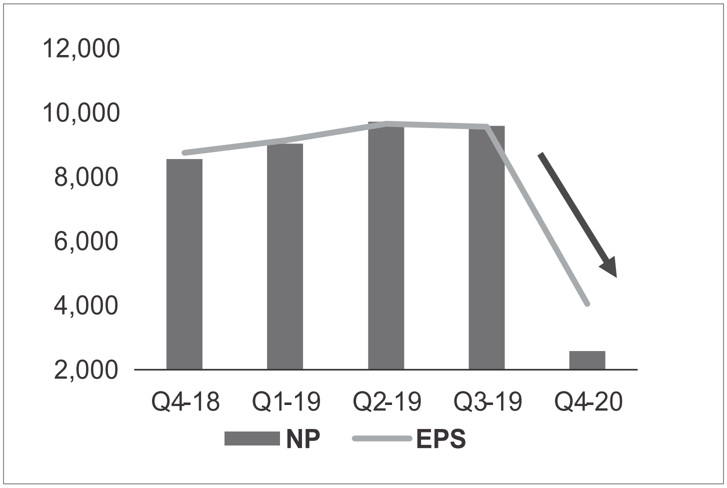


Figure 3: Hindustan Unilever Ltd. (HUL)

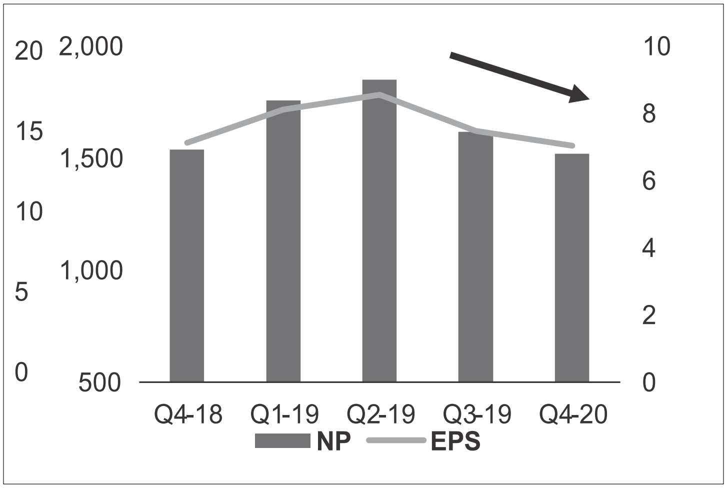


Figure 4: HDFC Bank Ltd.

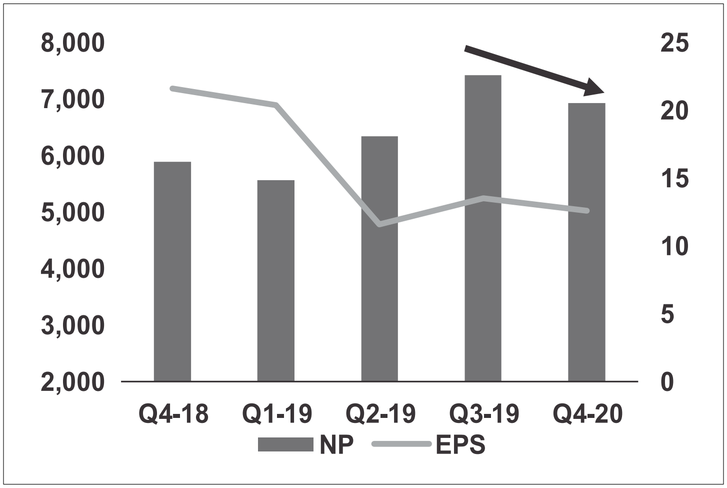
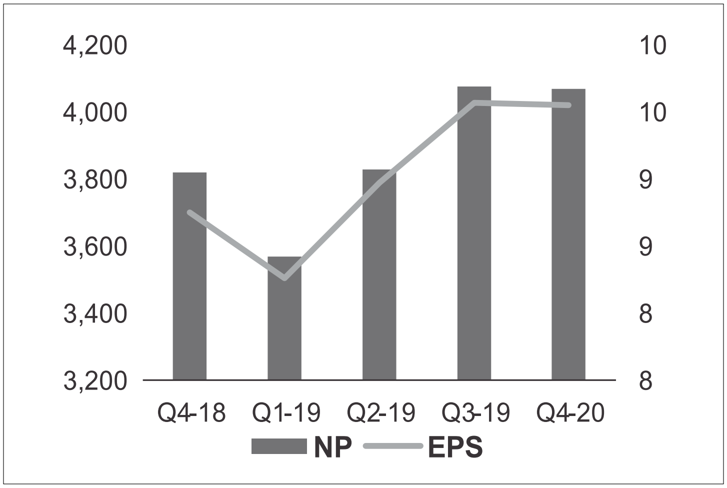


Figure 5: Infosys



Source: Authors' depiction based on data extracted from BSE portal as on 4th May 2020.

Following key pertinent observations emerge from Fig- 2 to 5:

1) All the four companies (with highest market cap as per BSE listing) have witnessed either dip or stagnancy in EPS and Net Profits in Q4 FY 19-20 ending as on Mar-2020 in particular (Refer Fig-2 to 5).

2) With formal lockdown announced in India from 24th March 2020, these companies have reported lower figures for profits and EPS in Q4 FY 19-20 (Refer Fig-2 to 4). Q1 FY 20-21 is expected to see even worse.

3) IT companies seem to have the least impact for the only reason that these are service-based and not product based (refer Fig-5).

4) Based upon separate analysis conducted for the manufacturing sector, the product sales volume dipped to its all-time low. If this persists for long, the same will aggravate the liquidity crisis among the corporates too.

The above indicates that the current pandemic has left the corporate sector scrambling for cash. Ironically, the situation cannot be compared at all with the 2008 financial crisis due to a difference in the growth trajectory before the crisis in 2008 vis-à-vis 2020. The key point to ponder is whether the Indian banking system could ensure the stability and survival to support in entirety when most of the corporates have so far failed to do the needful. Additionally, the time of action by the government is also questioned by some of the think-tanks for its due role only when everything has fallen apart. With greater leverage, the short-term ideology of private companies may not work. It is the situation of 'now or never' to act wisely and futuristic.

CONCLUSION

Needless to mention, the institutions are sailing through a grave phase. Since such natural-made (uncontrollable) disasters can't be planned in advance, the need of the hour is to think about macro prudential reforms that shall be a perfect amalgamation of both monetary and fiscal reforms to ease the liquidity and boost the economy post corona. The only silver lining that could emerge in the entire situation (in the corona phase) is that nations could really identify their respective inherent immunity to fight such unpredictable events. Further, institutions shall be strengthened much more than the current since these are the building blocks for any developing nation. For the mutual fund houses, they say that right asset allocation is the one that makes someone sleep well, duly balanced having the features of both fixed income securities and exposure of equity with simplicity. Fortunately, the current infusion has managed to cut-down net redemptions under credit risk category of funds by 81.5% just in three days (AMFI, 2020). Therefore, in order to have greater stability in the entire system, a series of such liquidity infusions might be the need of the hour depending upon the period of lockdown in future. The after-effects of such pandemics may take decades to recover, but it is said that *where there is a will, there is a way*. Much said and done, considering the current phase as the bad one, it has to follow the good one as per the concept of cyclicity.

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