Expectations from the Union Budget 2018

Equity markets have gained close to 1700 points since the start of this year and one of the key factors behind this bull run is the expectations from the Union Budget which will be presented on February 01, 2018. This budget is of increased significance as it will be the last full budget before the 2019 general elections. It is also the first budget since the introduction of GST.

Some of the key expectations from the budget are given below.

Expectations of the common man:

1. **Tax Slab Revision:** Post demonetisation, the government added 54 lakh new individual taxpayers in 2017 while the Goods and Services Tax (GST) brought Rs.92,283 crore to government's coffers. With the widened tax base, low evasion and high tax revenues from direct and indirect taxes, we can expect the direct tax rate will be lowered and the limit of non-taxable income increased.
2. **Housing:** The existing limit of loss on house property is Rs.2 lakhs and it can be carried forwards only for the next 8 years. It is difficult to achieve profits from a house property in the first eight years given that the loan instalments are high. Extension of this period/ raising the limit will benefit many homeowners. In addition to this, providing additional deduction for pre-construction interest and incentives for first time home buyers will be a welcome move.
3. **Taxation on Dividends:** Dividends are currently subject to Dividend Distribution Tax(DDT). In addition to this, Companies pay taxes on profits before distribution of dividends. Therefore, the current tax rate of 10% on dividends on excess of Rs. 10 lakhs creates a multiple layer of taxation on dividends and should be rationalized by enhancing the current limit/reducing or eliminating DDT.
4. **Increase in Section 80C cap:** Currently, section 80C allows deduction from gross total income (before arriving at taxable income) of up to Rs 1.5 lakh p.a on one or more eligible investments and specified expenses. This limit may not be enough for several tax payers, especially with FD interests at an all time low and the general public turning to alternate investment avenues.

Expectations of India Inc:

1. **Corporate Tax Rate:** There is an urgent need to revive private investment demand and to propel the "Make in India" program. Reducing the corporate tax rate will achieve these objectives and falls in line with the plan laid out by the Finance Minister in Budget 2015-16 to reduce the corporate tax rate to 25% over four years. Lower rates will lead to higher investments and job creation.
2. **Long term capital gains:** The Government is expected to tweak rules relating to taxation of capital gains from shares and increase the holding period for long term capital gains from shares to over two years from one year at present to bolster its revenues from financial markets. This is expected to dent equity markets. However, after an initial shock, the stock markets should stabilize. Domestic investors will realize that equities yield better post-tax returns than other asset classes and India will continue to be a part of the emerging market portfolio of foreign investors.
3. **Boosting Start-ups:** The Government is expected to focus on encouraging start-ups. The most important step towards this is reducing the angel tax which is currently 30.9%. With VCs typically scouting for angel-backed start-ups, money from angels or non-listed entities becomes imperative for the growth of a company. Other measures include capping the GST at 6-8% and reduction of regulations & policies faced by start-ups
4. **Job Creation:** The Government came into power promising to create 1 crore jobs. In an attempt to deliver on this, the Government is planning to introduce the country's first National

Employment Policy (NEP) in the Budget. The policy will outline a comprehensive road map for creation of quality jobs across sectors through economic, social and labour policy interventions. The multi-pronged employment policy will not only include incentives for employers to create more jobs, but also introduce reforms to attract enterprises and help medium and small-scale industries, which are major job providers.

Sectors expected to be in focus

Infrastructure: Infrastructure is expected to a priority in the Budget. Arun Jaitley has said that the Government wants to maintain the momentum at which new infrastructure is being developed in the country. The biggest ever highway development plan was recently approved by the Government under the Bharatmala Project. This year also witnessed the merging of the Railway budget with the Union Budget. Hence, railway infrastructure, rural infrastructure and housing are expected to form an important part of the Budget.

FinTech: Digital payments are expected to supersede cash by 2022. The government has created crucial supply-side infrastructure such as UPI, India Stack, eKYC, and Aadhar. It must address demand-side concerns and continue to incentivise digital payments and their providers to help the ecosystem gain greater adoption and synergy.

Healthcare: The current number of hospitals and primary healthcare centres fall far short of the requirement. Hence, this year's budget could see greater allocations for building more healthcare centres and medical institutes. The health care industry has also sought high investment in the diagnostics industry for early diagnosis of which in turn has the potential to improve productivity loss or delay onset of diseases or eliminate the necessity for tertiary treatment. For the people below the poverty line, the insurance cover provided by Rashtriya Swasthya Bima Yojana (RSBY) is expected to be increased from the current Rs.30,000.

Impact of the Budget on the market

Since 2010, the Sensex has gone up six times out of nine in the month after the budget. However, this time around, there is unlikely to be a sharp surge in Indian indices post the Budget (upside, if any, could be around 5%) because the markets are already at an all-time high and valuations are pricey. The current PE ratio of Nifty is 27.6. The primary factors holding sway over the market are likely to be the Union Budget's commentary on fiscal deficit and government's disinvestment target. A disinvestment target in excess of Rs.75,000 crores will be negative for the equity markets. Indian markets are now inextricably linked to global markets and the direction of global markets after the budget will matter.

Credence Capital

The Grand Bank Recapitalization Plan

Earlier this week, the finance ministry came out with its plan to recapitalize Indian public sector banks (PSBs). Accordingly, the PSBs would be infused with capital to the tune of Rs 88,139 crore by March 2018. This will be the first part of the Rs 2.11 lakh crore recap plan announced by the government in October last year.

The following set of questions and answers aim to make the reader aware of the entire purpose of the bank recapitalisation exercise.

Q) What is capital for a bank?

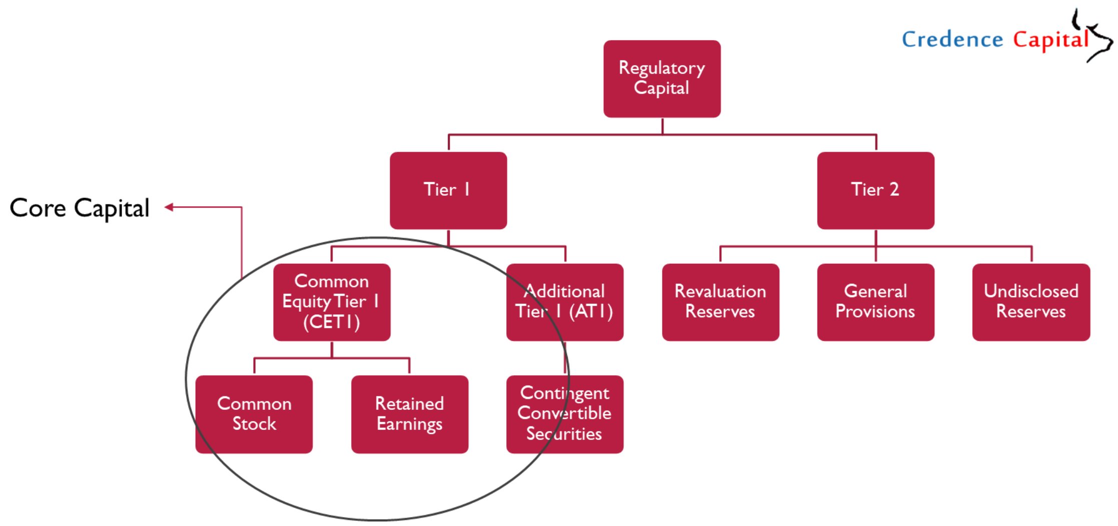
Ans) Put simply, capital is the buffer that banks have to absorb ***unexpected*** losses. It is analogous to equity for a traditional firm. However, having excess capital as against debt is not typically useful for a bank. This is because debt provides greater leverage and hence opportunities for the bank to make more money (and losses). That is why holding on to excess capital is expensive.

If the value of a bank's assets decreases (say loan defaults), then something on the liabilities side of the balance sheet(BS) has to reduce in value to keep the BS balanced. A capital cushion helps to withstand such losses. Other liabilities like inter-bank loans, customer deposits or RBI loans cannot be used for this purpose as the bank is obligated to pay back its lenders and customers.

Note that the operating word here is "***unexpected***" losses. Expected losses are provided for by provisions, reserves and retained earnings.

Q) In what ways is capital classified in the banking industry?

Ans)



Q) Why are capital requirements so important for banks?

Ans) Post the financial crisis of 2007-08, regulators around the world have enforced multiple regulations that require banks to maintain certain **capital standards** so that banks are in a better position absorb shocks and the systemic risk of the banking system comes down. **Stress tests** (like the Comprehensive Capital Analysis and Review, Dodd-Frank Act Stress Test) have also been introduced. These require banks to simulate stress scenarios (like a stock market crash) and submit the resultant impact on their BS and income statements. Under no situation, should the bank's capital numbers fall below the minimum requirement set by the regulator. If adverse results are indeed posted, it implies that the bank is not sufficiently capitalized and can pose a potential risk in the future. This may force the regulator to step in and put curbs on the way a bank conducts its businesses. The results of the stress tests are in public domain and influence bank ratings.

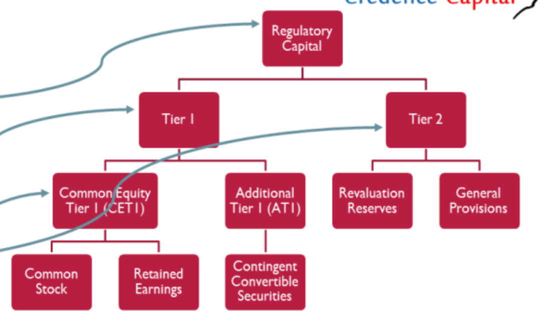
In India, as per the RBI directive, banks have to comply with the **Basel III norms** by March 2019. According to these, banks have to adhere to specific **capital ratios**, some of which are listed below.

$$Capital\,Adequacy\,Ratio = \frac{(Tier\ 1\ Capital + Tier\ 2\ Capital)}{Risk\ Weighted\ Assets} >= 11.5\%$$

$$\textbf{Tier1 Ratio} = \frac{Tier1\ Capital}{Risk\ Weighted\ Assets} >= 9.5\%$$

$$\textbf{Tier2 Ratio} = \frac{Tier2\ Capital}{Risk\ Weighted\ Assets} >= 2.0\%$$

$$\textbf{CET1 Ratio} = \frac{CET1}{Risk\ Weighted\ Assets} >= 8.0\%$$



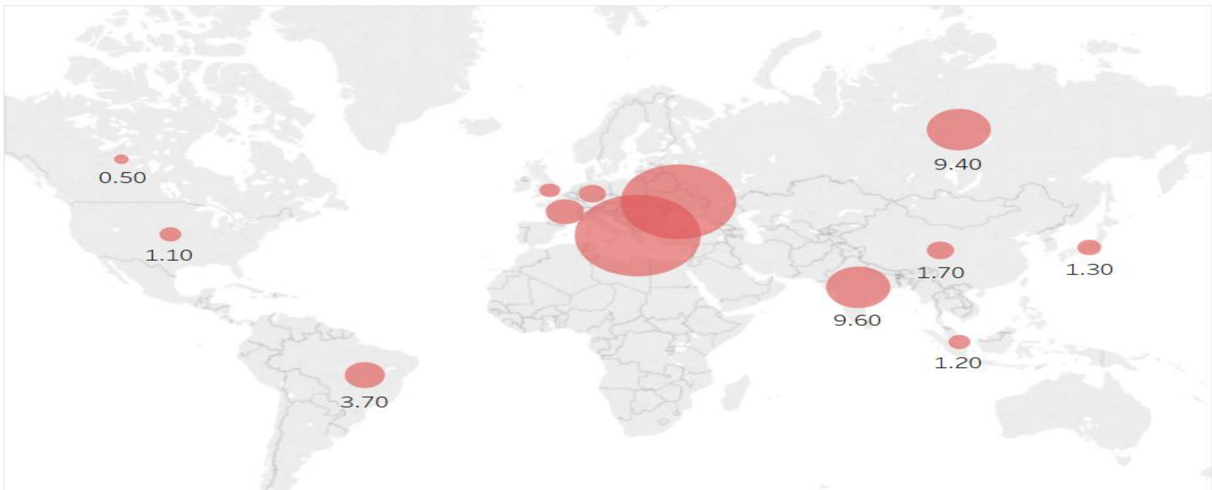
Q) So why are the Indian PSBs not sufficiently capitalized?

Ans) Simple answer – Non Performing Assets (NPAs). Lax loan underwriting by the PSBs (prior to 2015) is the major reason for the NPA problem in India.

An NPA is defined as an advance, or a loan wherein interest and/ or instalment of principal remain overdue for a period of more than 90 days.

Amongst the major economies of the world, India has the 2nd highest ratio of NPAs to total advances.

Share of Banks' Non-Performing Assets (in %)



Source: The Hindu

Currently, the stressed assets held by Indian banks amount to Rs 8.4 lakh crore. The PSBs are the primary culprits of the bad loan problem. They account for nearly 87% of the bad loans, with IDBI and the Indian Overseas Bank reporting as much as 24% of their advances as NPAs. Given the grim situation, the PSBs would have to be recapitalized and hence mandated government intervention. However, the recap plan of Rs 2.11 lakh crore (against Rs 8.4 lakh crore required) may not prove to be sufficient to alleviate all the pains of the banking sector. Nevertheless, the plan indicates that the government would not let the PSBs fail, as they are crucial for growth especially given their increasing presence in rural India. At the same time, the government has also made it clear that going forward the PSBs would have to reposition themselves as '*responsive'* and '*responsible'* banks.

Q) How would the bank recap work?

Ans) Of the Rs 2.11 lakh crore capital infusion plan, Rs 1.35 lakh crore would come via recap bonds and the remaining would come from budgetary allocation and the individual banks' own capital raising efforts from the market.

Recap bonds would be special long term, non SLR (statutory liquidity ratio), non-tradable bonds carrying a coupon rate equal to a comparable government security plus the government spread. Only banks can subscribe to the bonds. The bonds would be cash-neutral for the government in the sense that the money raised from the bonds subscription would be used to buy equity shares of the banks (thus shoring up the banks' capital).

Impact of Rising Oil prices on the Indian economy

Oil prices have been rising steadily, reaching their highest level since 2014. WTI crude has reached USD 65 and Brent crude at USD 70, which could have a significant impact on India, the world's third-largest oil importer.

QUICK OVERVIEW

Factors Driving the price rise

- Recovery in global economy and faster growth, creating a strong demand
- Higher than expected compliance in OPEC production cuts
- Geopolitical uncertainty in US-North Korea relations, demonstration in Iran and instability in Venezuela
- Slower uptake by US shale producers

Impact on the Indian economy

- Increase in trade deficit, and consequently, current account deficit
- Lower tax realization for Govt. due to decrease in excise duty and consequent rise in fiscal deficit
- Increase in inflation & depreciating INR, leading to lower room for RBI rate cuts
- Increase in bond yields & rising cost of borrowing, leading to lesser investment spending & consequent loss of GDP growth

Further risks

- Possible supply disruptions in politically stressed producers like Iraq, Libya and Nigeria
- Stronger demand growth
- Govt. finances could deteriorate rapidly due to upcoming election pressures & need to create economic boom, breaching fiscal deficit targets

INDEPTH TAKE

India was a major beneficiary of a sharp fall in oil prices starting in 2014 to $28 per barrel in 2016; the government shored up its revenues by significantly increasing excise duties on petroleum products without fully passing on the benefits of lower crude prices to consumers.

An analysis by JP Morgan indicates that India experienced a huge positive terms of trade shock due to the decline in oil prices. India meets about 80% of its entire fuel demand through imports. Net oil imports collapsed from 5.3% of GDP in 2014 to 3.2% of GDP in 2015. Consequently, India gained a 2.1% of GDP windfall. Of this saving, about 1.3 per cent of GDP was spent, thereby boosting growth by that amount, spread across two fiscal years. Over that time, India's GDP growth averaged 7.4 per cent. Additionally, govt. finances improved by approx. 0.9% of GDP due to increase in excise duty and reduction in fuel subsidies.

Now, all this is set for a reversal. The Indian basket of crude, which cost $46.56 a barrel in June 2017, rose to $77.22 on 22 January as the Organization of the Petroleum Exporting Countries, or OPEC, and Russia cut supplies. A further rise in oil prices will force the government to reduce excise duties in an already fiscally uncertain year owing to GST. The central government has already slashed taxes on petrol and diesel, which remain outside of GST, by Rs 2 a litre in October. High oil prices will also lead to increased spending on cooking gas subsidy. This can greatly affect India's fiscal math, even as the government faces the need to create a positive economic sentiment owing to the upcoming state and central elections.

Why is the fiscal situation important? Wider deficits will weaken the government bonds due to more govt. borrowing as well as the rupee. If the government borrows more from the market to meet its expenses, that will leave less money for private investors. Higher interest rates would ensue, making bank loans less attractive for investors.

The immediate worry is also the inflationary impact. Retail inflation has surged to a 17-month high of 5.21% in December from 4.88% in October, after remaining below 4% for 12 consecutive months, on higher food and fuel prices. Most economists say the Reserve Bank of India will have to keep its policy rates unchanged, and may even have to hike rates if retail inflation remains above 5% for two consecutive quarters in 2018. Higher interest rates at a time of tepid investment demand and weak consumer sentiment will put the onus of reviving the economy on fiscal policy, which may further complicate the fiscal situation.

Already starved of private investments in production capacities, any further slump will dent India's economic growth potential. Profit margins of companies which have crude and crude derivatives as their significant raw material components, the prices of which are linked to the market price, could see contraction. Industries such as airlines, tyre manufacturing and paint producers, may face strong downside risks to their margins, if the price of crude oil stays on the higher end or rises further.

Trends in FinTech and its impact on Financial Institutions

INTRODUCTION

FinTech is a buzzword these days, something which the internet was in the 1990s and the early 2000s. In layman terms, FinTech refers to leveraging technology to provide financial services to individuals and companies. It is an industry which is considered lucrative with VCs and corporate banks alike. Cumulative investments in FinTech were ~USD 25 Bn in 2015 (Source: KPMG), which is enough to make people consider whether FinTech is worth the money, does it have the capability to disrupt the status quo. FinTech is dependent on Artificial Intelligence, and as witnessed from its impact on other sectors, it is possible that it may change the Financial Services industry the same way internet made librarians obsolete.

TYPES OF FINTECH FIRMS

Application of technology is endless, and thus FinTech is no exception. It is a broad field, and thus comparing two dissimilar companies will be like comparing apples to oranges. The common linkage is technology, i.e. the application of Machine Learning and Artificial Intelligence. The following are the different types of FinTech firms:

FINANCIAL CONSULTANTS

Firms like TAINA Tech assist their corporate and individual clients in maintaining regulatory compliance. These activities may range from filing tax returns to ensuring that the standards of FATCA, Basel, IFRS, or any other regulatory body is met.

In a complicated legal environment, application of technology significantly reduced personnel requirements and that is the operational advantage such firms have over their traditional counterparts.

PAYMENTS PROCESSING COMPANY

Digital transaction firms are perhaps causing the biggest blow to the financial services companies. They are taking the basic function of banks away from them.

International Transactions Processing

Companies like TransferWise (Valued at USD 1 Bn) are peer to peer money transfer business which transfer money without the transaction costs. They also transfer money across international borders at a rate cheaper than what a bank would charge, less the remittance tax. They are not alone in this space. Currency Cloud processes USD 15 Bn annually for 125 corporate clients, assisting in cross border money transfer. WorldRemit is challenging Western Union by targeting the USD 600 Bn remittances market. Transferring money through mobile wallets is cheaper than using banking services, and that has many players worried.

Peer to Peer Transactions

Companies like Adyen are servicing huge corporate clients like UBER to help them reducing their transaction costs. In a crowded field with players like Stripe and Braintree, Adyen has received a valuation of USD 2.3 Bn, which signals to banks that VCs are serious about putting them out of business. Popularity of Google and Apple wallets signals to the firms that their days are numbered. Firms like Klarna are the next generation of PayPal, having their reach globally. Businesses no longer need to fulfil a minimum requirement to conduct online transactions. In India, companies like Airtel also have their own wallets, and Telcom companies are seeming to be an unexpected rival to the banking industry.

iZettle and Square provide plug and play card readers that can be attached to mobiles, tablets and smartphones. They are supported hugely by Mastercard.

INVESTMENT MANAGEMENT

Firms like NutMeg and eToro are new investment platforms that are helping take the market from the broker to the App. They provide a social media environment in the market, and also, don't charge a transaction or brokerage fees.

They move the whole personal finance ecosystem online. They help people in bill payments, money management, financial advisory, and a plethora of other activities which were erstwhile performed by banks and brokers

PEER TO PEER LENDING

Funding Circle, Zopa and Lending Club are major players in the peer to peer lending market. Such firms have one of two business models. Either they act as middlemen, connecting risk taking investors with individuals or institutions who require a loan, or they act as investment houses and provide loans themselves. They provide access to cheaper credit than the banks for a person with little to no credit history and makes loans which are risky.

They operate in the shadow banking space and peer to peer lending firms were responsible to 14% of the corporate loans to SMEs given out in Britain in 2016. That is enough to show that such firms are not trivial.

WHY ARE FINTECH FIRMS SUCCESSFUL?

FinTech Firms have proven to be successful because of the following reasons:

1. Lax Regulatory Requirements:
    a. They don't follow the traditional banking model. For example, P2P lenders can get money from investors, and don't have to depend on CASA accounts. That frees them up to take bigger risks
    b. Regulations are not well defined in the FinTech Marketplace and they are able to take an advantage of regulatory arbitrage.
2. Small Scale of Operations:
    a. Due to a small scale of operations and availability of VC backing, FinTech firms can afford to absorb losses. Not having to worry about their bottom line is a huge advantage they have over their traditional counterparts

3. Technological Advantage: FinTech firms have a technological edge over their counterparts.
    a. AI is helping them reduce manpower and hence improve margins
    b. AI is helping them identify the creditworthiness of their potential borrowers more accurately thus fueling their risk appetite
    c. AI is helping them take advantage of regulatory arbitrage
    d. AI is helping them give out financial advice

These advantages result in the following:

1. Little to no transaction costs, helping businesses save millions whether in intercountry or intracountry transactions
2. More convenience to customers, whether it be borrowers, or investors, or simply working people who need to perform day to day routine transactions

FinTech firms are thus encroaching on businesses that were considered to be safe by big financial institutions.

WHAT DOES THE FUTURE HAVE IN HOLD FOR FINTECH?

FinTech is a little child at this moment and its fate could go either way. Some of the risks that can be challenging for FinTech are:

1. They have emerged just after the recession when people were distrustful of banks, and regulatory requirements were tightening (Implementation of Dodd Frank, Basel III, etc.). Hence they enjoy goodwill which they will have to maintain
2. We are in a period when the market is hitting all-time highs and such firms have not stood the test of a difficult economy
3. They are yet to prove their mettle at the scale at which the global banks perform, and they are unlikely to dodge regulations if such comes to be the case
4. Unregulated FinTech could potentially fuel another financial crisis. Banks are up and arms about this, and globally are pushing regulators to tighten their hold on firms before they scale

CONCLUSION

FinTech has undoubtedly created an impact on the market. They have the interest of all the major VCs and corporate investors in the tech space. And they are here to stay, whether as a new sector, or whether absorbed in traditional financial institutions. They have democratized a sector which was seen by the public as an elite club. Whether they challenge the existing institutions or become a part of it is a question that can only answered by time.