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Financial Stability Report: RBI

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Financial Stability Report: RBI

- The FSR reflects the collective assessment of the Sub-Committee of the Financial Stability and Development Council (FSDC - headed by the Governor of RBI) on risks to financial stability and the resilience of the financial system.

- The Report also discusses issues relating to development and regulation of the financial sector.

Key Points

Increase in Bad Loans:

- The RBI warned that the Gross Non-performing Assets (GNPA) ratio of all Scheduled Commercial Banks (SCBs) may increase from 8.5% in March 2020 to 12.5% by March 2021.

- The GNPA ratio may also worsen to as high as 14.7% by the end of the current financial year, if the adverse economic impact of the Covid-19 pandemic would be 'very severe'.

- According to experts at least 5% of the moratorium loans could turn into NPA if Covid-19 impact persists in the economy.

- In the wake of Covid-19, the RBI had announced a six months loan moratorium to all term loans. The moratorium was first given for March-May (2020) but was later extended to June- August (2020).

- The Covid-19 lockdown had a significant impact on all industrial activities in the economy resulting in major income loss. This has impacted their loan repayment ability.

- This may lead to Gross Domestic Product (GDP) contraction by 8.9% in 2020-21.

Decreasing Capital Adequacy Ratio:

- The RBI projected that Capital Adequacy Ratio (CAR) ratio could slide to 13.3% in March 2021 under the normal scenario and to 11.8% under the very severe stress scenario.

- CAR is the ratio of a bank's capital in relation to its risk weighted assets and current liabilities. It is also known as Capital-to-Risk Weighted Asset Ratio (CRAR). Indian SCBs are required to maintain a CAR of 9%.

- Earlier the CAR of SCBs decreased to 14.8% in March 2020, from 15% in September 2019.

Risk Aversion by Banks:

- Risk aversion in Public Sector Bank (PSBs) was more as compared to private banks. PSBs chose to give money only to high-quality borrowers.

- However, the risk aversion tendency is also increasing in private banks.

- RBI has warned that extreme risk aversion would have adverse effects on the economy.

Risk to Financial System:

- The RBI said that the Indian financial system remained stable, despite the significant downside risks to economic prospects.
- The downside risks to short term economic prospects are high due to the lockdown induced disruptions to both supply and demand side factors, diminished consumer confidence and risk aversion.

Issues Involved:

- Recently, the former RBI Governor Urjit Patel has criticised the government for diluting the Insolvency and Bankruptcy Code (IBC) and the powers of the RBI.
- He has said that this has undermined the efforts made since 2014 to clean up the bad loan mess.
- The government uses ownership of banks as a means for day-to-day macroeconomic management rather than primarily for efficient intermediation between savers and borrowers.
- Banks have poor asset quality, lack of profitability, loss of capital, excessive risk exposure, poor conduct, and liquidity concerns.
- There is also a lack of a mechanism to address bank failures.
- Stress on Non-banking Finance Companies (NBFCs) and mutual funds is emerging as a strain on the financial system.

Suggestions:

- All the financial intermediaries need to assess the impact of Covid-19 on their balance sheet, asset quality, liquidity, profitability and capital adequacy for the FY 2020-21 and to work out possible mitigating measures.

- The idea is to ensure continued credit supply to different sectors of the economy and maintain financial stability.

- Financial intermediaries should make risk management in tune with the emerging contingencies.

- The risk management includes, building buffers and raising capital, which will strengthen the internal defences of banks against the risks posed by Covid-19 and also ensure credit flow.

- Recapitalisation plan for Public Sector Banks (PSBs) and private banks since the minimum capital requirements of banks may no longer be sufficient enough to absorb the losses.

- The minimum capital requirements of banks are calibrated based on historical loss events.