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RBI releases Financial Stability Report – December 2013

The Reserve Bank of India today released the Financial Stability Report (FSR) – December 2013. The eighth in the series, the FSR – December 2013 is being released against the backdrop of a mild positive market reaction to the announcement of tapering in the US Federal Reserves' bond purchase programme from January 2014. The commencement of the taper should signal a calibrated return to normal liquidity and credit conditions in the global markets and also better pricing of risk. This will mean a repricing of certain assets with consequent volatility. Efforts during the past few months have been directed to make the Indian economy more resilient to the ultimate withdrawal of liquidity from the system and less reliant on unstable external capital for growth.

The FSR, published every six months, aims to create awareness about the vulnerabilities in the financial system, to inform about the resilience to stress of the financial institutions and to generally serve as a health check on the financial system.

The Report reflects the collective assessment of the Sub-Committee of the Financial Stability and Development Council (FSDC) on risks to financial stability.

Highlights:

- The US Federal Reserve has now laid to rest the uncertainty on timing of the exit and tapering in its bond purchase programme, which is set to begin from January 2014. However, financial market volatility will be conditioned by the pace of tapering going forward.

  (Paras 1.1 – 1.2, Chapter I)

- Realignment of global growth as well as high inflation differential between advanced economies (AEs) and Emerging Markets and Developing Economies (EMDEs) is a potential source of exchange rate volatility and may result in volatile cross-border flows with every repricing of risk.

  (Paras 1.4 – 1.5, Chapter I)

- The delay in tapering allowed India to bring about adjustment in the current account deficit (CAD) and build buffers by replenishing its foreign exchange reserves. However, macro-economic adjustment is far from complete, with persistence of high inflation amidst growth slowdown. Fall in domestic savings and high fiscal deficit are other major concerns for India.

  (Paras 1.8 – 1.23, Chapter I)

- Corporate performance continues to be weighed down by boom period expansions and excess capacities, amid shifting asset composition towards financial investments.

(Paras1.24 - 1.27, Chapter I)

- House prices and outstanding loans for housing by housing finance companies have grown relatively faster during the last few years.

(Para 1.32, Chapter I)

- Inadequate social security coverage in India against a backdrop of changing demographics will pose challenges for expanding the pension system given the fiscal constraints. The National Pension System (NPS) was created to serve Government employees and private sector workers.

(Paras 1.35 – 1.37, Chapter I)

- The risks to the banking sector have further increased since the publication of the previous FSR in June this year. All major risk dimensions captured in the Banking Stability Indicator show increase in vulnerabilities in the banking sector.

(Para 2.1, Chapter II)

- Network tools have been used to assess impact of contagion due to risk of credit concentration. Failure of a major corporate or a major corporate group could trigger a contagion in the banking system due to exposures of a large number of banks to such corporates.

(Paras 2.4 – 2.17, Chapter II)

- Asset quality continues to be a major concern for Scheduled Commercial Banks (SCBs). The Gross Non-performing Assets ratio of SCBs as well as their restructured standard advances ratio have increased. Therefore, the total stressed advances ratio rose significantly to 10.2 per cent of total advances as at end September 2013 from 9.2 per cent of March 2013.

(Paras 2.28 – 2.29, Chapter II)

- Five sectors, namely, Infrastructure, Iron & Steel, Textiles, Aviation and Mining together contribute 24 percent of total advances of SCBs, and account for around 53 per cent of their total stressed advances.

(Paras 2.34 – 2.37, Chapter II)

- Macro stress tests on credit risk suggest that if the adverse macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further. However, under improved conditions, the present trend in credit quality may reverse during the second half of 2014-15.

(Paras 2.51 – 2.61, Chapter II)

- India stands committed to the implementation of the global regulatory reforms agenda and has made considerable progress on this front. Although firms and markets are beginning to adjust to the regulatory approach towards ending too-big-to-fail (TBTF), recent research indicates continued expectation of sovereign support to such institutions.

(Paras 3.1 – 3.5, Chapter III)

- Due to the interconnectedness with banks, liquidity pressure is felt by the money market mutual funds (MMMFs) whenever redemption requirements of banks are large and simultaneous. Regulatory measures taken to reduce the degree of interconnectedness seem to have been successful in reducing the liquidity risk in the system.

(Paras 3.13 – 3.17, Chapter III)

- India's domestic markets for interest rate derivatives have not taken off due to the absence of some of the basic building blocks. Efforts are on to address these issues.

(Paras 3.22 – 3.26, Chapter III)

- Action to create central repositories for the banking sector, corporate bond market and insurance sector has been initiated. This move is expected to break the information asymmetry in those markets.

(Paras 3.31 – 3.37, Chapter III)

- It has been observed that the equity prices of the companies in which the promoters had pledged significant portions of their shares, are relatively more volatile than the broader market during times of correction.

(Paras 3.51 – 3.55, Chapter III)

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Principal Chief General Manager

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