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India's Financial Sector remained Stress-free; But Risks arising from Macro-Economic Soft Spots and Global Growth Asymmetries remain: RBI's Second Financial Stability Report

The Reserve Bank of India presented its assessment of the health of India's financial sector in the second Financial Stability Report (FSR), released here today. The report reflects the Reserve Bank's continuing endeavour to communicate its assessment of the incipient risks to financial sector stability. The first FSR was released in March 2010.

The second FSR holistically assesses, from a systemic risk perspective, disparate elements of the financial sector eco-structure – the macroeconomic setting, policies, markets, institutions. The movements of various vulnerabilities between March and December 2010 and assessment of the resilience of the financial system have been presented in this Report. It also reflects the considerable efforts made within the Reserve Bank to upgrade the methods and techniques for assessing the health of the financial system in identifying and analysing potential risks to systemic stability.

According to the Report, growth has rebounded strongly in the Indian economy while financial conditions remained stable since the publication of the first Financial Stability Report (FSR) in March 2010. The financial sector in India remained stress-free notwithstanding intermittent volatility, especially in equity and foreign exchange markets. This is also displayed by the Financial Stress Indicator for India, which was introduced in the first FSR. Financial institutions remained healthy, credit offtake has picked up, as has profitability, especially in the first half of 2010-11. The Banking Stability Index points to a healthy improvement in the stability of the banking sector over the past few years. This is corroborated by the results of a range of stress tests undertaken by the Reserve Bank.

The Report points at some discernible soft spots. The current account deficit is widening while capital flows continue to be dominated by volatile components. External sector ratios have deteriorated, fiscal conditions are still under pressure and inflationary pressures persist. Liquidity conditions tightened beyond the Reserve Bank's comfort level and some policy measures have recently been taken to alleviate the stress. Some issues in the financial market microstructure will need to be addressed. Asset quality of banks and their asset-liability management position continue to warrant monitoring. Regulatory gaps in the non-banking financial sector will need to be plugged. A robust macro prudential framework for identification of systemic risks will need to be set up. Convergence with the emergent international reforms agenda presents challenges and will require careful calibration.

Referring to some tail risks to financial stability, the Report states that they are largely exogenous given the increasing correlation between global growth and that in Emerging Market Economies(EMEs), including India. The finance channel has assumed greater importance increasing the pace and degree of contagion from disturbances abroad, it states. Similarly, business cycle synchronisation of the Indian economy with most of the advanced economies and other EMEs has increased. With both financial and real sector still under stress in advanced economies, India will have to guard against vulnerabilities arising from risks to global growth and financial stability.

That the Reserve Bank will soon release the Financial Stability Report was announced in the Second Quarter Review of the Monetary Policy 2010-11 in November, 2010.

Highlights

Global Environment

- Global recovery continues to be uneven and uncertain while downside risks remain significant;
- A prolonged low interest rate regime in advanced countries, the two-track global recovery and divergent course of monetary policy actions have created push and pull factors for large capital inflows into EMEs;
- Global imbalances continue to persist and the progress towards rebalancing remains too slow;
- Significant amounts of sovereign debt, especially in European countries, are maturing in the next few years and any renewed turbulence could severely impair the fragile global recovery.

Domestic Outlook and Assessment

- In India, growth has rebounded strongly but inflationary pressures persist, driven both by domestic demand and increasing global commodity prices. Inflation, particularly food inflation, in India continues to rule at elevated levels reflecting in part the structural demand-supply mismatches resulting from, inter alia, rising incomes and changing consumption patterns;
- External sector ratios for India have deteriorated, fiscal conditions are still under pressure and inflationary pressures remain elevated;
- A potentially worrying feature of capital flows to India has been the dominance of portfolio flows which are prone to sudden stops and reversals. However, at present, stressed liquidity conditions warrant caution and a watchful management in the coming months;
- Household and corporate balance sheets are healthy.

Financial Markets

- Efficacy of the LAF corridor needs to be improved;
- Need for a well-developed term structure in money markets;
- Deeper and more liquid bond markets desirable;
- Increased integration of domestic financial markets has led to volatilities in forex markets rising in alignment with international levels;
- Growing offshore Rupee markets constrains the policy actions for maintaining orderly conditions in the domestic markets;
- Concentration of market activities in a few participants makes the market prone to bouts of illiquidity.

Financial Institutions

- Financial sector remained resilient but vigilance on asset quality and liquidity is needed;
- Provision coverage ratio met in aggregate, some laggards;
- Infrastructure loans could heighten ALM risks though there are mitigants;
- Off balance sheet (OBS) exposures of foreign banks warrants monitoring;
- A robust co-operative banking sector is critical for financial inclusion.

Regulatory Environment

- The proposed capital rules pose some challenges but the banking system is not likely to be unduly stretched;
- Leverage and liquidity norms not binding constraints but pose some challenges;
- Implementing international norms calibrated to local conditions will require concerted efforts;
- The supervisory structure for financial conglomerates (FC) will have to draw on international policy developments;
- NBFCs vis-a-vis banks – a few avenues for regulatory arbitrage remain;
- Entity regulation could leave regulatory gaps which need to be addressed;
- Microfinance institutions (MFIs) – recent concerns warrant closer examination;
- Network connectivity important for ascertaining systemic vulnerabilities;
- Strengthening the institutional mechanism for financial stability.

Financial Infrastructure

- Financial Market Infrastructure remained robust;
- Systemic risk bearing capacity of Central Counter-Parties has become critical;
- Deposit insurance system in India robust but some critical issues remain.

Stress Testing

- Stress testing on the credit, market and liquidity risks indicates a reasonable degree of resilience of the banking sector in India. The banking sector also displays resilience in response to stressed domestic macroeconomic variables;
- The impact of strong headwinds arising from any sharp deterioration in the global economic situation needs to be monitored;
- Some deterioration in the capital position of banks is evidenced only in case of a very sharp increase from the current NPA levels;
- Rising Interest rates and liquidity constraints under stringent stress scenarios faced by some banks warrant monitoring.

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