

## Foreword

This second edition of the *Financial Stability Report* (FSR) reflects the Reserve Bank's continuing endeavour to communicate our assessment of the incipient risks to financial sector stability. The objective is to interpret and assess disparate elements of the financial sector eco-structure – the macroeconomic setting, policies, markets, institutions – holistically from a systemic risk perspective.

Since the publication of the first FSR in March 2010, the differential in the pace of recovery between the advanced economies and the emerging market economies (EMEs) has further widened. In India, growth has rebounded strongly but inflationary pressures persist, driven both by domestic demand and increasing global commodity prices.

The policy agenda in most EMEs in recent months has been dominated by the management of capital flows. India's dilemma is somewhat contrarian to this. Our concern has been not so much the quantum of flows, which we have been able to absorb because of the widened current account deficit, but rather the nature of these flows. Much of the capital has come in the form of short term portfolio flows and debt flows which are significantly prone to sudden stops and reversals. While the level of reserves has imparted strength to our balance of payments, there has not been much accretion to reserves over the past several months which could alter the equation if global patterns of capital flows change significantly.

India's financial sector has by and large remained resilient save for some strains in the money market on account of tight liquidity. Banks continue to be well capitalised and the asset quality at the aggregate level does not cause serious concerns. The Reserve Bank will continue to monitor and address sectoral exposures as in the past. Effective management of asset-liability mismatches by banks, particularly in view of large long-term infrastructure related exposures, would be a key challenge to be addressed. The Reserve Bank is continuing its efforts to strengthen the prudential framework for banks and non-banking financial institutions. Strengthening the regulation of systemic linkages of large NBFCs and addressing regulatory gaps in the non-banking space would be key focus areas.

There have been significant efforts at both domestic and international levels to strengthen and preserve financial stability. This FSR presents, *inter alia*, an assessment of the Indian position on financial stability relative to the reform agenda being contemplated internationally. It highlights that the adjustment needed to comply with many of these reforms is not likely to stretch our banking system unduly since several of the key prudential safeguards are already part of the domestic regulatory framework. The extended implementation schedules will also ease the adjustment process. However, the space for future capital requirements for banks in a growing economy needs to be taken into account in evaluating the impact of the reforms on the Indian system. There remain important challenges which the regulators, financial market participants and all stakeholders will have to collectively address.

The Financial Stability and Development Council (FSDC) that the Finance Minister mooted in the budget in February 2010 is taking shape. The Reserve Bank's role in it would expectedly be critical. Meanwhile, considerable efforts have been made within the Reserve Bank to upgrade the methods and techniques for assessing the health of the financial system and for identifying and analysing potential risks to systemic stability. This FSR presents the results of some of these efforts.

Pursuit of financial stability is a continuing endeavour - much like the Greek mythological character Sisyphus, who has been likened to central bankers in a recent best seller "*Lords of Finance*". Sisyphus was condemned by the Gods to roll a huge boulder up a steep hill, only to watch it roll down again and having to repeat the task. The challenge for Central bankers is still bigger – they have to manage multiple boulders at a time. Only if central banks succeed in that multi-Sisyphian effort will they be able to keep the dynamic system stable.

We hope this Report would provide useful insights and information to all stakeholders. The Reserve Bank is keen on improving the quality of analysis and presentation in the FSR. Towards this end, we sincerely solicit views, comments and feedback on this Report at [fsu@rbi.org.in](mailto:fsu@rbi.org.in).

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