प्रेस प्रकाशनी PRESS RELEASE

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001
DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 2266 0358

वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

December 22, 2011

RBI releases Financial Stability Report: December 2011

The Reserve Bank of India presented its half-yearly assessment of the health of India's financial sector in its Financial Stability Report (FSR), released here today. The FSR embodies the Reserve Bank's continuing endeavour to communicate its assessment of the incipient risks to financial sector stability. The FSR was first released in March 2010, followed by December 2010 and June 2011.

The FSR holistically assesses soft spots in India's financial sector from a systemic perspective. It outlines the key risks arising from macroeconomic environment, financial markets and institutions and regulatory and other infrastructure. It also seeks to assess the position in respect of continuing vulnerabilities even as new ones are emerging.

There are two distinguishing features of this FSR *vis-à-vis* the earlier ones. It represents the collective views of the Sub-Committee of the Financial Stability and Development Council (FSDC) on risks to systemic stability and hence is a more holistic assessment of financial stability. The FSR also showcases the Reserve Bank's endeavour to constantly upgrade its tools to identify and measure systemic risk through a new chapter describing them. In addition, stability maps and indicators have been designed for every segment to present a bird's eye view of the assessment of risks and their evolution in various segments over the previous period.

Highlights:

- FSR for December 2011 shows that the domestic financial system remains robust.
- This was attested by the confidence reposed by the respondents of the Systemic Risk Survey in the financial system
    - Over half the respondents were 'confident' or 'very confident' about the stability of the Indian financial system.
    - Respondents identified risks arising from asset quality as the biggest concern, followed by market volatility and global risks.
- A series of macrofinancial stress tests, which assess the resilience of the banking system to adverse macroeconomic developments found that banks' capital adequacy remains above regulatory requirements even under severe stress scenarios.

- The Financial Stability Map and Indicator – quantitative tools designed to measure movements in risk dimensions affecting the entire financial system - however, point to some heightening of risks.

Macroeconomic Environment

- All components of domestic demand (private and government, consumption and investment) have decelerated.
- Inflationary pressures remain elevated, driven by a host of factors. Exchange rate depreciation has inflationary implications. The increase in petrol and diesel prices and minimum support prices appears to be neutralising the demand moderating impact of monetary policy measures.
- Risks to the external sector have risen as imports remain high while there is some slowdown in exports.
- The fiscal position remains challenging. The additional demand for supplementary grants points to the risk of slippages.

Financial Markets

- Indian markets, particularly, equity and currency markets, remained volatile during the period under review affected by adverse developments abroad.
- Currency depreciation has been the sharpest in those countries among emerging markets which have external deficit, including India, compared to those countries which have surpluses. This would impact the Indian economy through various channels:
    - Translation losses on the large and rising gross external liabilities and transaction losses on trade exposures
    - Repayment/ redemption of ECB and FCCB would become costlier and refinancing at higher domestic rates might become necessary
    - FIIs might stay away further affecting sentiment in equity market
- Some issues in the equity market microstructure, particularly in the derivatives segment warrant monitoring

Financial Institutions – Soundness and Resilience

- There has been some deterioration in financial soundness indicators (*viz*., capital adequacy and asset quality) but capital adequacy remains well above regulatory requirements and asset quality indicators continue to compare favourably with ratios in peer countries.
- Going forward, if GDP growth slows down, there could be some downstream impact on asset quality. At the same time, additional capital will need to be raised due to the compulsions of implementation of Basel III, a growing (albeit at a potentially decelerated rate) economy and financial inclusion.
- Higher provisioning requirements (due to higher slippages) and increased interest expenses has weighed on the profitability of the banking sector.
- Urban banks and NBFCs also exhibited resilience to credit risk shocks.
- The insurance and pension sectors – given their ‘long only’ and long term investment styles typically add to the stability of financial markets.

Payment and Settlement Systems

- The RTGS system, which creates incentives for market participants to postpone payments to the latter half of the day, can increase the liquidity risk in the system and can also magnify the impact of an operational event.

Cross-sectional Exposures

- The banking system as also the financial sector is distinctly tiered. This means that some banks and institutions are much more connected than others and could have a larger source of contagion impact that in a less tiered network. Insurance companies and asset management companies as lenders would be affected by any disturbances in the banking system (which is the major borrowing segment).

Distress Dependencies between Banks

- The assessment of distress dependencies based on various indicators shows that the joint probability of distress is low at present though there is a marginal uptrend in the recent past.

Details

Domestic financial system remains stable despite some soft spots

The FSR observes that the domestic financial system remains stable in the face of an adverse international backdrop. Market participants and stakeholders in India reposed their confidence in the stability of the domestic financial system and stringent stress testing brought out the resilience of the system. FSR, however, points out some soft spots that need to be addressed, going forward.

The poorer global growth prospects and sovereign debt crisis in Europe have heightened external sector vulnerability. At the same time, domestic growth has weakened, while inflation has remained high. Exchange rate depreciation has inflationary implications through the increase in the cost of oil and other imported goods which are inputs in overall production. The increase in petrol and diesel prices and minimum support prices, have a cascading effect on the entire economy, and appear to be neutralising the demand, moderating impact of the monetary policy measures. Inflationary expectations, which continue to remain high, also cause stickiness in the downward movement of the price level. Further, the fiscal situation remains challenging as the revenue collection were lower than expected in the first half of the current year.

Volatility in financial markets needs monitoring

Indian financial markets have experienced higher than normal levels of volatility and uncertainty. The reliance of domestic firms on international sources of finance denominated in foreign currency has been growing on account of interest rate differentials, among other things. The recent depreciation of the Indian rupee would test the resilience of those firms in the corporate sector's having currency mismatches on their balance sheets. The equity market has corrected lower during the period too. The evolving equity market microstructure, namely, derivatives trading which surged not accompanied by higher cash market turnover and rise in share of proprietary trading in derivatives segment need to be monitored.

Slight decline in capital adequacy and rise in NPAs; Yet, Indian banks robust

According to FSR, Indian banks remain robust, notwithstanding a small decline in capital adequacy and rise in NPA levels, mainly in retail, real estate, infrastructure and priority sectors, in the recent past. The growth rate of credit to power sector has been much higher than the aggregate banking sector's credit growth and could unravel in case of a sharp economic downturn. The rapid spread of contagion from the European sovereign bond markets to international banks could trigger further deleveraging. This could raise the cost of foreign currency borrowing for both, Indian banks and firms. A slowdown in domestic growth could also raise the risks for the banking system. While Indian banks will migrate to Basel III from a position of strength, the new standards may require adjustments in lending behaviour.

To assess the resilience of institutions, a number of stress tests were carried out on scheduled commercial banks. The stress tests assessed banks' vulnerabilities and resilience to credit concentration, liquidity, foreign exchange, interest rate and equity price risk. Various macro stress tests on system level asset quality were also performed. For the first time, bank group wise macro stress test based on panel regression and sector wise macro stress test based on multivariate regression have been attempted in this FSR. This exercise indicated that the banks are reasonably resilient though capital adequacy of some individual banks does get affected under severe credit risk stress scenarios.

The FSR has noted that the regulatory arrangements are being strengthened, emphasising a coordinated approach, in line with the current international developments and best practices. The financial market infrastructure continued to function without any major disruption. The payment and settlement systems remained robust but trends in intraday liquidity may need to be monitored, FSR observes.

New tools for risk assessment

Recognising the critical importance of supplementing the assessment of systemic risks through a wider consultation, this FSR has introduced some new tools for risk assessment. These are Systemic Risk Survey and Systemic Liquidity Indicator in addition to network model introduced in last FSR.

The Systemic Risk Survey was conducted of select individuals from banks, financial institutions, insurance companies, asset management companies, non-banking financial companies, primary dealers and broking firms. The survey identified deterioration in the asset quality of banks as the most significant risk to the financial system followed by risks from heightened market volatility, including exchange rate volatility, global risks, risks from high inflation and high interest rates. The Systemic Liquidity Indicator (SLI), showed that there was moderate increase in funding difficulties in September and October, 2011. A network model (introduced in the previous FSR), which sought to analyse the contagion risks arising from an initially idiosyncratic problem that becomes more widespread, has been upgraded in this FSR to include an assessment of the interconnectedness in the entire financial system and to further probe into the nature of the network of the banking system and of the financial system. The analysis showed that the Indian banking system remains clustered and is also distinctly tiered. It also showed that Insurance and mutual fund sector, being the liquidity providers are vulnerable to any disturbances in the banking system.

Stability measures too have been enhanced to model the distress dependencies in the banking sector, among specific groups of banks and that associated with an individual bank. Finally, a series of macrofinancial stress tests were done to focus on the impact of macroeconomic shocks on the financial system recognising the fact that the worsening of credit risk conditions is one of the most dominant sources of bank risk. The probability of distress of entire banking system was observed to be very low during the recent period. Also, the expected number of banks that become distressed given that at least one bank becomes distressed has been low and stable for the last one and half years.

The next FSR is scheduled to be published in June 2012.

Alpana Killawala
Chief General Manager

Press Release: 2011-2012/984