Financial Stability Report: RBI

Why in News

Recently, the **Reserve Bank of India (RBI)** released its **Financial Stability Report (FSR)** for the month of July 2020.

- 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.

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