Key Takeaways from RBI's Financial Stability Report

Why in news?

The Reserve Bank of India (RBI) has released its latest Financial Stability Report (FSR) for second half of the year 2021 that details the state of financial stability in the country.

What is FSR about?

- The Financial Stability Report (FSR) is published twice each year by the RBI.
- It presents an assessment of the health of the financial system.
- The RBI also conducts a **Systemic Risk Survey (SRS)**, wherein it asks experts and market participants to assess the financial system on five different types of risks
    1. Global
    2. Financial
    3. Macroeconomic
    4. Institutional
    5. General

What is the significance of FSR?

- FSR details the current status of different financial institutions such as all the different types of banks and non-banking lending institutions.
- It also maps the state of credit growth and the rate at which borrowers are defaulting on paying back loans.
- FSR tells us how robust or vulnerable our financial system — especially our banking system.
- It also tells us whether and to what extent will our banks and other lending institutions (such as NBFCs and Housing Finances Companies) be able to support future growth.
- The RBI looks at the state of both the global as well as domestic economy and conducts certain tests to figure out how different variables may be affected if the economy does not grow as anticipated.

What are the key takeaways from the latest FSR?

Global growth has started to pause

- Since July 2021, the rejuvenation of the global recovery in the first half of 2021 has started losing momentum.
- The global recovery was impacted by resurgence of infections, supply disruptions and bottlenecks and the persistent inflationary pressures.
- **The Goods Trade Barometer of the WTO** shows that the World merchandise trade volumes, which had risen 22.4% year-on-year in Q2 of 2021, have been slowing in the second half of the year.
- **The Baltic Dry Index**, which is a measure of shipping charges for dry bulk commodities, crossed its highest mark in more than a decade in October 2021, but it recorded a sudden

drop after that.

- **The Global Economic Surprise Index (GESI),** which compares incoming data with economists' forecasts to capture the surprise element, went into negative territory during Q3 of 2021.
- The rise of the Omicron variant has a considerable impact on even the emerging economies (such as India) where vaccination rates are lower than advanced economies and are also likely to suffer from central banks in developed countries making money costlier by raising interest rates.

Disconnect between real economy and India's equity markets

- Lifted by the bull run in equity markets across the globe, the Indian equity market surged and strong investor interest has driven up **price-earnings (P/E) ratios** substantially.
- Other valuation metrics such as the price-to-book value (P/B) ratio, the market capitalisation to GDP ratio, and the cyclically adjusted P/E ratio or Shiller P/E are also above their historical averages.
- This reflects some disconnect between the real economy and equity markets as high levels of divergence are a concern from the point of view of financial stability.

Bank credit growth is improving, but not fast enough

- The banking stability indicator (BSI), which indicates the changes in underlying conditions and risk factors of India's commercial banks, showed improvement in soundness, asset quality, liquidity and profitability parameters.
- There is an improvement in the credit growth rate as it forms a "U-shaped" recovery but still there are some matters of concern.
    - The growth rate is still far off the ideal level.
    - Retail credit (less than Rs 5 crore) is growing at a decent clip but the wholesale credit (Rs 5 crore and above) growth continues to struggle.
    - Most of the wholesale credit is being picked up by public sector undertakings while the private sector is holding back from raising fresh funding.
    - Bank credit to the MSME segment slowed down by the end of September 2021 compared to March 2021.
    - Flow of credit to lesser rated corporates continues to be a problem.

Non Performing Assets (NPAs) may rise by September 2022

- The latest FSR pegs the NPA of India's Scheduled Commercial Banks (SCBs) at 6.9% at September 2021.
- Stress tests indicate that the Gross NPA ratio of all SCBs may increase to 8.1% by September 2022 under the baseline scenario and further to 9.5% under severe stress.
- Within the bank groups, public sector banks' GNPA ratio of 8.8% in September 2021 may deteriorate to 10.5% by September 2022 under the baseline scenario.

Each FSR conducts some "stress tests" to find what will happen to the NPA level if things go wrong. These stress tests are hypothetical adverse economic conditions and are done by taking progressively worse values of variables such as GDP growth, combined fiscal deficit-to-GDP ratio, CPI inflation, weighted average lending rate,

exports-to-GDP ratio and current account balance-to- GDP ratio.

Systemic risks evenly balanced

- There are five levels of risks — very high, high, medium, low and very low.
- As per the Systemic Risk Survey (SRS), all broad categories of risks to the financial system were perceived as 'medium risk' in magnitude.
- The risks arising on account of global and financial markets were rated **higher** than the rest.
- For India, the main sources of risks are commodity prices, domestic inflation, equity price volatility, asset quality deterioration, credit growth and cyber disruptions.

Banking prospects improve

- Almost 64% of respondents expect the economy to recover fully in the next 1-2 years while 22% believe it may take up to 3 years.
- The latest FSR's analysis suggests that India's banking and financial system has largely improved since the July 2021 report.
- But with global growth faltering, monetary tightening in the developed countries as well as the rise of omicron, the risks are evenly balanced.

What is the challenge now?

- As banks have ample capital, the government need not find funds for recapitalisation but the challenge now is to induce banks to step up industrial lending, which holds the key to capital expenditure revival and sustained economic growth.
- Banks' incremental lending is now flowing to individuals seeking personal loans rather than businesses seeking commercial credit.
- In FY21, retail loans accounted for as much 64% of all incremental bank credit, while industrial credit was reduced by 22%.
- While credit flowing to individuals may hope for a consumption-driven revival but the proportion of sub-prime borrowers in consumer loans has increased to 29.9% in September 2021.
- Even within commercial credit, lending appears to favour PSUs (12.4% growth) while private sector borrowers (5.8% contraction), particularly lower rated ones, seem to be getting the short share.
- Disbursements to MSMEs seem to be flagging again with credit growth at just 1.9% in the September 2021 quarter.

References

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