RBI’s Financial Stability Report

January 14, 2021

Economic activity has begun making a hesitant and uneven recovery from the unprecedented steep decline in the wake of the COVID-19 pandemic. Active intervention by central banks and fiscal authorities has been able to stabilise financial markets. In a period of continued uncertainty, there are implications for the banking sector as its balance sheet is linked with corporate and household sector vulnerabilities. So, Financial Stability outlook becomes important from UPSC perspective.

In news: Reserve Bank of India released the 22nd issue of the Financial Stability Report (FSR).

Placing it in syllabus: Economy

Dimensions

1. Highlights of the report
2. Loan restructuring and msme restructuring due to covid
3. IBC and suspension due to covid
4. What is stress test of Banks
5. Latest result of stress test on Indian Banks

Content:

Highlights of the report:

- In the initial phase of the COVID-19 pandemic, policy actions were geared towards restoring normal functioning and mitigating stress. The **focus is now** being oriented **towards supporting the recovery and preserving the solvency** of businesses and households.
- Positive news on vaccine development has underpinned optimism on the outlook, though it is marred by the second wave of the virus including more virulent

strains.

- **Policy measures** by the regulators and the government **have ensured the smooth functioning of domestic markets and financial institutions**.
- **Managing market volatility amidst rising spillovers has become challenging** especially when the movements in certain segments of the financial markets are not in sync with developments in the real sector.
- **Credit flows to the manufacturing sector have been lukewarm** at a time when output of the sector is emerging out of a prolonged contraction. The **focus of the policy** efforts is **shifting from provision of liquidity and guarantees to supporting growth** – including consumption and investment.
- **Bank credit growth has remained subdued**, with the moderation being broad-based across bank groups.
- **Performance parameters of banks have improved significantly**, aided by regulatory dispensations extended in response to the COVID-19 pandemic.

Financial Stability Report (FSR)

- RBI publishes the Financial Stability Report (FSR) biannually (i.e. twice in a year)
- It includes contributions from all the financial sector regulators.
- It reflects the collective assessment of the Sub–Committee of the Financial Stability and Development Council (FSDC-SC) on risks to financial stability.

Loan restructuring and msme restructuring due to covid:

- A six-month **moratorium on repayment** from March till August-end was announced by the Union government.
- This was aimed at helping borrowers as companies cut salaries and laid off people after India imposed the world’s strictest lockdown, freezing economic activity.
- The question of further extension of moratorium has

become highly contentious – Business leaders want extension and banks oppose it.

- As a middle ground, the Reserve Bank of India has allowed lenders to restructure loans with some conditions

Loan restructuring and other measures announced by the government to help the industry hit by the coronavirus pandemic include:

- In August 2020, RBI permitted one-time restructuring of both corporate and retail loans without getting classified as a non-performing asset (NPA).
- Restructuring benefit can be availed by those whose account was standard on March 1 and defaults should not be over 30 days.
- Borrowers also have the option of converting the interest accrued during the moratorium period into a separate loan.

Other measures include:

- **Increase in Loan to Value (LTV) ratio for gold loans:** LTV for loans against pledge of gold ornaments and jewellery for non-agricultural purposes has been enhanced from 75 per cent to 90 per cent up to March 31, 2021.
- **Interest Subvention Scheme for MSMEs**: Co-operative Banks have been included as Eligible Lending Institutions from 3rd March 2020. The scheme provides an interest relief of 2% per annum to eligible MSMEs with coverage limited to all term loans /working capital to the extent of Rs 1 crore. The validity of the Scheme has been extended to March 31, 2021

IBC and suspension due to covid:

- In December 2020, the Union Government had extended the suspension of the Insolvency and Bankruptcy Code (IBC) till March 31, 2021.

- Earlier, the government also exempted all Covid-related debt from the definition of default under IBC
- The government also introduced an ordinance for decriminalising the Companies Act and moved the majority of compoundable offences to an internal adjudication mechanism.
- The reforms announced as part of Prime Minister Narendra Modi's call for Atmanirbhar (self-reliant) India also include a special insolvency framework for micro, small, and medium enterprises (MSMEs) by introducing a new section in the IBC.
- These were done to help businesses cope with major stress posed by the Covid-19 pandemic
- However, the suspension of the IBC is not applicable to any default committed before March 25, 2020

What is stress test of Banks?

- Stress tests by design are aimed at studying the health of financial institutions in different scenarios.
- So, the aim of these tests is to gauge what the books of a bank will look like if gross non-performing assets rise, leading to an increase in provisions that weigh on profitability and also capital.
- Stress testing is commonly described as the **evaluation of a bank's financial position under a severe but plausible scenario** to assist in decision making within the bank.
- It enables a **forward looking assessment of risks**, which overcomes the limitations of statistical risk measures or models based mainly on historical data and assumptions.
- It also facilitates internal and external communication and helps senior management understand the condition of the bank in the stressed time.
- **Stress testing** outputs are **used by a bank in decision**

making process in terms of potential actions like risk mitigation techniques, contingency plans, capital and liquidity management in stressed conditions, etc

- Stress tests gauge the adequacy of capital and liquidity buffers with financial institutions to withstand severe but plausible macroeconomic and financial conditions.

There are broadly two categories of stress tests used in banks:

- **Sensitivity tests:**

It **estimates the impact** on a bank's financial position **due to predefined movements in a single risk factor** like interest rate, foreign exchange rate or equity prices, shift in probabilities of defaults (PDs), etc

The **source of the shock on risk factors is not identified** and usually, the underlying **relationship between different risk factors or correlation is not considered or ignored**.

For example, the impact of adverse movement in interest rate or foreign exchange rate on profitability is considered separately but the fact that movement in interest rate and foreign exchange rate is inter-related is ignored to keep stress tests simple.

These tests **can be run relatively quickly** and form an approximation of the impact on the bank of a move in a risk driver.

- **Scenario tests:**

These include scenario analysis with system-wide interactions and feedback effects.

They cover **forward-looking scenarios** to incorporate different possibilities of multi-level stress tests, changes in portfolio composition, new information and emerging risk possibilities.

compilation of forward-looking scenarios r**equires combining the knowledge and judgment of experts**

Latest result of stress test on Indian Banks:

The functioning of financial markets in the recent months has been characterised by the economic impact of the COVID-19 pandemic, with financial institutions largely cushioned by abundant liquidity in the banking system, lowering of the cost of funds, and regulatory forbearance in asset classification of specified loans.

Despite **subdued credit offtake**, **banks reported better than anticipated results**.

However, the fuller **impact of the deterioration in the macroeconomic environment on banks' asset quality, capital adequacy and profitability may unfold gradually**.

A shock of such large dimensions is likely to place pressure on the balance sheets of banks going forward. The **pre-pandemic vulnerabilities** of some relatively weaker institutions **may get accentuated.**

RBI carried out an assessment of financial stability aspects through performance parameters and level of interconnectedness of Indian financial institutions, supplemented by macro stress tests, including bottom-up stress tests.

Method used in the Financial Stability Report for stress tests:

- Macro-stress tests were performed to assess the resilience of SCBs' balance sheets to unforeseen shocks emanating from the macroeconomic environment.
- Drawing on the results of the exercise, capital and impairment ratios are projected over a one-year horizon under a baseline and two adverse – medium and severe– scenarios.

The stress test results indicate that:

- The **GNPA ratio of all SCBs may increase to 13.5 per cent by September 2021** under the baseline scenario GNPA ratio may escalate to 14.8 per cent under a severe stress scenario. This **highlights** the **need for proactive building up of adequate capital to withstand possible asset quality deterioration**.
- Under the **baseline scenario**, **four banks may fail to meet the minimum capital level** by September 2021, without factoring in any capital infusion by stakeholders.
- In the **severe stress scenario**, the number of **banks failing to meet the minimum capital level may rise to nine.**
- Macro-stress tests for credit risk show that GNPA ratio of SCBs may worsen under various stress scenarios and capital ratios may be eroded.
- Network analysis reveals that **total bilateral exposures among entities in the financial system increased marginally** during the quarter-ended September 2020. With the inter-bank market continuing to shrink and with better capitalisation of banks, the **contagion risk to the banking system under various scenarios declined** as compared to March 2020.

Mould your thought:

1. Define Stress tests on banks. Describe the different tests carried out in stress tests. Outline the findings of RBI in the recent stress tests.

Approach to the answer:

- Define stress test of banks
- Write about Scenario test and Sensitivity tests
- Add findings of recent stress test
- Way forward