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RBI releases First Financial Stability Report Says Limited Risk to Financial Stability, but Monitoring Required on an Ongoing Basis

As announced in the Annual Policy Statement of April, 2009 the Reserve Bank of India established a Financial Stability Unit in August, 2009. The Second Quarter Review of Monetary Policy in October, 2009 made specific mention of a periodic Financial Stability Report (FSR) for India to enhance transparency and augment confidence in the financial system. The [Financial Stability Report \(FSR\)](#) published today is the first of these reports and is an attempt at institutionalising the implicit focus and making financial stability an integral driver of the policy framework.

In general, the Financial Stability Reports will focus on reviewing the nature, magnitude and implications of risks that have bearing on the macroeconomic environment, financial institutions, markets and infrastructure. It will also assess the resilience of the financial sector through stress tests. It is hoped that FSRs will emerge as one of the key instruments for directing pre-emptive policy responses to incipient risks in the financial system.

The FSR will be a key supplement to the evolving institutional arrangements in the coming months. The specific composition and the role of the proposed Financial Stability and Development Council (FSDC) is yet to crystallise. But the role of the Reserve Bank in any future arrangement, as regards financial stability, will continue to be critical.

This inaugural report details the prevailing financial system in India and also gives some background on past financial stability initiatives.

Global Outlook

The forceful and coordinated global policy response to the crisis has facilitated the relative stabilisation of global markets and easing of credit risk concerns after the financial turmoil, especially in the second half of 2009. Uncertainties about growth prospects and financial stability, however, persist. The unevenness of the global recovery adds to this uncertainty. Further, concerns about sovereign credit risk have also intensified in the light of the fiscal woes of Greece and some other Euro zone nations.

While global imbalances declined somewhat due to contraction of demand in advanced economies during the financial crisis, the structural problem associated with the imbalances remains. There are some incipient signs of the recurrence of these imbalances with the economic recovery, which is reminiscent of the pre-crisis days and could emerge as a cause for concern. Though the exposure of the Indian financial system to the international markets remains relatively low, the contagion impact from the global macroeconomic shocks on the Indian financial sector cannot be ruled out.

Outlook for India

There are evident signs of recovery in the growth increasingly taking hold. Hence, the process of monetary policy exit has already begun. Early steps to exit from

the fiscal stimulus measures have also been initiated with the Union Budget for 2010-11 committing a return to the process of fiscal consolidation. The process of fiscal consolidation should facilitate better monetary management. In recognition of the Government's intent to bring down deficit and debt levels, along with the positive outlook on domestic economic growth, S&P has recently upgraded its outlook on India from "Negative" to "Stable".

Going forward, however, there are several factors which may have a bearing on financial stability considerations, including inflationary pressures and expectations, management of government borrowing program, and capital flows.

Key Findings of Report

Banking Sector

- The banking sector remains broadly healthy. Banks remain well capitalized in terms of regulatory capital adequacy ratios, with higher core capital and sustainable financial leverage, and this contributes to financial stability
- Stress tests for credit and market risk reveal banks' ability to withstand unexpected levels of stress.
- Credit quality continues to remain robust. The share of low cost current and savings account deposits in total deposits is high. Banks are required to hold a minimum percentage of their liabilities in risk free government securities. This, to a large extent, takes care of liquidity and solvency issues.
- Stress tests indicate that the banking sector is comfortably resilient and, even if, in a worst case scenario, it is assumed that all restructured standard advances were to become NPAs, the stress would not be significant.
- The margins of banks may face pressure from the MTM impact on the investment portfolio, increased provisioning requirement and calculation of interest on savings bank deposits on a daily basis from April 1, 2010.
- The Asset Liability Management (ALM) analysis does not indicate any significant mismatches at the current juncture. The credit growth in recent times, however, has been mostly marked in sectors like infrastructure and commercial real estate, both of which require longer term funding. The resultant ALM mismatches would require careful monitoring on an ongoing basis.
- Over-reliance on bulk deposits in certain institutions, which remain at elevated levels, and this could impact the cost and stability of the deposit base. With a fast expanding corporate sector and extant exposure norms, the headroom available to banks is constrained and needs to be addressed.
- While the resilience of the commercial banks to credit and interest rate shocks has improved over time, the liquidity scenario analysis shows some potential risk.

Household and Corporate Sectors

- The balance sheets of households and corporates suggest that the financial system is not exposed to the risk of large leverages in these sectors.
- The propensity to take unhedged corporate foreign exchange exposures constitutes a potential source of risk to the banking sector.

Management of Capital Account

- Uncertainty with regard to capital flows could pose a challenge for management of the capital account. At the current juncture, though, there is little evidence that the quantum of inflows has exceeded the absorptive capacity of the economy.

While there is a menu of policy options to respond to the challenge, the optimal policy mix will have to be carefully calibrated taking into account the evolving state of the economy and financial stability considerations.

Non-Banking Financial Sector

- The sector was able to manage the fallout of the crisis without creating systemic issues. However, ALM mismatches, credit quality and the interconnected flows between NBFCs and other financial sector entities would need to be closely monitored.
- Given the increasing significance of the non-banking financial sector, the supervisory regime for the systemically important non-deposit taking NBFCs will need to be strengthened for a more robust assessment of the underlying risks.

Financial Conglomerates

- A monitoring and oversight framework for systemically important financial institutions (called financial conglomerates (FC) in India) is already in place, which needs to be strengthened. The Reserve Bank, in consultation with other sectoral regulators is in the process of implementing an enhanced framework for regulation and supervision of financial conglomerates

Financial Markets & Infrastructure

- The real challenge in developing financial markets and products in the future would be the de-concentration of risks from the banking system. In the Indian context, the key underpinnings while developing the markets would be to ensure that one, the process of disintermediation away from banks is genuine and two, wherever banks and non-bank finance companies are involved, there is clear, transparent capture of the risks within a prudential framework.
- Central counterparties have emerged as critical elements for the smooth functioning of the financial markets and as a means to reduce systemic risk posed by derivative markets. These entities are increasingly becoming systemically important market institutions and need to be regulated more firmly for robust risk management systems. Their capital, margining and collateral requirements need to be assessed from a prudential and systemic stability perspective.
- The delay in disposal of legal suits is a major concern in the Indian context, particularly in the case of insolvency proceedings. Legislative initiatives are required in this regard.

Data Issues

- India has made significant strides in enhancing its data dissemination standards. Data gaps need to be overcome in the area of interconnectedness of financial institutions, household indebtedness and a system level database on asset prices in certain segments like the commercial real estate exposure.