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RBI releases Financial Stability Report: June 2013

The latest issue of the Financial Stability Report (FSR) of the Reserve Bank of India, the seventh in the series, is being released at a time when debate about the appropriateness, timing and pace of imminent exit from unconventional monetary policies by the US is intensifying and the consequent tremors are being felt in financial markets across the globe.

The FSR aims to create awareness about the vulnerabilities in the financial system, to inform about the resilience to stress of the financial institutions and to encourage debate on issues relating to development and regulation of the financial sector.

The Report reflects the collective assessment of the Sub-Committee of the Financial Stability and Development Council (FSDC) on risks to financial stability.

Highlights:

i. Global growth remains subdued and recovery is multi-paced. Policy actions in advanced economies had reduced the risks of tail events. The Federal Reserve's indication of a tapering of its bond buying programme, commencing later this year, has led to large scale sell offs in foreign exchange, bond and equity markets, especially in emerging markets. (*Paras 1.1-1.4; Chapter: I)*

ii. The risks, which have been building up over the last five years of excess liquidity in the global system are now surfacing. The markets, especially, in emerging economies need to be prepared for spells of high volatility and uncertainty going ahead. *(Paras 1.5-1.10; Chapter: I)*

iii. Macroeconomic risks facing the Indian economy have increased during the last six months, mainly on the dimensions of domestic growth, external sector and corporate sector performance. Current account deficit and its non- disruptive financing have emerged as major challenges from the perspective of macroeconomic stability. The recent fall in inflation and significant fiscal consolidation have provided some relief. *(Paras 1.11-1.20; Chapter: I)*

iv. The performance of Indian corporate sector has been sluggish and in the emerging scenario, the increased external borrowing and un-hedged foreign exchange exposures of corporates may further increase their vulnerabilities.*(Paras 1.33 – 1.34; Chapter: I)*

v. The risks to the banking sector have increased marginally since the publication of the last FSR in December 2012. Tight liquidity and deteriorating asset quality are the major contributors to the decline in stability of the banking system over this period, although the asset quality of SCBs, has recorded marginal improvement in March 2013 quarter. *(Paras 2.1, 2.32; Chapter: II)*

vi. The network of the Indian financial system shows that asset management companies, insurance companies and Non-Banking Financial companies (NBFCs) have a high degree of connectivity with the banking system. *(Paras 2.7-2.15; Chapter: II)*

vii. A significant degree of 'seasonality' is seen in the performance of banks on the parameters of credit, deposit, and asset quality during the last quarter of the financial year. *(Paras 2.18-2.20 and 2.34; Chapter: II)*

viii. Banks with higher leverage were observed to have lower risk-weight-asset density. Globally, this trend is observed when banks graduate to an internal ratings based (IRB) approach under Basel II. (*Para 2.29: Chapter: II and Paras 3.4 – 3.7; Chapter: III)*

ix. Stress tests results indicate that if the current macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further. However, the comfortable position on the banks' capital adequacy front lends resilience. *(Paras 2.46-2.57, Chapter: II)*

x. A major part of the new business premium in life insurance is from single premium policies with rising ticket size. *(Paras 2.77-2.78, Chapter: II)*

xi. In respect of the many Defined Benefit pension fund schemes, currently under implementation as well as newly announced (mostly in the government sector), the weaknesses in liability computation can be a potential source of fiscal stress in years when there are large payouts, especially in a world of rising life expectancy. *(Paras 2.80-2.82, Chapter II)*

xii. The emerging inconsistencies in regulatory approach and a tendency towards home-bias in some of the major jurisdictions, while implementing reforms, may affect the functioning of international as well as domestic financial markets. Inter-regulatory agency implementation groups have been formed, with focus on implementation of specific areas of reforms in India.
(Paras 3.1-3.3; Chapter: III)

xiii. The financial sector regulators have signed a Memorandum of Understanding (MoU) for co-operation in the field of consolidated supervision and monitoring of financial groups identified as financial conglomerates. Bilateral Memoranda of Understanding (MoU) have been signed with overseas supervisory bodies, and Supervisory Colleges established for two big Indian banks for improved cross border banking supervision and cooperation. *(Paras 3.30 -3-32; Chapter: III)*

xiv. Instances of mis-selling of financial products, mainly insurance products and other wealth management services at some banks have underscored the need for strengthening consumer protection mechanisms and ensuring adherence to KYC / AML guidelines. (*Paras 3.47 – 3.58; Chapter: III)*

xv. India has been proactive in implementing a framework for regulating the practice of algorithmic trading and steps have been taken to address the risks from erroneous trades. SEBI is examining the risks from algorithmic and high frequency trading and aims to provide greater equality and fairness in order handling to the participants who do not use co-location services. (*Paras 3.68 – 3.71; Chapter: III)*

xvi. The latest Systemic Risk Survey of the Reserve Bank conducted during April-May 2013 revealed that global risks and domestic macro-economic risks were perceived to be the two most important factors affecting the stability of Indian financial system. *(Annex 1 to the FSR)*

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