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Financial Stability Report July 2021

Why in news?

The Reserve Bank of India recently released its latest Financial Stability Report (FSR).

What is the FSR?

- 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 FSR primarily looks at questions like the following:
    1. Do Indian banks (both public and private) have enough capital to run their operations?
    2. Are the levels of bad loans (or non-performing assets) within manageable limits?
    3. Are different sectors of the economy able to get credit (or new loans) for economic activity?

What is the significance of the FSR?

- The data and information in the FSR allows the RBI to assess the state of the domestic economy.
- The FSR also allows the RBI to assess the macro-financial risks in the economy.
- As part of the FSR, the RBI also conducts "stress tests."
- This is to figure out what might happen to the health of the banking system if the broader economy worsens.
- Similarly, it also tries to assess how factors outside India might affect the domestic economy.
- E.g. the crude oil prices or the interest rates prevailing in other countries
- Each FSR also contains the results of something called the Systemic Risk Surveys.

What are the highlights of the recent report?

- **GNPAs** - In June 2020, the FSR had noted that Gross NPAs (GNPAs) could rise from 8.5% (of gross loans and advances) at the end of March 2020 to a two-decade high of 14.7% by March 2021.

- The recent FSR has found that the actual level of bad loans as of March 2021 is just 7.5%.
- However, the GNPA ratio of Scheduled Commercial Banks may increase from 7.48% in March 2021 to 9.80% by March 2022 under the baseline scenario.
- Under a severe stress scenario, it could increase to 11.22%, as shown by "macro-stress tests" for credit risk.
- So, the relief provided by the RBI in 2020 has contained the number of Indian firms that openly defaulted on their loan repayment.
- But things could get worse, especially for the small firms (or MSMEs).
- [The relief measures include cheap credit, moratoriums and facilities to restructure existing loans]
- **Regulatory relief and NPA** - A clear picture of NPAs will emerge only when the regulatory relief provided by the RBI is taken away.
- But it is not always clear when a central bank should pull back such regulatory relief.
- Historical experience shows that credit losses remain elevated for several years after recessions end.
- Indeed, in EMEs [Emerging Market Economies], NPAs typically peak 6 to 8 quarters after the onset of a severe recession.
- The longer the blanket support is continued, the higher the risk.
- Because providing excess regulatory relief might help inherently inefficient firms too.
- On the other hand, banks need sufficient buffers to absorb losses along the entire path to full recovery.
- So, support measures cannot be phased out before firms' cash flows recover.
- **Credit growth** - At less than 6%, the overall rate of credit growth in commercial banks is quite dismal.
- What is particularly worrisome is the negligible growth rate in wholesale credit [refers to loans worth Rs 5 crore or more].
- The rate of growth for retail loans (loans to individuals) had become much better in comparison.
- Notably, there was a sharp fall in credit growth much before the Covid pandemic hit India.
- It points to a considerable weakness in demand even before the pandemic.
- This, in turn, suggests that recovery in credit growth may take longer than usual.
- **Systemic Risk Survey (SRS)** - The FSR also published the results of the latest round (April 2021) of the Systemic Risk Survey (SRS).
- It reflects upon the major risks faced by the Indian financial system.

- The risks are broadly classified into five categories - global, macroeconomic, financial market, institutional and general.
- The overall risk perception is “medium.”
- However, there were several factors on which experts expected a worrying picture than the one provided in the January 2021 FSR.

Source: The Indian Express