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What the Reserve Bank's Financial Stability Report portends?

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Central banks are positioned at the apex of the financial system. They possess enormous power to create money "out of thin air"; for example, using electronic accounting entries, the New York Federal reserve built up a balance sheet of nearly 4.5 trillion dollars through quantitative easing, post the Global Financial Crisis. COVID-19 and associated monetary stimulus measures have seen further balance sheet expansion of most major central banks, close to the GDP of some economies.

The Reserve Bank of India, by virtue of its independence and professionalism, carries tremendous respect in the financial markets. Stories are legion of the governors of RBI fiercely protecting their independence from their political masters, from YV Reddy to Subba Rao, Raghuram Rajan to Urjit Patel. Much of this institutional credibility has carried forward to the current dispensation, headed by a former senior government official, a significant difference in profile from the economists/technocrats who led the central bank in the past. A non-controversial relationship between the central bank and the government may better suit today's turbulent times for the COVID-19 economy and the financial system, in contrast to the frequent tussles played out in the media in the past. The tussle is best exemplified by the fiery speech of the former RBI Deputy Governor Dr. Viral Acharya about "governments that do not respect central bank independence sooner or later incurring the wrath of financial markets, igniting economic fire, and coming to rue the day they undermined an important regulatory institution". With an impassive head at the helm now, the media will have to look elsewhere for such headlines!

Apart from its power to create bank reserves, the central bank plays several critical roles in India. It is the banker to banks, banker to the Government of India and its debt manager, issuer of currency, regulator and supervisor of banks, manager of the country's foreign exchange reserves which today top nearly half a trillion dollars, conducting monetary policy, etc. For the general public, a less well-known responsibility of the central bank is maintaining financial stability.

The Reserve Bank's annual Financial Stability Report is an eagerly awaited document among the financial market participants and the media. In today's COVID-19 scenario, the central bank's views on financial stability are, therefore, all the more critical. This article seeks to examine the latest report from RBI and the messages that it carries.

Disconnect between financial markets and the real economy

Stock market indices have recovered most of their losses, jumping by about 50% from their March lows and are just about 10% of their 2020 pre-COVID highs. Corporate bond markets that went through a selloff and tremendous illiquidity have also since gained, with a collapse in bond yields, from their March highs. Bond prices and yields move in the opposite direction.

According to RBI's report, domestic economic activity virtually came to a standstill in April 2020; however, for several sectors, the contraction became less severe from May 2020. Early data arriving for June 2020 indicate some plateauing much below the pre-COVID-19 levels. Agriculture and allied activities, however, showed continued resilience on the back of all-time production highs and huge buffer stocks of rice and wheat. The above-normal rains predicted for 2020-21 also boded well for agricultural production. PMI (Manufacturing) has also consistently improved from 27.4 in April to 30.8 in May and further to 47.2 in June 2020. But it has shrunk again to 46.0 in July 2020. For the fiscal year as a whole, there is still heightened uncertainty about the duration of the pandemic. As such, the downside risks to growth remain significant and full restoration in economic activity would be contingent upon the support for robust health infrastructure, recovery in demand conditions and fixing of supply dislocations, in addition to the state of global factors like trade and financial conditions.

Understandably, the report does not paint a totally dire scenario, but the reality on the ground is much bleaker. Though the government at the centre has, by and large, lifted the lockdown in many sectors (though not all), many state governments have been much more conservative. Reopening and closing again repeatedly has led to uncertainty for businesses. Public transportation on which the workforce depends is yet to commence in many states. The migrant workers who went back to their home towns and villages en masse, are yet to return in strength. Supply chain domestically and internationally is still a far cry from the pre-COVID days. Layoffs and salary cuts/freeze, uncertainty on employment and lack of significant direct fiscal stimulus portend unprecedented demand destruction. Tourism, aviation and hospitality sectors are still in lockdown mode, even if some partial relaxations have been made, with the resumption of limited flights. But with many states requiring air travelers to quarantine and travelers' fear of catching the virus, travel is still muted.

RBI's report devotes more space and attention to the economic devastation globally while being relatively cautious on the impact of Covid-19 on the domestic economy. The RBI Governor says that for the year 2020-21 as a whole, real GDP growth is expected to be negative. That could well be an understatement.

A rare current surplus

The collapse in oil prices, with crude futures even trading at a negative price for a brief period, is sweet music for India, a significant oil importer. Prices have since rebounded to about USD 44 per barrel, but are significantly below pre-COVID levels. Fall in volume in oil imports along with lower prices, negligible gold imports, etc. have led to a rare current account surplus. The surplus may not be a cause for celebration entirely, as a fall in imports is a sure sign of contraction in the economy.

Meanwhile, the consumer now pays more than pre-COVID prices for petrol and diesel as the government has taken away the benefit of falling international oil prices, through an increase in taxes. If international oil prices rise further or the rupee depreciates, the government's windfall on account of additional petroleum product taxes may reverse; any further increase in fuel prices will be both inflationary and pinch the pockets of consumers already suffering from weak earnings.

Central government finances

In another understatement, the Financial Stability Reports states that Central Government finances are likely to "suffer some deterioration'' in 2020-21. With both direct and indirect tax revenues falling significantly, and additional government expenditure on COVID relief (though modest in comparison to advanced economies), coupled with contraction in GDP, published fiscal deficit numbers of both the Centre and the states this year will be nightmarish. On top of this, a large part of the deficit does not sit on the central government's balance sheet directly but figures on the balance sheets of public sector entities like the Food Corporation of India, power finance companies, the public sector airline, credit guarantee trusts etc. both on the balance sheet and off-balance sheet. Contingent liabilities for the centre had been growing even in the pre-COVID period through schemes like Mudra; but they will now be exacerbated by schemes like the guaranteed emergency credit line of Rs 3 lakh crore to the MSME sector. When these contingent liabilities fructify, this will impact the fiscal deficit, a few years down the line. India is in good company here, with the likes of the underfunded Social Security Scheme of the US government. For Individuals, corporates or governments, the favorite way of dealing with a problem is to postpone the day of reckoning, more so for current governments and their elected officials, who can hope to be no longer around when the chickens come home to roost.

Loan moratorium, restructuring and asset quality of banks

On a similar vein, the central bank has permitted loan moratorium to borrowers till August 31, without a downgrade of loans into non-performing category. Nearly half of the customers accounting for around half of outstanding bank loans opted to avail the benefit of the relief measures as on April 30, 2020. These numbers have since improved. But some analysts have looked askance at the declared moratorium figures, as certain lenders

may have classified loans where installment may have been paid for say the June month, but with previous installments of April/May unpaid, as loans not under moratorium. If banks have adjusted the additional facilities on account of the guaranteed emergency credit line towards the outstanding loan moratorium, that would further paint an unduly positive picture.

The full picture of the asset quality of banks will be revealed when the loan moratorium is lifted on August 31. Even here, to push the problem even further down the line, there has been a growing clamor to allow restructuring of loans, without downgrading the loans to non-performing assets. On 6 August 2020, RBI has announced such a loan "resolution" scheme with a Committee appointed to come out with the parameters for carrying it out. While this will undoubtedly help borrowers under stress for reasons beyond their control (COVID-19) and forestall recovery actions from banks, "extending a loan and pretending that all is well" merely kicks the proverbial can down the road. The full impact of COVID-19 on the balance sheets of banks may be known only years down the line. Everyone, including borrowers, banks, the central bank and the government, credit rating agencies, and financial market participants, can sleep easy until then!

The stress tests of the RBI indicate that the GNPA ratio of all scheduled commercial banks may increase from 8.5 percent in March 2020 to 12.5 percent by March 2021 under the baseline scenario. If the macroeconomic environment worsens further, the ratio may escalate to 14.7 percent under the very severely stressed scenario. With RBI permitting the aforesaid loan resolution/restructuring, it may moderate some of these figures.

Capital adequacy

Capital adequacy and asset quality are two sides of the same coin. As any risk manager or central banker will tell us, it is all about adequate capital, when it comes to banks, especially in today's extreme scenario. Capital from shareholders and others (AT1 bond and Tier2 bond investors), provides a buffer to depositors against credit losses. Stress test results indicate that five banks may fail to meet the minimum capital level by March 2021 in a very severe stress scenario, assuming no further recapitalization or mergers. Furthermore, 23 banks with a share of 64.5 percent in total assets might fail to maintain the required capital to risk-weighted assets ratio (CRAR) under an extreme shock scenario, according to RBI's Financial Stability Report.

Even if these numbers don't play out in the immediate future and with the scenario being further muddied by the loan restructuring scheme, failure of even one bank may pose a contagion risk to the banking system. The government/central bank-led rescue of Yes Bank is an indicator that no bank will be allowed to fail, barring cooperative banks. But rescue missions come with a cost, as this will pose further stress on the balance sheet of the bank(s) bailing out such failing entities.

Private sector banks are on a massive capital raising spree, while the owner of the public sector banks (the government) has been silent on capitalizing them. The Financial Stability Report has not touched upon this subject, despite calling out possible capital shortfall at public sector banks. However, the RBI Governor alluded to this in a speech on July 11, 2020, stating that a recapitalisation plan for public sector banks has become necessary.

For the five years between 2015-16 and 2019-20, the Government had infused a total of Rs 3.08 lakh crore in public sector banks. The infusion was necessitated due to pre-COVID NPA's on account of large corporate borrower defaults. NPA's and resultant taxpayer funded bank recapitalization seems to be a never-ending story for public sector banks, with COVID impact resulting in fresh capital requirement running potentially into a few lakh crores again. We may yet again see the recapitalization bond route being adopted by the government, which is a swap mechanism and cash neutral, with only interest payment on the bonds having a fiscal impact.

Perhaps once things revert to normalcy post COVID, talks of bank privatization will gather speed, though that may not be a panacea. Private sector banks have not exactly covered themselves in glory, with the private sector Yes Bank's bailout funded largely by tax paper owned SBI. Again India is in good company, with large scale government-sponsored bailouts of private sector commercial and investment banks in the US and Europe at the peak of the Global Financial Crisis. In the interest of financial stability, no economy can afford to see even a mid-sized bank fail, for fear of setting off a contagion effect on the rest of the banking system.

RBI's Financial Stability Report of July 2020 assures us that the financial system in India remains sound while cautioning on the need to stay extremely watchful and focused.

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