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Parsing the RBI's Financial Stability Report

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The Reserve Bank of India sits at the apex of the financial system. It is the banker and debt manager to the Government of India, banker to banks, regulator, licensor and supervisor of banks, regulator of payment and settlement systems and manager of foreign exchange of the country. It has an important role to play in monetary policy formulation and subsequent modulation of liquidity conditions to ensure transmission of monetary policy to the financial system. It is the issuer of paper currency and can also create electronic money "out of thin air", when it pays banks for the securities it purchases from them.

Any action of RBI therefore attracts a flurry of attention in the financial media, even if it is something as mundane as the publication of a report on financial stability. The latest such report published in December 2019, has the usual platitudes like "India's financial system remains stable notwithstanding weakening domestic growth" and "risks arising out of global/domestic economic uncertainties and geopolitical developments persist". The report also provides many interesting insights into the state of the economy and the banking system. While underscoring the slowdown in aggregate demand, it has understandably kept away from touching upon sensitive issues like demonetization and GST implementation.

The cobra effect

Shunning the usual conservative language and adding a dash of spice to an otherwise routine report, the central bank governor, in the preface to the report, warns of a "cobra effect", alluding to the unintended consequence of ultra-low/negative interest rates in some economies, which can lead to asset bubbles, rather than bringing back growth and inflation to acceptable levels.

NPA's, a bottomless pit

The report anticipates that the Gross NPA (GNPA) ratio, based on stress tests, may increase from 9.3 per cent in September 2019 to 9.9 per cent by September 2020. This is surprising given the significant Rs 42,000 recovery expected by banks from Essar Steel in this period and the recognition of many large ticket corporate NPA's having taken place already in the last few quarters. Yet to be recognized NPA's like a defaulting non-banking finance

company with a Rs 1 lakh crore balance sheet, may be a contributing factor, among others. If a forensic audit indicates a fraud, banks would need to provide 100% of their outstanding with more stringent timelines compared to a default due to a "genuine" business failure. The industrial sector's GNPA ratio is by far the highest compared to agriculture and services, with the least being that of the retail sector.

NPA's merit categorization after 90 day default. This is the tip of the iceberg. While the extent of stressed assets in the 1-90 day default range (known as Special Mention accounts i.e. SMA's) is available with the central bank, strangely this information is not disclosed for all SMA accounts viz. 0,1,2. The only information available from the financial stability report is that SMA-2 loans increased by about 143 per cent between March 2019 and September 2019, with the SMA 2 ratio at 2.2%. This alarming but significant piece of information is buried somewhere deep in the report. SMA's are the immediate precursor to NPA's and an increase in SMA2 ratio is a harbinger of higher Gross NPA's at banks.

Current account deficit

The report, released in the last week of December 2019 has forecast that current account deficit is likely to be under control "reflecting muted energy price outlook". In just a week since then, the geopolitical situation has taken a turn for the worse in the Middle East, with the clash between the US and Iran, resulting in higher oil prices. Though the price quickly corrected, the Middle East situation continues to be volatile as always, putting India's current account deficit in a similar situation. Overall, the report appears to support a bearish view on energy prices, which is good news for a huge oil importer like India.

Foreign exchange reserves

In Q1:2019-20, current account deficit widened to 2.0 per cent of GDP from 0.7 per cent in the preceding quarter, but this was more than offset by net capital flows. Foreign direct investment (FDI) recorded net inflows of USD 13.9 billion in Q1:2019-20 as compared to USD 9.6 billion in the corresponding quarter of the previous year, along with increase in external commercial borrowings (ECB's). This has led to increase in foreign exchange reserves which now stand at a significant USD 454.49 billion. The RBI's intervention in the foreign exchange market "to curb rupee volatility" (perhaps a euphemism for preventing rupee appreciation and its impact on exports) would have helped in building the FX reserve war chest to face sudden outflows or speculative attacks on the rupee in the offshore non deliverable forward markets.

The report opines that as US monetary easing takes a breather, the exchange rate outlook for emerging market (EM) currencies will be a large determinant of EM local currency bond flows.

Worries on credit growth highlighted

The aggregate growth (y-o-y) in banking sector's gross loans and advances noticeably slowed from 13.2 per cent in March 2019 to 8.7 per cent in September 2019. This raises the issue of causality. Did the slowdown in the

economy result in lower credit offtake or did banks' aversion to lend to the fraud prone industrial sector, lead to economic slowdown? Perhaps, the truth lies in between, with each feeding off the other.

Rating shopping, RBI calls it out

It's been an open secret until now, that issuers shop around for the best credit rating and rating agencies fall into this competitive trap to secure business by providing rosy ratings, which therefore are of no value to the lender/investor. The central banks concludes, using data, that for ratings that are withdrawn, the new ratings assigned are either the same or an improvement over the earlier ratings. Although replacement of withdrawn ratings by better or similar ratings by a different rating agency is visible across all rating grades, such instances are particularly pronounced at BBB and below. The issue of possible rating shopping behavior on the part of obligors clearly requires serious attention, says the central bank. Whose attention?! That of the market regulator, which regulates rating agencies?

Equity market, a better harbinger of defaults?

The report, while hesitating to spell out that rating agencies are behind the curve in recognizing defaults, makes no bones of its opinion that a relatively vibrant and active equity price is the only source of emerging information for all stakeholders including rating agencies. In other words, equity markets can predict defaults better than credit rating agencies.

Enforcement, a weak link

During July 2019 to December 15, 2019, RBI's Enforcement Department undertook enforcement action against 29 banks and one NBFC, and imposed an aggregate penalty of ₹47.92 crore for non-compliance with/ contravention of directions on fraud classifications and reporting by the banks, reporting of fraud on the CRILC platform, fraud monitoring in NBFCs, discipline to be maintained while opening current accounts, discounting/ rediscounting of bills by the banks, monitoring the end use of the funds, violations of directions/ guidelines issued by the Reserve Bank on know your customer (KYC) norms, Income Recognition and Asset Classification (IRAC) norms etc.

Even discounting for the size of India's banks versus those in the US/EU, the circa USD 7 million penalty by the banking regulator in India, is an abject figure compared to the multibillion dollar penalties on banks in the US and Europe for violations. The Indian market regulator's similarly modest penalties on errant credit rating agencies, led to a rally in their share prices when the penalty figures were announced recently. The timid response of our banking and market regulators cannot act as a deterrent to the banking and market players from ever more egregious violations.

Good news for real economies is bad news for the markets

The drafters of the Financial Stability Report appear to have taken pot shots at traders chasing negative yielding bonds. The report highlights that the extraordinary monetary expansion in the wake of persistent economic weakness has distorted global yields and that about a quarter of investments is in negative yielding bonds. Investors are betting on negative yielding bonds for capital gains for which yields need to go down even further. However, when the tide turns, bringing in good news for the real economies, it turns out to be bad news for the markets.

To conclude, the latest edition of the Financial Stability Report by the Reserve Bank of India is rich in data and analysis, provides several meaningful insights, even appears to pontificate to its peer market regulator, but stays away from political hot potatoes like the impact of GST rollout and demonetization.

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