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‘STRETCHED VALUATIONS THREATEN STABILITY’

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Reserve Bank of India (RBI) Governor Shaktikanta Das has flagged the growing disconnect between exuberant equity markets and real economic activity and warned that the ‘stretched valuations of financial assets’ threaten overall financial stability.

“The disconnect between certain segments of financial markets and the real economy has been accentuating in recent times, both globally and in India,” Mr. Das wrote in his foreword to the RBI’s biannual Financial Stability Report (FSR), which was released on Monday.

“Stretched valuations of financial assets pose risks to financial stability,” he cautioned.

Pointing to the interconnected nature of the financial system, the RBI Governor urged banks and financial intermediaries to be cognisant of the risk. India’s stock markets have been on a tear since plunging to their lowest levels in more than three years in March in the wake of the COVID-19 pandemic’s outbreak and ensuing lockdowns.

As of Monday’s close, the benchmark S&P BSE Sensex had appreciated almost 90% from its March 23, 2020, low.

The pandemic could also trigger balance sheet impairments and capital shortfalls, especially as regulatory reliefs are rolled back, Mr. Das cautioned.

‘Obscure true picture’

“Congenial liquidity and financing conditions have shored up the financial parameters of banks, but it is recognised that the available accounting numbers obscure a true recognition of stress,” Mr. Das wrote.

As per the FSR, the gross non-performing assets (GNPA) and net NPA (NNPA) ratios of banks fell to 7.5% and 2.1%, respectively, by September 2020. But the RBI warned that the withdrawal of pandemic-triggered reliefs could see a jump in bad loans at lenders.

“The improvements were aided significantly by regulatory dispensations extended in response to the COVID-19 pandemic. Macro-stress tests for credit risk show that SCBs’ GNPA ratio may increase from 7.5% in September 2020 to 13.5% by September 2021 under the baseline scenario,” the RBI observed.

‘Ratio may escalate’

“If the macroeconomic environment deteriorates, the ratio may escalate to 14.8% under the severe stress scenario. These projections are indicative of the possible economic impairment latent in banks’ portfolios,” it said.

“Consequently, maintaining the health of the banking sector remains a policy priority and preservation of the stability of the financial system is an overarching goal,” Mr. Das said.

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