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STATE OF STABILITY

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

The broad message from the RBI's latest financial stability report is that, despite some recent dislocation, the financial system is stable. Specifically, the problem of bad loans that has plagued the banking system appears to have been arrested. Gross NPAs of banks declined to 9.3 per cent of advances at the end of March 2019, from 11.5 per cent the year before. The central bank expects them to fall to 9 per cent by March 2020. Further, the number of banks with more than 20 per cent NPAs — mostly public sector banks — has also come down. The provision coverage ratio has also improved, indicating an improvement in asset quality. This is good news. Quick resolution of cases that are currently stuck in the IBC process would further aid the sector's recovery.

But the liquidity and solvency issues of non-banking financial companies continue to pose risks to the financial system. According to the RBI, NPAs of NBFCs have risen to 6.6 per cent in FY19, from 5.8 per cent in FY18. This is likely to be an underestimate. While an asset quality review could reveal the true extent of bad loans, and help identify the bad apples, the process will only delay an end to the uncertainty surrounding the sector. Already, the ripple effects of the crisis are being felt in the larger economy. Data released by the finance industry development council shows that loans sanctioned by NBFCs (excluding HFCs) fell by 31 per cent in the fourth quarter of 2018-19.

So far, the RBI has resisted calls to set up a special liquidity window for NBFCs. The central bank is rightly worried about issues of moral hazard. And the sector, which has seen unsustainable growth, requires a shakeout. But the situation appears to be worsening. Recent reports suggest that some of the bigger players in this segment are struggling to meet their loan obligations. It might be a mistake to assume that this poses no systemic risk. RBI's own tests show that failure of the largest NBFC/HFC will not only erode part of the banking system's tier 1 capital, but will also lead to the failure of one bank. Given the interlinkages in the financial system, that is built on trust, this could have cascading effects. The shortterm consideration should thus be to prevent the situation from worsening further. Perhaps backstopping the 263 systematically important non-deposit taking NBFCs could be a start, while putting in place a turnaround plan, and tighter regulations.

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