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Highlights of RBI's Financial Stability Report

RBI has attested to the strength of the Indian economy in its latest half-yearly Financial Stability Report. India's macroeconomic fundamentals have been underlined by moderating inflation, narrowing CAD, sustained growth and rising foreign exchange reserves. Against this backdrop, the health of the financial sector continues to be steady amidst sustained growth in bank credit, adequate capital, liquidity buffers, strong earnings and lower NPAs. Balance sheets of both corporate and banking sector have also strengthened and this is prompting anew investment and credit cycle. Apart from this, stress tests results indicate that even under severe stress scenario, capital reserves of SCBs remain adequate and GNPA ratios are also likely to inch up only marginally.

The FSR also noted that due to increasing interconnectedness, the share of interbank exposures in the total assets of banking system reached a 3-year peak in Sep'23. This leaves the financial system susceptible to contagion risk. However, it is unlikely to lead to the failure of any bank. With heightened volatility and uncertainty in the global financial system, risks of a spillover also cannot be entirely ruled out. It is therefore important to closely monitor the evolving picture and react proactively. This also needs to be supplemented with prudent management exposures and building of financial buffers

RBI's in the Financial Stability Report (FSR) alluded to the strength of the domestic banking system. The strong performance of the financial system has been underlined by:

- adequate buffers,
- robust earnings and
- improvement in asset quality.

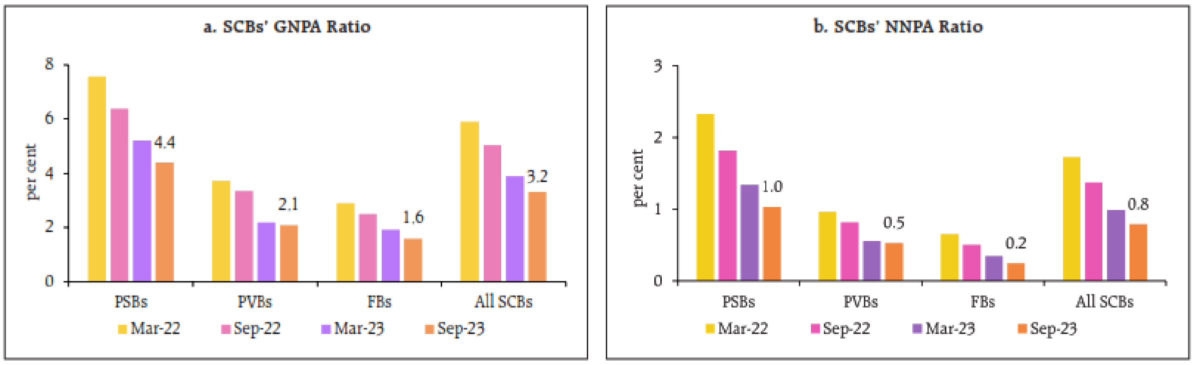
Improved margins due to higher interest rates has helped banks' profitability. However, with the interest rate cycle expected to have peaked, some pressure on this front is expected. Concerns have also been raised on the impact of sustained period of high interest rates on banks due to valuation losses. This is particularly important since banks hold ~63.6% of their investments in held-to-maturity (HTM) category, which are not marked to market. However, RBI's assessment showed that unrealized losses on HTM securities have fallen from Mar'23.

Some of the highlights mentioned in the report are:

- Underpinned by strong interest margins and buoyant credit demand the net interest income (NII) of banks have improved leading to a pickup in earnings. RoA and RoE have increased to 1.2% and 12.9% respectively in Sep'23, from historic lows of (-) 0.2% and (-) 2.2%, respectively, in Mar'28.
- Credit growth has continued to outpace deposit growth.

- Monetary policy transmission to both lending and deposit rates has been higher in this rate cycle.
- Banks' risk-weighted asset ratio (CRAR) remained robust at 16.8% in Sep'23, which is much higher compared with the minimum regulatory level of 11.5% (including capital conservation buffer).
- Further, the common equity tier 1 (CET1) ratio, representing the highest quality of regulatory capital was also above the regulatory threshold of 8% (including capital conservation buffer), and stood at 13.7% in Sep'23.
- Gross non-performing assets (GNPA) dipped further to 3.2% in Sep'23 from 3.9% in Mar'23.
- Net NPA also at a multi-decade low of 0.8% versus 1% in Mar'23.

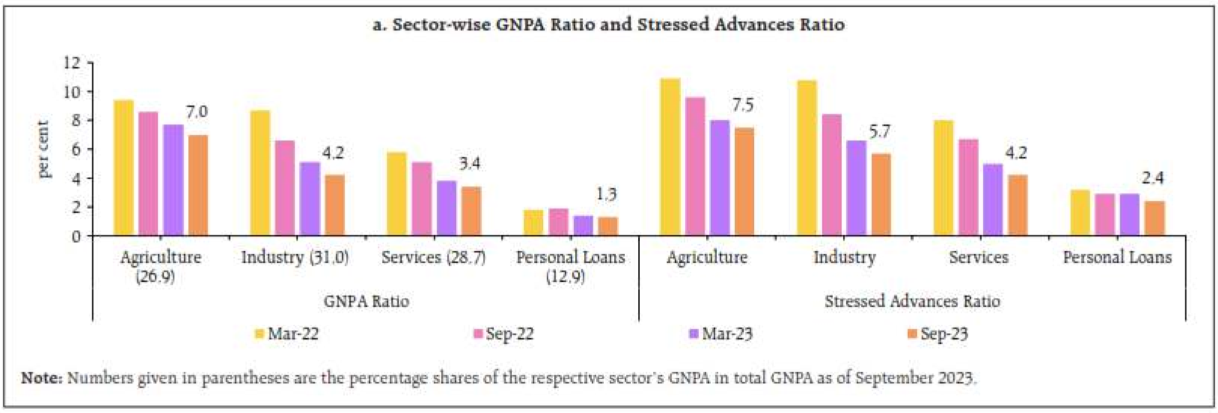
Figure 1: GNPA and NNPA ratios by bank type



Source: RBI-Financial Stability Report, Bank of Baroda Research

- Sector wise, there has been a broad based improvement in GNPA ratios across all key sectors. Even so, at 7%, GNPA ratio in the agriculture sector remained elevated.
- The FSR also highlighted that lending to retail segment, particularly unsecured loans by both banks as well as NBFCs has increased sharply in the past two years. However, the GNPA ratio for personal loans has moderated in Sep'23.

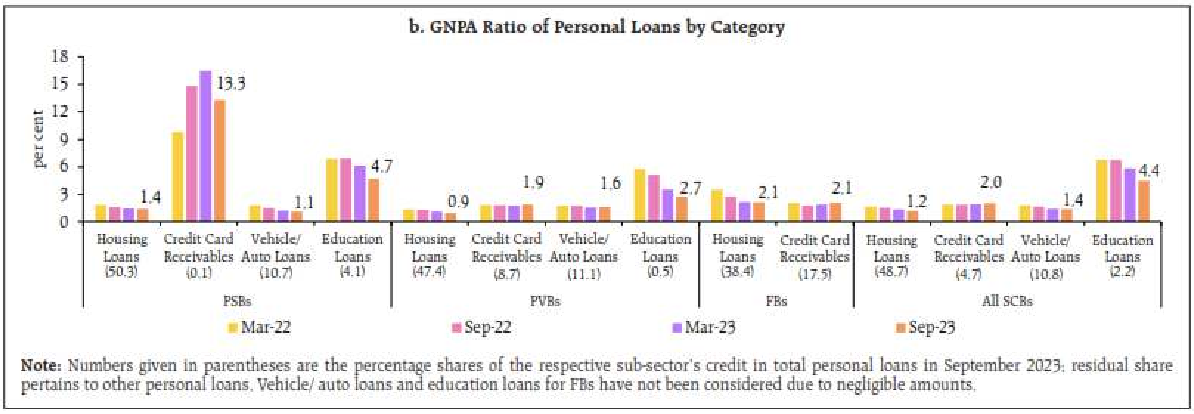
Figure 2: GNPA ratios by sectors



Source: RBI-Financial Stability Report, Bank of Baroda Research

- However, within personal loans, higher GNPA levels can be seen for credit card receivables, particularly for private sector banks (PVBs) and Foreign banks (FB).
- Despite higher rates, NPAs in the housing sector have remained relatively stable.
- For SCBs as a whole, GNPA ratio under unsecured retail loans has improved to 2% in Sep'23 from 2.5% in Sep'22.
- However, there are signs of stress in terms of risk profiling and high vintage delinquency. Apart from this, it was found that 42.7% of customers availing consumption loans already had three live loans at the time of origination and 30.4% of customers availed more than three loans in the last six months. Even more importantly, 7.3% of customers availing a personal loan below Rs 50,000 had at least one overdue personal loan.

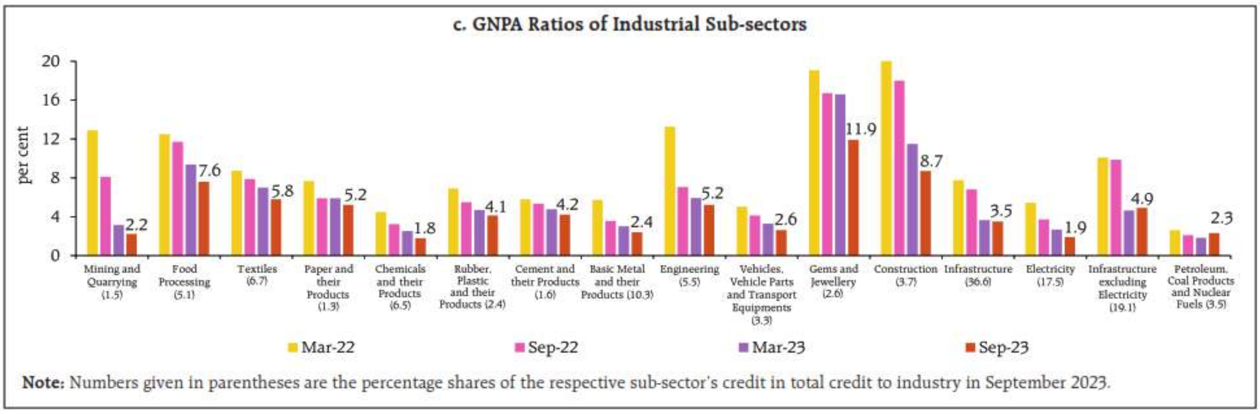
Figure 3: GNPA ratios under personal loans



Source: RBI-Financial Stability Report, Bank of Baroda Research

- Under industry, GNPA for infrastructure sector (ex. electricity) and petroleum and coal products has shown an uptick.

Figure 4: GNPA ratios under industry



Source: RBI-Financial Stability Report, Bank of Baroda Research

- Bank lending to SCBs, both by public sector banks (PSBs) and private sector banks (PVBs) accelerated in H1FY24, despite the expiry of Emergency Credit Line Guarantee Scheme (ECLGS).
- Overall, the GNPA ratio for this sector has declined to 4.7% in Sep'23 from 6.8% in Mar'23 and 7.7% in Sep'22.
- SMA-2 accounts, however, rose to 1.7% in Sep'23 from 0.9% in Mar'23.
- GNPA of loans extended under the ECLGS has increased to 6.5% in Sep'23 from 5.5% in Mr'23 with services and trade accounting for a majority of delinquencies.

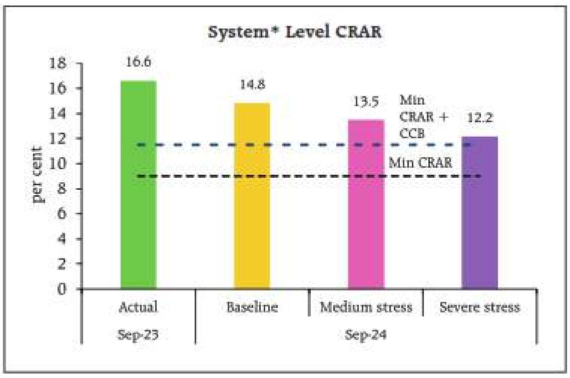
Some other interesting observations made in the FSR are:

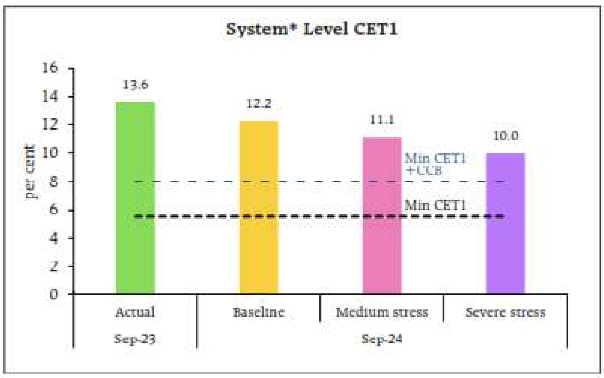
- With respect to bank lending to NBFCs, the report noted that almost 80% of bank credit goes to NBFCs which are rated AA or above.
- However, due to increase in co-lending initiatives between banks and NBFCs, and high ratios of SMA (1+2) for some banks, there are inherent risks. To mitigate this, the RBI introduced a preemptive step of increasing the risk weight risk weights on certain segments of consumer credit by banks and NBFCs, along with increasing the risk weight of bank credit to NBFCs.
- As a result, the CRAR of SCBs estimated to decline by 71bps to 16% and CET1 may fall by 58bps to 13.2%. However, this will vary from bank to bank.

Results of stress test:

- Results of macro stress test reveal that Indian banks are well capitalized to handle any macro-economic shocks, without requiring additional capital infusion.
- Consolidated CRAR of 46 major banks is expected to dip from 16.8% in Sep'23 to 14.8% in Sep'24 under the baseline scenario, 13.5% under medium stress scenario and 12.2% under severe stress scenario. Even so, it will remain above the minimum regulatory threshold under all the three scenarios.
- CET1 ratio is also expected to decline to 12.2% (baseline), 11.1% (medium stress) and 10 (severe stress) by Sep'24.

Figure 5: CRAR

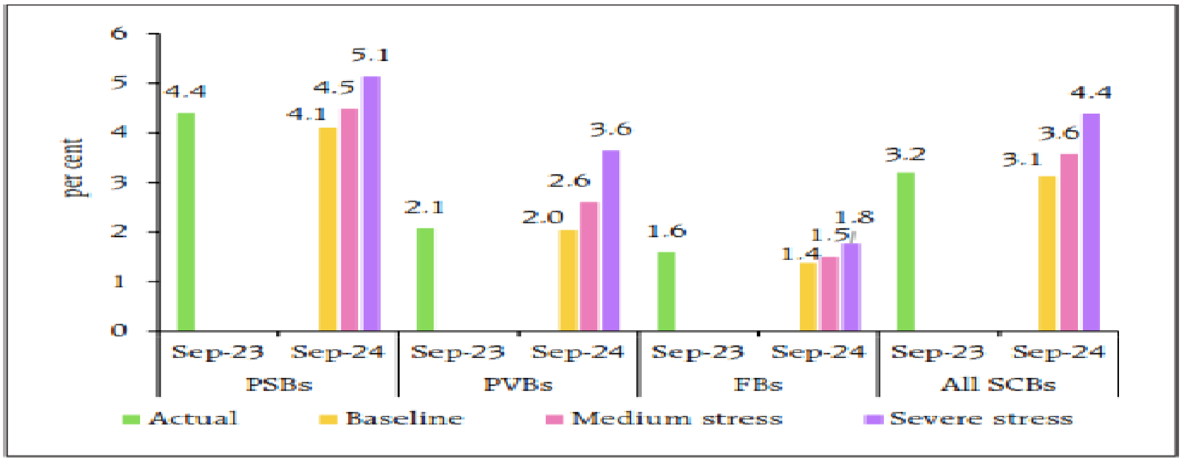




Source: RBI-Financial Stability Report, Bank of Baroda Research

- GNPA ratio of SCBs is expected to moderate further to 3.1% by Sep'24 under baseline scenario, from 3.2% currently. Under medium-stress scenario, it is expected to rise to 3.6%, and further to 4.4% under severe stress scenario.

Figure 5: Projections for SCBs' GNPA ratio



Source: RBI-Financial Stability Report, Bank of Baroda Research

For the NBFC sector, the FSR notes the following:

- CRAR for NBFCs stood at 27.6% in Sep'23 versus the regulatory requirement of 15%.
- GNPA ratio has declined from a high of 7.2% Dec'21 to 4.6% in Sep'23.
- The report also noted that due to the difference in nature of operations of different NBFCs, there are inherent risks which can spill over to the financial system.
- NBFC-Investment and Credit Companies (ICCs) which are primarily engaged in retail lending, depend heavily on bank borrowings (48% of their total borrowings in Sep'23). Consumer loans, on which risk weights were increased recently, formed 44.7% of the incremental retail loan growth over the last one year.
- Alarmingly, the share of unsecured loans in the NBFC sector rose from 24.6% in Mar'23 to 31.9% in Sep'23, increasing at a CAGR of over 20%.
- Even for NBFCs-IFCs (Infrastructure Finance Companies), are another source of risk as their exposure to the power sector makes them vulnerable. Share of bank borrowings to this category of NBFCs stands at 29.5% as of Sep'23.
- Stress tests for NBFCs to shocks from credit risks for 146 NBFCs suggest that under the baseline scenario, the one-year ahead GNPA ratio and CRAR is estimated at 3.8% and 22% respectively. Under a medium risk shock GNPA ratio increases to 5% per cent and the resultant income loss and additional provision requirements reduce the CRAR by around 70bps from the baseline. Under the high-risk shock, CRAR declines by 101bps relative to the baseline, to 21%.

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