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Towards a more stable banking in India

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ABSTRACT

Banks in advanced economies continue to be weighed down by slow credit growth, funding risks, reliance on government and central bank support, contagion impact from the concerns about sovereign debt sustainability, etc. In contrast, the Indian financial system which is largely dominated by the banking sector remains well capitalized. Asset quality remained robust though some concerns emanated from the fact that slippages exceeded the rate of growth of advances, and resulted in increased requirements for provisions. The present paper aims to analyse the stability of Indian banking sector as compared to world scenario in terms of Capital to risk weighted assets ratio, Overall Asset Quality and Interest rate sensitivity. The paper based on RBI Financial Stability Report 2010 also analysis the stability of Indian banking in terms of bank Stability Index.

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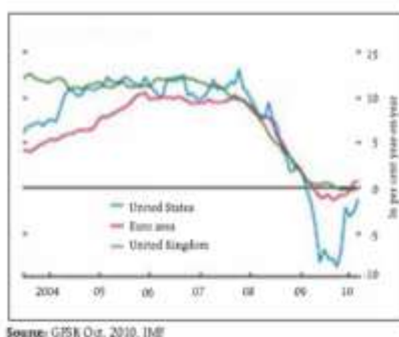
Introduction

The World Banking Scenario:

Banks, globally, remained vulnerable to the still tentative global recovery and to the disturbances caused in global financial markets by the sovereign debt crisis which first emerged in May 2010. The EU-IMF bailout package and the publication of the results of stress tests conducted on many large European banks by the EU helped restore some normalcy. Credit off take improved (Fig 1), estimate of crisis related bank write downs declined (from US $ 2.8 trillion in April 2010 to US $ 2.3 trillion in October 2010) and substantial recoveries were made. The banking system in advanced economies, however, continued to remain vulnerable to confidence shocks, and to excessive reliance on government or central bank support.

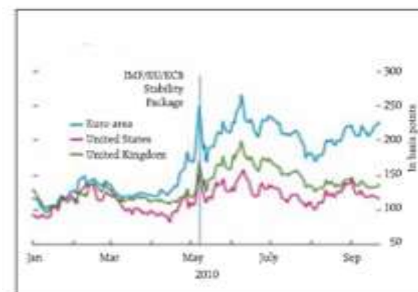
Fig 1: Banks' Private Credit Growth in Advanced Economies



Source: GFSR Oct. 2010, IMF

Concerns about the sustainability of the improved conditions and about imminent further deleveraging remain (on account of funding risks as banks face a “wall of redemptions” in the next couple of years) Banks improved their capital adequacy ratios even as the global reforms agenda unfurled requiring them to keep aside much higher levels and improved quality of capital than before. However, the banks have a long implementation period extending up to 2019 to adjust to the requirements for higher quality and quantity of capital The above trends were reflected in the movements of the banking sector CDS (credit Default swap spreads (Fig. 2) and in the performance of banking stocks (Fig: 3). Banking stocks in Asia performed better reflecting the less severe impact of the crisis on Asian economies and their faster recovery.

Fig 2: Banking Sector CDS Spreads



Source: GFSR Oct. 2010, IMF

Fig 3: Global Banking Indices
Global Banking Indices

Indian Scenario: Banks in India remained resilient even during the crisis and do not face the funding and maturity risks of the kind encountering the global banks. However, given the growing integration of the Indian financial sector with the global economy, the CDS spreads of the banks in India as also their equities' performance largely paralleled the global trends, especially trends in Asia.

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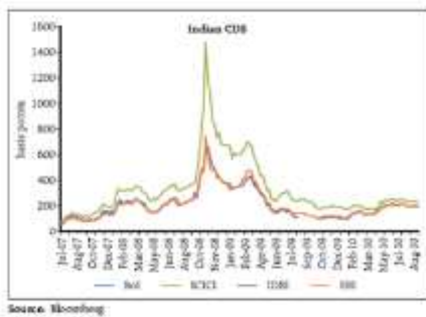
Fig 4: CDS Spread of Select Indian Scheduled Commercial Banks



Source: Bloomberg

Financial Soundness Indicators of Indian Banks

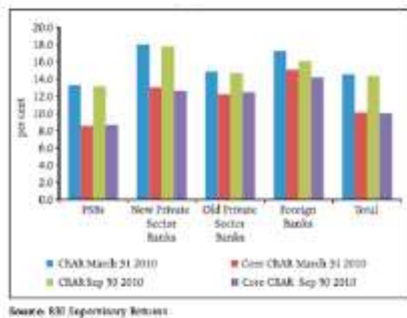
Capital to risk weighted assets ratio (CRAR): **I**ndian banks remain well capitalised. No bank had CRAR less than stipulated minimum.

SCBs with overseas presence migrated to the Basel II framework with effect from March 31, 2008 while other commercial banks (except RRBs) migrated to the new framework with effect from March 31, 2009.

The time schedule for implementation of advanced approaches under Basel II has also been notified though there remain several challenges (with respect to creating requisite IT and risk management infrastructure, upgrading skills and building requisite historical data) in migrating to these approaches SCBs in India are required to maintain capital to the extent of 9 per cent of risk weighted assets (as against the Basel II requirement of 8 per cent). With effect from April 1, 2010, they are also required to maintain a core CRAR (Tier I capital to total risk weighted assets) of 6 per cent (as against the Basel II requirement of 4 per cent).

The capital adequacy position of SCBs was well above the regulatory requirements with CRAR and core CRAR being in excess of 14 per cent and 10 per cent respectively in March 2010 and in September 2010. The ratios declined marginally in September 2010 due to greater credit off take (Fig: 5)

Fig 5: Capital Adequacy under New Capital Adequacy Framework



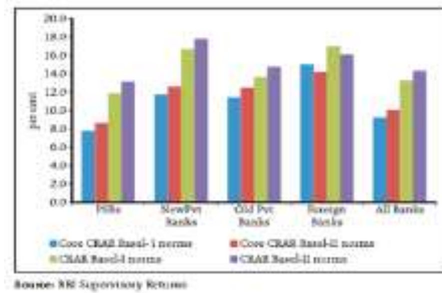
Source: RBI Supervisory Returns

There was no commercial bank which had CRAR less than 11 per cent or core CRAR less than 6 per cent as on September 30, 2010 indicating that the capital adequacy position of banks was comfortable both at the micro and the macro level.

As an additional safeguard, domestic regulations required SCBs to compute their respective capital adequacy ratios under Basel I guidelines in addition to computing the same under Basel II guidelines in order to ensure that the capital maintained in respect of credit and market risks by SCBs is not less than 80 per cent of the capital requirements under Basel I.

The capital adequacy ratios under Basel I guidelines, though a tad lower than the ones under Basel II guidelines7 were also well above the minimum prescribed (Fig: 6).

Fig 6: Capital Adequacy under Basel-I and Basel-II Frameworks (September 2010)



Source: RBI Supervisory Returns

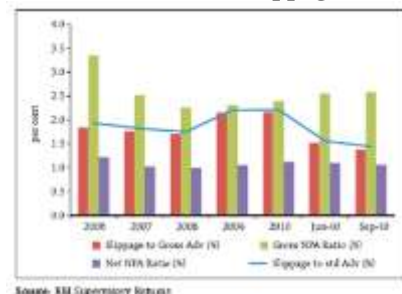
Overall Asset Quality: Asset quality continued to deteriorate in the aftermath of the Global financial crisis

During 2009-10, growth in the stock of NPAs was 20.61 per cent which outpaced the rate of growth of gross advances at 16.68 per cent. Consequently, the gross and net ratio of NPAs to gross and net advances deteriorated during 2009-10. The deterioration in the asset quality continued as at end September 2010, as the gross NPAs increased by about 19.34 per cent on year on year basis (Fig: 7).

Fig 7: Growth Rates of Gross NPAs of SCBs

The gross NPA ratio at 2.39 per cent as at end March 2010 increased to 2.58 per cent as at end September 2010. However, the net NPA ratio improved (from 1.12 per cent to 1.06 per cent) as banks increased their provisions in a bid to meet the regulatory requirement of 70 per cent provision coverage ratio (Fig; 8)

Fig 8: **NPA Ratios and Fresh Slippage Ratios of SCBs**



Source: RBI Supervisory Returns

Interest rate sensitivity: Evidence of increase in interest rate risk is visible

Though a normal part of banking and an important source of profitability and shareholder value, excessive interest rate risk can pose a significant threat to a bank's earnings and capital base. Interest rate risks are typically measured by simple gap analysis or duration gap analysis14 or with the help of other more sophisticated tools like Value at Risk (VaR) or Stress Testing Techniques. Regulatory provisions for the SCBs in this regard were first prescribed in February 1999 stipulating a simple gap analysis for interest rate risk measurement from the 'earnings perspective'. Banks were, however advised to migrate to modern techniques such as Duration Gap Analysis (DGA), Simulation and VaR over a period of time.

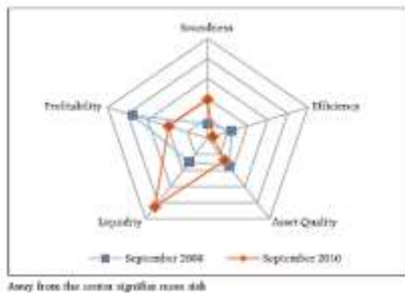
Data on maturity time bucket wise Rate Sensitive Assets and Liabilities (RSAs and RSLs) in September 2010 pointed to build up of mismatches in the time bucket of beyond 5 years which may partly be due to increasing exposure to infrastructure financing (Fig: 9).

Fig 9: Asset Liability Mismatches of SCBs

Measuring Banking Stability (based on select indices)

Risks related to liquidity indicators have increased 4.65 An overall assessment of the stability of the banking sector during the year September 2009- September 201015 was conducted using a stability map (FIG: 10).

Fig 10: Banking Stability Map



The stability map is based on five critical indices for explaining any change in the risk dimensions of the banking sector with respect to the position as on a past date, in this case with reference to September 30, 2009.

The banking stability map indicates that risks affecting liquidity of the banking sector recorded dimensional increase (year on year) as at end September 2010 as compared to September 2009. This partially reflects the relative deterioration as indicated by increased reliance of the banks on borrowings and decline in the level of their liquid assets**.**

Conclusion

The banking system in advanced economies continues to be vulnerable to confidence shocks and funding risks and remains excessively reliant on government or central bank support. Banks improved their capital adequacy ratios even as the global reforms agenda unfurled making it clear that banks would have to keep aside much higher quantity and quality of capital than before.

The financial sector in India remains resilient. Capital adequacy ratios of scheduled commercial banks are well above the regulatory requirements – both from a micro and a systemic perspective - implying that the distance to compliance with Basel III requirements, when adopted, may not be very significant at the system level. Leverage ratios remain comparatively low as compared to ratios in advanced nations

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