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Management

FINANCIAL STABILITY: AN OVERVIEW

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ABSTRACT

The paper highlights the issue of financial stability in the Indian context, prevention of financial crises including banking, securities market with respect to financial stability. The paper also highlights the two most important factors that have occupied the minds of policy makers within the RBI-inflation and interest rates. The paper also examines the need for financial stability.

Keywords: Financial instability, IMF, Inflation, Interest rate, RBI.

INTRODUCTION

Ensuring financial stability has come to occupy a very important position in the responsibility of a Central Bank. However, a widely accepted definition of 'Financial Stability' is still elusive. On many occasions, financial instability has been explained and financial stability has been explained as its corollary. It was generally accepted that minimizing financial instability was the way to ensure financial stability. The birth of the discipline '*Financial Stability*' can be traced to the East Asian crisis during the 1990's. Following the crisis, the IMF introduced the 'Financial Sector Assessment Programme' in 1999 which aimed at assessing the strengths and weaknesses of the financial systems of member countries at regular intervals. IMF also started publishing the 'Global Financial Stability Report', which sought to highlight the undercurrents that could impact the financial stability.

Financial and economic uncertainty, large swings in economic activity, high inflation and excessive volatility in foreign exchange and financial markets were seen as some of the potential factors that could impact financial stability. Further it was generally accepted that instability increases uncertainty, discourages investment, impedes economic growth, and hurts living standards. Any dynamic economy has an inherent measure of volatility

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– more so far developing economies which undergo structural changes. The challenge to regulatory authorities is to minimize volatility without injuring growth, employment and living standards.

FINANCIAL STABILITY – EXPANDING HORIZON

For two decades in the aftermath of the East Asian crisis, the shenanigans of the financial world were confident that they know the levers that impacted financial stability. The Global Financial Crisis of 2008 bought in a new dimension to financial stability. None of the conventional drivers of the financial instability like investment slowdown, high inflation or declining living standards were noticed. In fact it was acknowledged that the ability of the US financial markets to create innovative instruments to attract and sustain high levels of capital flows as a positive for the stability of financial markets. It was even perceived that a wider dispersion of credit risks was a measure of de-risking for the financial sector. However, the crisis that unfolded underlined the need to look at a new set of parameters that could signal potential instability. Capital and liquidity reserve requirements, foreign exchange intervention, explicitly limiting leverages are some of the tools that have come back in the arsenal of the central banks of even developed economies.

REVIEW OF LITERATURE

Rakesh Mohan focusing on growth with financial stability and his unique perspectives from government, the central bank, and academia has shed fresh light on the challenges of economic and financial liberalization. His book, *Growth with Financial Stability* (2011), provides a rare insider view of the development and working of central banking and the financial sector in India. Using a rigorous analytical approach, the book unravels the key to India’s macroeconomics and financial stability and provides fresh insights on lessons for the future.

Douglas W. Arner analyze how financial crises have become an all too common occurrence over the past twenty years, largely as a result of changes in finance brought about by increasing internationalization and integration. As domestic financial systems and economies have become more interlinked, weaknesses can significantly impact not only individual economies but also markets, financial intermediaries, and economies around the world. This volume addresses the twin objectives of financial development in the context of financial stability and the role of law in supporting both. Financial stability (frequently seen as the avoidance of financial crisis) has become an objective of both the international financial architecture and individual economies and central banks. At the same time, financial development is now seen to play an important role in economic growth. In both financial stability and financial development, law and related institutions have a central role.

1. Comprehensive analysis of the role of law in financial development and stability.
2. Analysis of the role of the international finance architecture in financial stability and financial development.
3. International and comparative perspective by a financial sector development reform specialist.

FINANCIAL STABILITY IN THE INDIAN CONTEXT

The concept of financial stability in the Indian context was a direct outcome of the global financial crisis. The Financial Stability Unit (FSU) was announced by the RBI in the Annual Policy Statement of April 2009 to perform the following function:

1. Conduct of macro-prudential surveillance of the financial system on an on basis;
2. Preparation of financial stability reports;
3. Development of a database of key variables which could impact financial stability, in co-ordination with the supervisory wings of the Reserve Bank;
4. Development of a time series of a core set of financial indicators;
5. Conduct of systemic stress tests to assess resilience;
6. Development of model for assessing financial stability in due course.

Consequent to the formation of FSU, RBI started publishing the *Financial Stability Report*, the first edition of which was published in May 2010. As opposed to the concept of limiting the monetary policy measures to the single agenda of 'inflation targeting', RBI's stated position has been to focus on price stability, growth and financial stability. This coupled with a strong regulatory oversight, both on banks and the financial markets, has helped RBI achieve the objective of financial stability.

However, interest rates and inflation have come to become the two most important factors that have occupied RBIs mind space. For a country which has witnessed spiraling interest rates and persistent double digit inflation, it is natural for the monetary policy to focus on interest rates and inflation.

INFLATION AND INTEREST RATES

However, with the economy undergoing structural changes, the relationship between interest rates and inflation also appears to be getting complex. With services being the engine of economic growth, capex is no more an indicator of growth. Similarly, a large part of the informal sector which used to be a cash economy was not impacted by interest rate movements. Further, supply side dynamics were also playing a significant role in price-rise and inflation, where monetary tools were not effective. A look at the comparison of interest rates and inflation over a two year period(Figure 2) shows that there are factors other than interest rates that have a bearing on inflation.

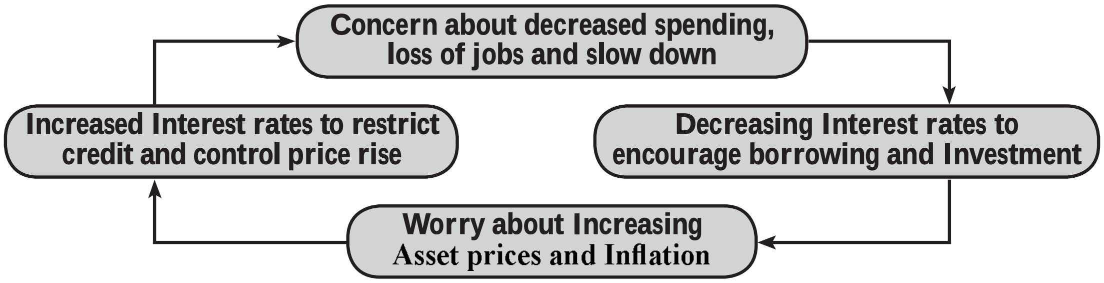
Concern about decreased spending, loss of jobs and slow down
Decreasing Interest rates to encourage borrowing and Investment
Worry about Increasing Asset prices and Inflation
Increased Interest rates to restrict credit and control price rise

Figure 1: Determining Factors for Interest Rate and Inflation

The banking sector is an important component of the financial stability scene. A very significant part of the financial system is dependent on the banking system and it is essential that banking sector is well governed and regulated to ensure the stability of the financial system. To this end the RBI has been proactive in addressing the concerns of the banks, through an effective supervisor role. Two important developments that are likely to have a significant impact on the Banking systems are the (1) Insolvency and Bankruptcy code and the (2) Scheme for Sustainable structuring of Stressed Assets (S4A).

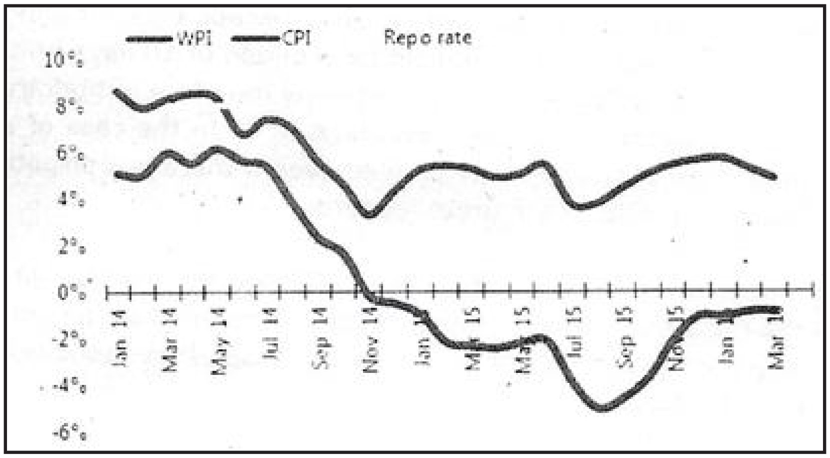

Figure 2: Comparison between Inflation and Interest Rate(2- Year graph)

Insolvency and Bankruptcy Code: The much awaited law codifying the Insolvency and Bankruptcy processes was enacted on May 28, 2016. The Law establishes the process for resolution in the event of a debtor not being able to pay the dues and subsequent liquidation in the event of inability of the parties to arrive at a resolution. Closure of business and honorable exit by all the parties have been vexed issue in the Indian corporate landscape with a host of legislations and a multitude of regulators governing the process. The new Law seeks to act as a 'one stop shop' for the process of liquidation. The enactment is seen as a step towards *'Ease of Doing Business'*.

The Law has all the right ingredients for speedy measures in the event of inability of a business to pay its creditors:

1. Separate processes for corporate entities and partnership and proprietorship firms.
2. Separate Adjudicating Authorities for Corporate (National Company Law Tribunal, NCLT) and partnerships and individuals (Debt Recovery Tribunal, DRT).
3. An independent Insolvency Resolution Professional to manage the process of resolution.
4. Independent information utilities to provide the necessary unbiased financial information.

5. A defined timeframe for resolution and in the event of inability to resolve, automatic liquidation.
6. A change in the hierarchy of payments in the event of liquidation. From a situation where the government dues are to be paid first in the event of liquidation under the current laws (wherein almost all liquidation cases, as also the liquidation proceeds are exhausted once the Government dues are paid up) to a situation where the Government stands for the satisfaction of other creditors.

The Law seeks to protect the interests of both the Financial Creditor - one who has provided with funds for the business and an Operational creditor – who has sold goods or services in the ordinary course of business. Employees are also considered as operational creditors to the extent of their unpaid dues.

Potential Pitfalls: While the intent of enacting such a Law is honorable, some of the specific provisions have the potential to disrupt the business even in the face of a short term liquidity crunch. It appears that an unwitting business entity may end up being unnecessarily drawn into the process of insolvency resolution. Any operating creditor can file an application for initiating a corporate insolvency resolution process if his dues remain unpaid for a period of 10 days from the date of demand. There could be numerous occasions where a company may face temporary cash flow problems and an unscrupulous creditor could take advantage of it. In the case of a financial creditor, an application for insolvency resolution may be filed even if there is a dispute regarding the financial debt. This could land businesses in great jeopardy.

The adjudicating authorities are the NCLT and the DRTs. While the NCLTs are just coming into being and will take over the work of the Company Law Board and the BIFR, the DRTs are already overworked. Given the workload of these entities it is not clear how the insolvency resolution process is expected to be completed in 180 days.

The law appears to be on sound footing when it comes to liquidation – when the resolution process fails or when the company comes into voluntary liquidation. The change in the hierarchy and allowing secured creditors to exercise their right is a move in the right direction to bring confidence to lenders. However, only time will tell the efficacy of this law to achieve resolution in the event of non-payment of dues.

Scheme for Sustainable structuring of Stressed Assets (S4A): The scheme for Sustainable structuring of Stressed Assets (S4A) is yet another tool to tackle the growing challenge of stressed assets in the banking sector. The earlier schemes like 5:25 and SDR have not had the desired effect and this is an improvisation over those initiatives. S4A envisages the determination of a sustainable debt level for the borrower. The outstanding debt is sought to be divided into sustainable debt and equity/quasi-equity instruments. The equity component is expected to provide a potential upside to lenders. It seeks to cover projects that have started commercial operations and have outstanding loan of Rs. 500 crore (reduced to Rs. 250 crore subsequently). The transparency of the resolution process is ensured by way of appointment of an external agency for technical evaluation and also oversight of an independent committee comprising experts.

The scheme provides an opportunity to lenders to deal with stressed assets that have the potential to be received. Entities facing genuine difficulties on account of external factors which are beyond their control have an avenue to rework their financial structure and turn viable.

CONCLUSION

With hardening interest rates and the imminent increase in cost of funds, the credit growth is expected to slow down, which could adversely affect the profitability. The bank's profitability has recently improved, buoyed by increased Net Interest Income (NII) though non-interest income remained stagnant. An increase in NII facilitated growth of around 20% in aggregate net profit of the banking system, even with an almost stagnant non-interest income and increase in risk provisions. Banks may face extreme liquidity constraints, under severe stress scenario.

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