COVID-19: May Perpetuate Uncertainty in Indian Financial Sector

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The corona virus pandemic, COVID-19 has unfolded a tremendous level of uncertainty in the global economy. Like any previous episode of economic slowdown, the most immediate fall-out of this pandemic would be on the financial sector. This is the reason why the Reserve Bank of India (RBI) came out with a Rs 3.74 trillion of support that enveloped most sectors. Never before has the RBI cut the interest rate at which it lends to banks by 75 basis points. The other key measure announced was the forbearance on payment of installments on all sorts of loans including farm loans. This will apply to all loans offered by regional rural banks, small finance banks and local area banks, co-operative banks, scheduled banks, and NBFCs (including housing finance companies and micro-finance institutions)[1].

The measures are meant to ease disruptions in fund flows to real sectors of economy, avoid working capital shortage for businesses and stem panic withdrawals by households from banks and non-banking deposit-taking institutions. The confidence building measures have also had a positive impact on outflows of capital by foreign institutional investors (FIIs) as well as drying up of external commercial borrowings. The move to reset working capital loans will particularly provide support to SME financing, averting significant distortion of supply chains.

Already anticipating the possible seizure of the financial sector in the world economy, the major global financial institutions such as International Monetary Fund (IMF), World Bank and Bank for International Settlements (BIS) and Multilateral Development Banks (MDBs) like New Development Bank (NDB), Asian Infrastructure Investment Bank (AIIB), etc have announced different financing support packages to counter further deceleration in global economic growth. In addition, IMF and the World Bank have announced easing the debt burden of the developing countries by delaying their payments.

Despite the RBI package, Indian banking and financial sector faces tough challenges in the coming months. Some sectors of economy such as travel, hospitality and transportation & logistics are badly hit. Credit exposure of commercial banks and non-banking financial companies to those sectors may gradually turn into bad assets in the coming days. COVID-19 could further exacerbate the erosion of confidence in the Indian financial system due to the Punjab and Maharashtra Cooperative (PMC) Bank and Yes Bank crises. Before settling the blame over higher accumulation of non-performing assets (NPAs) in the commercial banking sector over the past few years, the banking regulator, the Reserve Bank of India (RBI) had to face systemic regulatory collapses in PMC and Yes Bank credit exposures sending worrying signals of the health and resilience of the banking sector. As per the Financial Stability Report published by RBI in December 2019, "…..sources of vulnerabilities are continuously interacting" which probably had allowed the banking sector to pursue accommodative monetary policy in the recent years. The report further underscores the fall in wholesale credit growth and challenges in transmission of monetary policy impulses to real sectors of economy. On the flip side the sharp rise in usage of digital money could change for the better the domestic financial landscape.

The assessment of COVID-19-related dislocation in Indian financial sector can be studied from two angles: firstly, the channels that would perpetuate the risks already built up over the past few months, and secondly, the new challenges emanating from global economic shocks in the form of falling foreign direct investment (FDIs) and collapse of export revenues, remittance flows, etc. Following the first strand, despite noticeable improvement in banking segment in terms of capital adequacy, liquidity and asset quality after seven years of deterioration, Indian banking is not entirely free from challenges. Overhang of NPAs and low credit growth by scheduled commercial banking (credit growth during 2018-19 was primarily aided by private banks) indicates build up of risks in the system which may deteriorate further if cut in aggregate demand and business activity prolongs. Macros-stress test for credit risk suggest that NPAs may increase to 9.9 per cent in September 2020 from 9.3 per cent in September 2019. These numbers may have to be further revised now. One positive point that contributes to the resilience of Indian banking sector is remarkable improvement in provision coverage ratio, compliance to Basel III standards with stable Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Moreover, the Capital to Risk-Weighted Assets Ratio (CRAR) of the scheduled commercial banks improved from 13 per cent in 2014-15 to 15.1 per cent in first half of 2019-2020.

Likewise, the second channel of risks for Indian banking and financial sector is the contagion from faster transmission of global shocks. Exports from India touched $292.9 billion in the 11 months to February 2020, while imports were $436.03 billion but these will certainly taper off in 2020-21. Till 27 March, foreign institutional investors have pulled out Rs 58,408.15 crore from Indian capital markets[2]. On a single day the BSE Sensex crashed by 4000 points. All these developments would help aid the slowdown to worsen in a synchronized fashion thereby impacting commercial banking. Moreover, the depreciation of Indian Rupee could deteriorate current account balance even though lowering of oil prices has provided some relief. However foreign exchange reserves are still stable for India and the stock of all essential supplies of food, vegetables, medicines, etc amidst 21-day lock-down is not an issue at the moment.

A sense of how the fall in economic activity and consequent fall in tax revenues would constrain the fiscal space of the government would be visible when the RBI and the finance ministry issue their borrowing calendar this week. At the same time it may be necessary for RBI to pause further steps till the spread of the disease is arrested. Higher allocation of government expenditure towards fighting corona virus manifested in the form of medical supplies and health infrastructure would cut or postpone capital expenditure in other sectors to a great extent. India may need to explore emergency COVID-19 funding support from AIIB and NDB as well. AIIB contributed US$ 1 million to China by ensuing necessary medical supplies while NDB extended RMB 7 billion emergency assistance package. In order to sustain efforts directed towards COVID-19, Indian financial sector needs to be prepared for tougher times in the coming days.

Endnotes

1 COVID-19 – Regulatory Package (Revised), RBI, March 27,2020; https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11835&Mode=0

2 FII & DII TRADING ACTIVITY DURING MAR '20, Money Control; https://www.moneycontrol.com/stocks/marketstats/fii_dii_activity/index.php

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