

Link between banks, NBFCs raises risk of contagion in a financial crisis: Bimal Jalan committee

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RBI and govt must be aware of the sources of financial instability: Bimal Jalan panel report

The government and the Reserve Bank of India (RBI) must be mindful that new potential sources of financial instability from systematically important financial institutions cannot be ruled out, according to the report of the Bimal Jalan committee to review the RBI's extant economic capital framework.

In this regard, the committee said the interconnectedness in Indian markets between banks and non-banking financial entities is enlarging rapidly, thus increasing the risk of contagion in a financial crisis.

According to the June 2019 issue of the Financial Stability Report, the total outstanding bilateral exposures among the entities in the financial system increased to ₹36.3-lakh crore in March 2019 from ₹31.4-lakh crore in March

2018.

Public sector banks have a net receivable position vis-à-vis the non-banking financial sector. In the event of stress in the non-banking financial sector, the committee observed that the banking sector, and particularly public sector banks, will likely come under stress.

The current stress being experienced by the NBFC sector, for example, led to calls for appropriate Lender of Last Resort (LoLR) action by the RBI, it added. It may be pertinent to note here that defaults by non-banking entities, such as IL&FS and DHFL, have had a ripple impact on the financial system.

Risk provisioning

On the possibility of the RBI making emergency liquidity assistance (ELA) losses, even when a major part of the banking sector is in the public sector, the committee was of the view that prudence would necessitate risk-provisioning as the losses could materialise, including from ELA support, to private sector banks.

According to the committee's report, having a public sector-dominated banking sector does not make an economy immune to bank runs. The 2002 crisis in a Latin American economy largely involved PSBs. Further, the experience from the global financial crisis has shown that the ownership of the banking sector becomes more public sector-oriented during periods of crisis.

NPA crisis

While large public sector ownership has been seen as a positive in preventing bank runs in the past, the committee underscored that the NPA crisis has thrown light on the challenges that arise if a sizable majority of the banking sector looks at the government for recapitalisation.

“Here lies the challenge of assessing the risk-provisioning requirements of the RBI. The central bank would theoretically not be exposed to ELA losses if the government recapitalises these banks.

“However, the European debt crisis has demonstrated that private sector debt crises can transform into a sovereign debt crisis if the government overstretches itself in recapitalising distressed banks,” the committee said. In this regard, the committee felt that the position could be even more severe in India.

It reasoned that given India’s sovereign rating is at the lowest investment grade – any downgrade, due to fiscal slippages caused by recapitalisation – could exacerbate the capital flight caused by the financial crisis.

The committee further stated that the rupee not being a reserve currency will greatly limit India’s capability to manage financial crises.

The committee, therefore, recognised that the RBI’s financial stability risk provisions need to be viewed for what they truly are – the country’s savings for a rainy day (a financial stability crisis), built up over decades and maintained with the RBI in view of its role as the LoLR. Its balance sheet, therefore, has to be demonstrably credible to discharge this function with the requisite financial strength.

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