GOVERNMENT OF INDIA
FINANCE
LOK SABHA

UNSTARRED QUESTION NO:4118
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VULNERABLE BANKING SYSTEM
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Will the Minister of FINANCE be pleased to state:

(a) whether the Reserve Bank of India (RBI) in its semi-annual Financial Stability Report has warned that the country's close ties between lenders would leave the banking system specially vulnerable to contagion in case of trouble at a single institutions; and

(b) if so, the details thereof along with the reactions of the Government thereon?

Answer

The Minister of State in the Ministry of Finance (SHRI JAYANT SINHA)

(a) & (b): The interconnectedness between financial institutions though is an indicator of the level of maturity of the market, it does expose the system to contagion risks in the event of stress scenarios. The US experience of one institution going bust leading to the failure of a dozen others due to common exposures is an example. A contagion analysis is conducted to estimate potential loss to the banking system triggered by the hypothetical failure of either one or several banks. Such an analysis is a good indicator about the toxicity of banks and provide an additional input in identifying systemically important banks. Apart from that, it is also meant for the supervisory agencies given their limited resources to focus on the major areas where the risk is concentrated. In this context, Reserve Bank of India (RBI) hasre-emphasised that the analysis is hypothetical and depicts a worst-case scenario. Irrespective of this, as stated in the recent issue of FSR (December 2014), good interconnectedness amongst financial institutions is essential and even inevitable.

The recent issue of FSR (December 2014) has stated that the banking system's Tier-I capital could be adversely affected in the case of failure of highly connected banks. The potential contagion caused by the hypothetical failure of each of the top five connected banks under liquidity, solvency and joint solvency-liquidity contagion has been presented in the FSR.