Composite Financial Stability Indicator

Outline

❖ Financial Soundness Indicators

❖ What is Financial Stability

❖ Signs of Financial Instability

❖ Purpose of developing CIFS

❖ Construction of the Indicator

❖ Results

Financial Soundness indicators

❑ Financial soundness indicators "FSIs" are indicators that measures the health and soundness of the financial institutions in Oman as well as their corporate and household counterparty.

❑ FSIs supports our macroprudential analysis

Asset Quality:

- Stage 3 or specific provisions to NPLs ratio
- Gross NPL ratio

Solvency:

-Capital to Risk-weighted Assets Ratio

-Common Equity Tier-1 Capital Ratio

Liquidity:

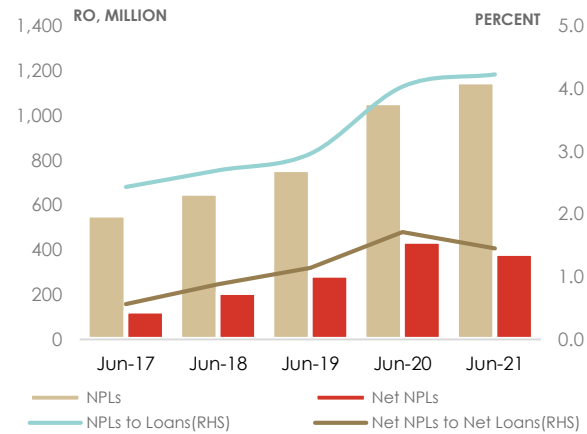-Liquidity Coverage Ratio

-Net Stable Funding Ratio

Profitability:
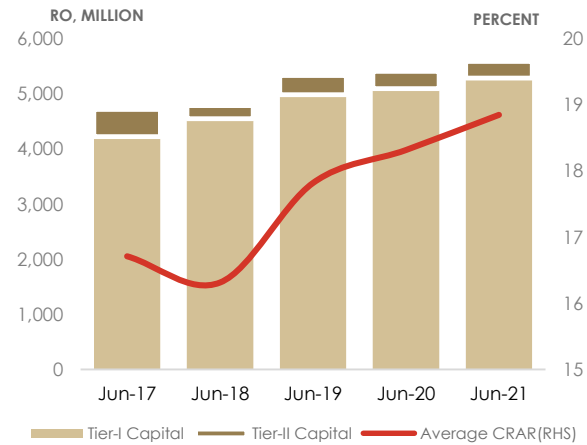
-Return on Assets

-Return on Equity
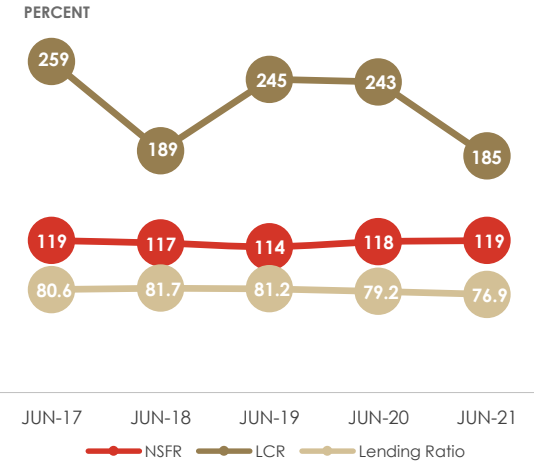
TRENDS IN NON-PERFORMING (STAGE 3) LOANS

RO, MILLION   PERCENT

NPLs — Net NPLs — NPLs to Loans(RHS) — Net NPLs to Net Loans(RHS)

Solvency

CAPITAL BUFFERS

RO, MILLION   PERCENT

Tier-I Capital — Tier-II Capital — Average CRAR(RHS)

Asset Quality

PRUDENTIAL LIQUIDITY INDICATORS

PERCENT

NSFR — LCR — Lending Ratio

Liquidity

What is Financial Stability?

The World Bank

Absence of system-wide episodes in which the **financial system** fails to function (crises). It is also about resilience of the financial system to stress.

Bank of England

A stable **financial system** is one that can provide crucial services to households and businesses in good times and bad.

Federal Reserve

Financial stability is about building a **financial system** that can function in good times and bad, and can absorb all the good and bad things that happen in the U.S. economy at any moment.

ECB

Financial stability can be defined as a condition in which the **financial system** – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances.

Signs of Financial Instability

Instability can be observed is several forms

➤Large Change in Asset prices

➤Excessive increase in risk or uncertainty

➤Illiquidity in the financial system

➤Bank Runs particularly Systemic Institutions

Purpose of Developing CIFS

Why CIFS

01 To create a single aggregate measure that enables policy makers to assess the current degree and evolution of financial stability

02 Adds in transparency by providing a quantitative information to the market

03 Enabling policy makers to anticipate the sources and causes of financial stress

04 Easier to communicate the findings to the national public

Methodology:
Many of the MENA region countries developed an aggregate measure of financial stability in the form of an Index.

Variables Included:
Common indicators are: Banking stability indicator, Macroeconomic Stability Indicator and Capital Market stability indicator. While some studies especially advanced economy focused solely on market indicators.

Weights:
Majority of the studies allocated weights in the form of expert judgement and regulatory requirement

Methodology

Rating Mechanism:
The financial stability rating of the Sultanate follows a scale from 1 to 5, a three-point benchmark are set for each variable.

Assumptions
The three point benchmark for each variable and the weights are based on a mixture of **regulatory measures imposed and expert judgment.**

Rating Transformation
Linear interpolation is used to transform the values into a rating of **1 to 5**

Central Bank of Oman
البنك المركزي العُماني

Example: Capital Adequacy Ratio

20%

13.25%

10%

Rating of 5

This rating assumes that the indicator is at a point where the likelihood of instability is low.

Rating of 3

This rating assumes that the indicator is at a point where the likelihood of instability is Medium.

Rating of 1

This rating assumes that the indicator is at a point where the likelihood of instability is High.

Example: Government Debt to GDP

30%

Rating of 5

This rating assumes that the indicator is at a point where the likelihood of instability is low.

50%

Rating of 3

This rating assumes that the indicator is at a point where the likelihood of instability is Medium.
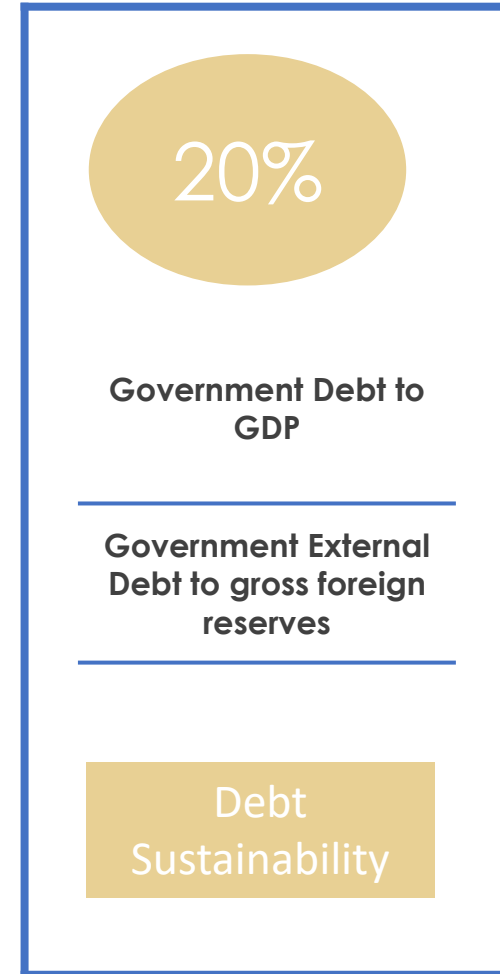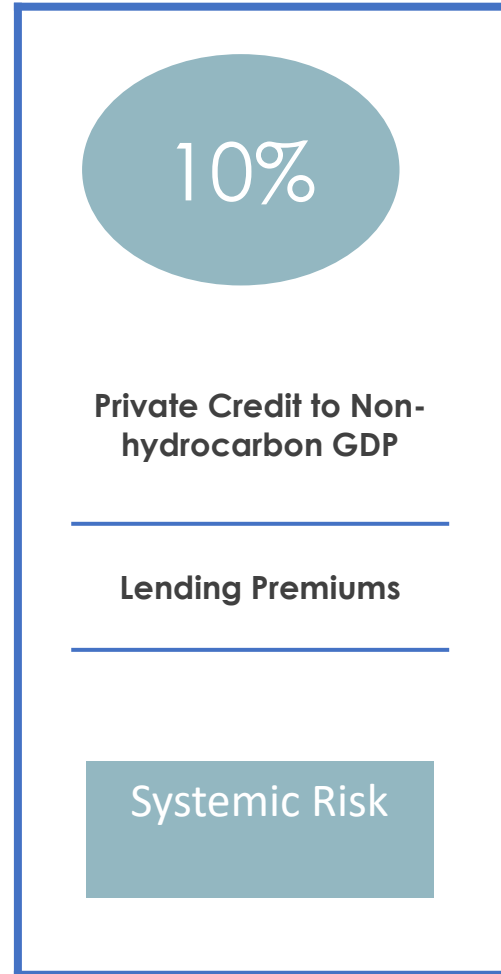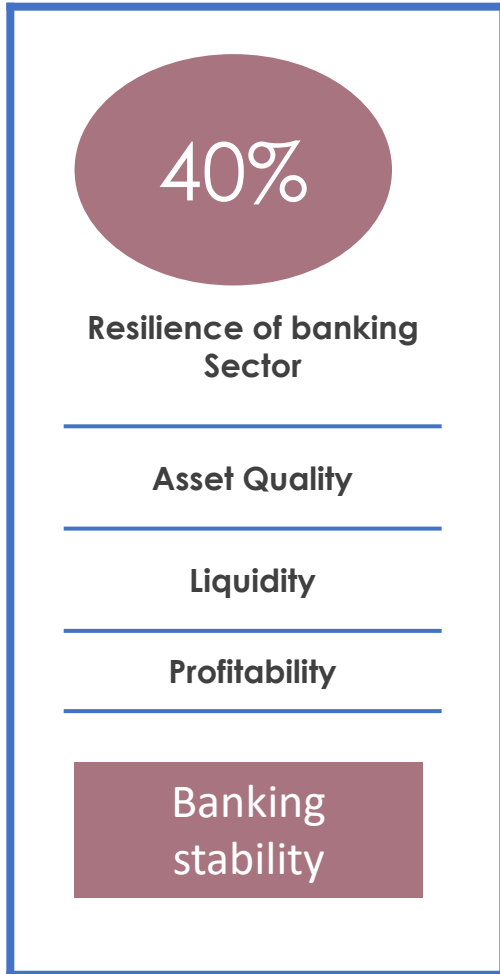
100%

Rating of 1

This rating assumes that the indicator is at a point where the likelihood of instability is High.

Construction of the Indicator

Data (2008Q1-2020Q4)

40%	**10%**	**20%**
Resilience of banking Sector	**Private Credit to Non-hydrocarbon GDP**	**Government Debt to GDP**
Asset Quality	**Lending Premiums**	**Government External Debt to gross foreign reserves**
Liquidity		
Profitability		
Banking stability	Systemic Risk	Debt Sustainability

Construction of the Indicator

Data (2008Q1-2020Q4)

20%

Forward Exchange rates

Import Cover

CPI Inflation rate spread

Interest Rate spread

Currency Stability

10%

Quarterly changes in rate of return

Quarterly Changes in Market turnover growth

Financial Sector Beta

Capital Market Uncertainty

Construction of the Indicator

Banking Stability Sub-Indicator

Variable	Signalling properties (+/-)
Capital Adequacy (15%)	
• **Core Capital (+)**	Low levels indicate the inability of banks to absorb losses (+)
• **Capital Adequacy ratio (+)**	
Asset Quality (10%)	
• **Performing restructured loans (-)**	Lower loan standard may adversely influence the financial stability (-)
• **Stage 2 to gross loans (-)**	
• **Gross NPL ratio (-)**	The coverage ratio illustrates the banks' ability to absorb potential losses from its NPLs (+)
• **Coverage ratio (+)**	

Construction of the Indicator

Banking Stability Sub-Indicator

Variable	Signalling properties (+/-)
Liquidity (15%) • **Lending ratio (-)** • **LCR & NSFR (+)**	Signals the ability of banks to cover any unforeseen fund requirements (-) A higher ratio signals better ability of banks to meet its short term and longer-term financial obligations (+)
Profitability (10%) • **ROA (+)** • **ROE (+)** • **NIM (+)**	The higher the ratio the better the profitability of the banking sector (+)

البنك المركزي العُماني
Central Bank of Oman

Systemic Risk Indicator & Debt Sustainability Sub-Indicator

Variable (Systemic Risk Indicator)	Signalling properties (+/-)
• **Private credit to Non Hydrocarbon GDP (+)** • **Lending Premiums**	• Basel III acquaint with a countercyclical capital buffer (CCB) intended to strengthen banks' buffers against the build-up of systemic vulnerabilities (+) • Measures flight to quality and flight to liquidity

Variable (Debt Sustainability Indicator)	Signalling properties (+/-)
• **Government Debt to GDP (+)** • **Government External Debt to Gross Foreign reserves**	High debt levels may indicate unsustainable government indebtedness hence forming an inverse relationship with FSI (-)

Currency Stability Sub-Indicator

| Variable	Signalling properties (+/-)
• **Forward Exchange rates**	• OMR at forward discount indicates pressure on the currency / peg
• **Import Cover**	• Foreign Reserves Adequacy signals how resilient is the country's currency towards any unforeseen shocks (+)
• **Interest Rate Spread**	• Since Oman is operating under a fixed exchange rate environment, a deviation of the overnight interest rate from the effective fed fund rate may adversely impact the financial system.
• **Inflation Rate Spread**	• Significant inflation growth indicates structural weakness in the economy.

Capital Market Uncertainty Sub-Indicator

Variable	Signalling properties (+/-)
• **Volatility in MSx market returns** • **Volatility in MSX market turnover**	• Huge fluctuations in a relatively short period may indicate uncertainty in the market and hence adversely impact confidence.
• **Financial Sector Beta**	• Relatively riskiness of the financial sector stocks. The higher the financial sector β, the greater the banking sector's stress.
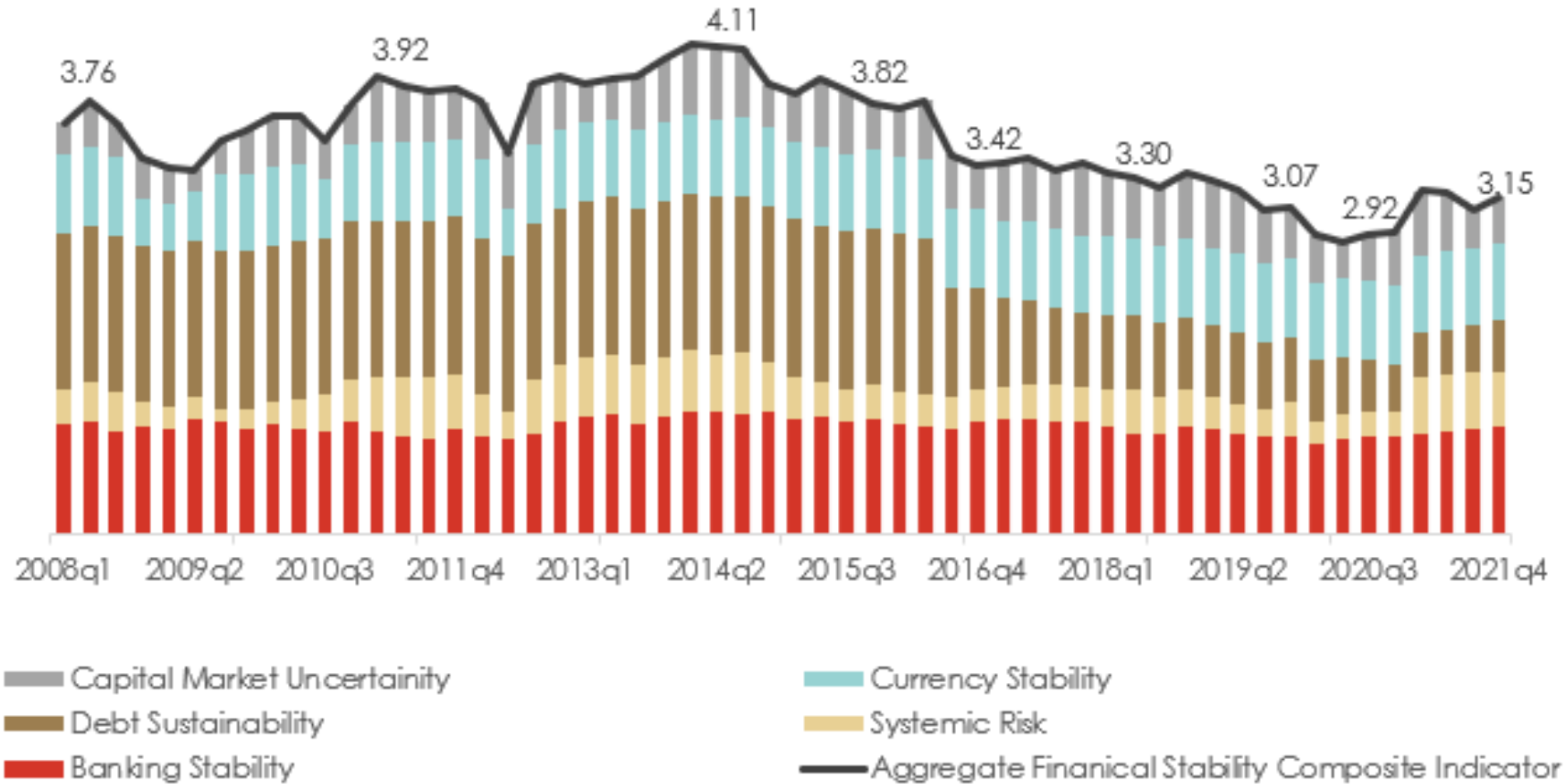
البنك المركزي العُماني
Central Bank of Oman

Thank You