

## Overview

### Macro-Financial Risks

#### Global Economy and Markets

Global recovery remains fragile amidst slowdown in trade, rising tendency towards protectionism and slower growth in productivity. Global financial markets continue to face elevated levels of uncertainty, notwithstanding the resilience exhibited in overcoming the outcomes of Brexit referendum and the US presidential election.

While the unconventional monetary policy measures have so far fallen short of achieving their intended objectives, the systemic central banks in advanced economies are unlikely to end them abruptly because of the concerns on potential impact on financial stability and limited scope for alternative measures on fiscal front. However, financial markets would continue to grapple with headwinds from uptick in US interest rates.

#### Domestic Economy and Markets

Domestic macroeconomic conditions remain stable with significant moderation in inflation. Moreover, reduced policy uncertainty and legislative and tax reforms such as implementation of goods and services tax (GST) and enactment of bankruptcy laws are expected to reinforce the benefits from the strong macro fundamentals. The withdrawal of legal tender status of specified bank notes (SBNs) could potentially transform the domestic economy. While the overall risks to the corporate sector moderated in 2016-17, concerns remain over its recovery.

India's external sector reflects significant improvement in terms of contraction of current account deficit, although there may be concerns on account of weakening of remittance inflows. While the redemption of foreign currency deposits raised in late 2013 was managed relatively smoothly,

volatility in capital flows emanating from global events may add to exchange rate pressure.

Domestic debt and equity markets witnessed foreign portfolio investment outflows since October 2016 reflecting expectations of increase in the interest rates by the US Fed. The domestic mutual funds have emerged as a counter balance to foreign portfolio investors as they increased their net investments significantly.

#### Financial Institutions: Soundness and Resilience

The banking stability indicator (BSI) shows that the risks to the banking sector remained elevated due to continuous deterioration in asset quality, low profitability and liquidity. The business growth of scheduled commercial banks (SCBs) remained subdued with public sector banks (PSBs) continuing to lag behind their private sector peers. System level profit after tax (PAT) contracted on y-o-y basis in the first half of 2016-17.

The GNPA (gross non-performing advances) ratio of SCBs increased to 9.1 per cent in September 2016 from 7.8 per cent in March, pushing the overall stressed advances ratio to 12.3 per cent from 11.5 per cent. The large borrowers registered significant deterioration in their asset quality.

#### Stress Tests and Network Analysis

The macro stress test shows that GNPA ratio of SCBs may increase further if macroeconomic conditions deteriorate sharply. The PSBs may record the highest GNPA ratio and lowest capital to risk-weighted asset ratio (CRAR) among bank-groups although the CRAR at the system as well as bank-group levels may remain above the required regulatory minimum. Given the higher level of impairment, SCBs may remain risk averse in the near future as they focus on cleaning up their balance sheets and their capital

positions may remain insufficient to support higher credit growth.

Asset quality of scheduled urban co-operative banks (SUCBs) deteriorated. Asset quality of the non-banking financial companies (NBFCs) also worsened.

The degree of interconnectedness in the banking system measured by the connectivity ratio showed a declining trend. SCBs were the dominant players accounting for nearly 57 per cent of the total bilateral exposures followed by NBFCs. On a net basis, asset management companies managing mutual funds (AMC-MFs) followed by the insurance companies were the biggest fund providers in the system while NBFCs followed by SCBs were the biggest receivers of funds.

#### **Financial Sector Regulation and Infrastructure**

With the implementation of global regulatory reforms most of the major international banks have become more resilient in terms of capital and liquidity. However, risks of divergence from the demanding global standards amidst discriminatory treatment of foreign financial institutions seem to have increased. Scaling down on correspondent banking activities by some of the major global banks due to regulatory and profitability concerns may discourage formal financial intermediation channels to reach out to financially underserved parts of the world. At the same time, some risks inherent in banks may be getting transferred to other segments of the financial markets due to increased regulatory scrutiny and elevated capital requirements for banks.

While regulatory measures on partial credit enhancement will support the corporate bond market in India, the guidelines on market mechanism

and large exposures will help in reducing banks' exposures to large corporates. The macroprudential and other regulatory measures are expected to enhance transparency in the functioning of financial markets and empower customers with wider product-choices and more effective mechanism for grievance redressal.

The Securities and Exchange Board of India (SEBI) has taken several measures that include tightening of insider trading norms and enhancing transparency in the policies and procedures adopted by credit rating agencies (CRAs).

The guidelines issued by Insurance Regulatory and Development Authority of India (IRDAI) seek to address operational aspects such as monitoring the foreign direct investment in insurance sector, approval of share transfer, and ceiling of holdings on various classes of investors, among others.

The National Pension System (NPS) continued to gain traction in terms of the number of subscribers as well as assets under management (AUM). Introduction of two new life cycle funds and creation of a separate asset class for alternate investment are expected to provide more options to investors in pension schemes.

#### **Assessment of Systemic Risk**

India's financial system remains stable. The stress on banking sector, particularly the PSBs remain significant. The results of the latest systemic risk survey (Annex 1) conducted by the Reserve Bank in October 2016 indicated that among risks affecting the financial system, 'global risks' were perceived to be in 'medium' category while average quality of credit was expected to remain unchanged over the next quarter.