Overview

Macro-Financial Risks

Global Economy and Markets

The global economy has picked up steam and the growth momentum appears sustainable. Notwithstanding the efforts to normalise monetary policy by the Federal Reserve and the Bank of England, financial conditions in the advanced economies remain accommodative. Commodities space is firming up, and increased geopolitical risks imply likely volatility in commodity prices. In the emerging market context, exports are growing at their fastest clip in six years on the back of a pick-up in global growth. Notwithstanding hardening of US treasury yields, debt flows to emerging economies remain robust.

Domestic Economy and Markets

Domestic growth rebounded in 2017-18:Q2, after initial hiccups associated with the roll-out of the nationwide goods and services tax (GST), coming on the back of demonetisation. The ongoing deleveraging in the heavily indebted parts of the corporate sector and poor credit growth in public sector banks present a downside risk to growth.

The overall investment climate remains challenging as seen from the decline in new investment proposals. The positive signals of improvement – 'the decline in number and cost of stalled projects in 2017-18:Q2', 'the efforts to improve the quality of government expenditure', 'ease of doing business ranking', 'India's sovereign rating upgrade by Moody's' and the 'bank recapitalisation announcement' – are expected to provide a significant fillip to investment sentiments.

The overhang of liquidity conditions in the wake of demonetisation has led to unprecedented flows to both equity and debt mutual funds. Foreign portfolio investment (FPI) flows into the capital market also remained buoyant with a greater preference for debt.

Financial Institutions: Soundness and Resilience

The banking stability indicator (BSI) shows that the risks to the banking sector remain at an elevated level weighed down by further asset quality deterioration. Credit growth of scheduled commercial banks (SCBs) showed an improvement between March and September 2017, while public sector banks (PSBs) continued to lag behind their private sector peers. SCBs' return on assets (RoA) remained unchanged at 0.4 per cent between March and September 2017, while PSBs have continued to record negative profitability ratios since March 2016.

The gross non-performing advances (GNPA) ratio of SCBs increased from 9.6 per cent to 10.2 per cent between March and September 2017. The GNPAs grew by 18.5 per cent on a y-o-y basis in September 2017. Private sector banks (PVBs) registered a higher increase in GNPAs of 40.8 per cent as compared to their public sector counterparts (17.0 per cent).

Stress Tests and Network Analysis

The macro stress test for credit risk indicates that under the baseline macro scenario, the GNPA ratio may increase to 10.8 per cent by March 2018 and further to 11.1 per cent by September 2018.

The network analysis indicates that the degree of interconnectedness in the banking system has decreased gradually since 2012. The joint solvency-liquidity contagion analysis shows that losses due to default of a bank have declined.

Financial Sector: Regulations and Developments

While global banks have strengthened their resilience in terms of capital and liquidity, their activity moderated in terms of cross-border lending. On the domestic front, regulations on resolution have ultimately evolved into the bankruptcy framework, and stakeholders have to maintain a fine balance among various options available to them for the most optimum resolution. Corporate governance in banks is key to ensuring the success of the recapitalisation of banks.

Financial savings in the form of mutual funds (MF) investments and pension schemes not only continued to grow, but, are also getting broad-based in terms of the spatial distribution and investor profile. The domestic insurance sector has recently seen significant activity in terms of going public and consolidation; five insurance companies have already been listed on the stock exchanges and two more are in the process of being listed. The new insovency and bankruptcy regime is showing significant progress in dealing with financial and operational creditors to insolvent companies in a market determined and time bound manner.

Assessment of Systemic Risk

India's financial system remains stable. The stress in the banking sector, particularly the PSBs, while significant, appear to be bottoming out. The results of the latest systemic risk survey conducted by the Reserve Bank in October 2017 indicated that among risks affecting the financial system, 'global risks' and the risk perception on macro-economic conditions and institutional risks were perceived to be in 'medium' category.