Overview

Macro-financial Risks

Global Economy & Markets

After years of sluggish growth, the global economy seems poised for a turnaround. While there are uncertainties, the underlying feeling of a stable transition from a global accommodative monetary policy regime to a normal rate cycle is evident in equity and fixed income markets. However, unlike past business cycles wherein credit growth acceleration preceded an uptick in GDP growth, growth in private credit to non-financial corporations is muted. While global trade has picked up, US dollar has recently weakened *vis-à-vis* other global currencies. The divergence in 'rate outlook' between the Fed and the other advanced economies (AEs), and soft commodity prices may impact AE currencies. Geopolitical risks are elevated and a real concern is the perceived weakening of international institutional mechanisms to deal with them. At the same time, one has to await the on-going churning in political processes across the world to assess how much of the rhetoric on protectionism and populism will ultimately materialise.

Domestic Economy & Markets

Domestically macroeconomic conditions remained stable and the expectations of accelerated reforms and political stability further reinforced the overall positive business sentiment. Retail inflation witnessed significant decline during the recent quarters and the real gross value added (GVA) growth decelerated to 6.6 per cent in 2016-17 from 7.9 per cent in 2015-16, largely reflecting slowdown in services. Government's commitment to fiscal discipline had a positive impact on macroeconomic outlook. However, concerns arise over States' fiscal position and the stretched debt capacities of some parastatals. Going forward, reforms in foreign direct investment, implementation of goods and services tax (GST), and revival in external demand are likely to contribute to a better growth outlook. The impact of demonetisation, if any, on exchange rate and portfolio flows was fleeting. Amidst concerns over asset quality, credit intermediation by public sector banks has retrenched while that by NBFCs and mutual funds has increased significantly. Notwithstanding the current benign conditions, it is important to guard against geopolitical risks.

Corporate sector

Although the current period data of non-financial companies may not be strictly comparable with the previous periods due to adoption of Ind-AS in a phased manner from 2016-17, the half-yearly positions of select non-government non-financial (NGNF) listed companies indicated improvement in performance of the corporate sector, especially growth in sales. While a significant proportion of companies in the sample deleveraged during the year, the total borrowings of all companies in the sample expanded about 4 per cent during 2016-17. As regards industries, telecommunication and power remained areas of concern. Significant increase in share of 'debt at risk' is seen under a sensitivity test for such companies.

Financial Institutions: Soundness and Resilience

During 2016-17, while deposit growth of scheduled commercial banks (SCBs) picked up, credit growth remained sluggish putting pressure on net interest income (NII), particularly of the public sector banks (PSBs). While profitability ratios showed a marginal increase, PSBs continued to show a negative return on assets (RoA). The gross non-performing advances (GNPAs) of the banking sector rose but the stressed advances ratio declined between September 2016 and March 2017 on account of agriculture, services and retail sectors. Overall, capital to risk-weighted assets ratio (CRAR) improved from 13.4 per cent to 13.6 per cent between September 2016 and March 2017 owing to improvement in capital adequacy of private and foreign banks. The share of large borrowers both in SCBs' total loans portfolio as well as GNPAs showed a reduction between September 2016 and March 2017.

At the system level, the CRAR of scheduled urban co-operative banks (SUCBs) increased from 13.0 per cent to 13.6 per cent between September 2016 and March 2017. While the aggregate balance sheet size of the NBFC sector expanded by 14.5 per cent during 2016-17, their net profit was down by 2.9 per cent.

Stress Tests and Network Analysis

The banking stability indicator (BSI) worsened between September 2016 and March 2017 due to deterioration in asset quality and profitability. The macro stress test indicates that under the baseline scenario, GNPAs of SCBs may rise from 9.6 per cent in March 2017 to 10.2 per cent by March 2018. A severe credit shock is likely to impact capital adequacy and profitability of a significant number of banks.

The network structure of the financial system indicates that SCBs were the dominant players accounting for nearly 51 per cent of the bilateral exposures followed by asset management companies managing mutual funds (AMC-MFs), non-banking financial companies (NBFCs), all-India financial institutions (AIFIs), insurance companies and housing finance companies (HFCs).

Financial sector – Regulation and development

While convergence of global regulatory standards remains the core area of the Basel Committee on Banking Supervision (BCBS), its focus is shifting from standard setting to ensuring effective supervision by further improving supervisory tools and techniques. The recent Basel standards are in the areas of NPAs, forbearance, disclosures and adoption of IFRS 9. In the domestic context, imminent transition to Ind AS will be challenging for Indian banks in terms of skills as well as the requirement of higher amount of provisioning. RBI tightened its disclosure and standard assets provisioning requirements, while adopting a more proactive approach in resolution of stressed assets. It reinforced its supervisory and enforcement frameworks by revising the prompt corrective action (PCA) framework and establishing an Enforcement Department. Lower impairment in home loans and weak credit growth have prompted the RBI to take a counter-cyclical measure of reducing risk weights and standard asset provisioning for individual housing loans. Further, prudential norms on masala bonds have been harmonised with those for external commercial borrowings (ECBs).

SEBI, along with RBI, allowed derivative transactions in International Financial Services Centers (IFSCs), while making the disclosure requirements for top listed entities more comprehensive. Investor protection measures were further enhanced by SEBI. PFRDA has allowed the second record keeping agency to be established, which has brought down operating charges.

The efficiency and competitiveness of the banking sector is likely to increase with entry of differentiated banks, posing some transitional challenges to the universal banks. The mutual funds market is expanding beyond the top 15 cities. Various initiatives by regulators to develop the corporate bond markets seem to be bearing fruit as reflected in increased issuance and turnover in the secondary market. Concerns arising from frauds and cyber-attacks remain elevated with the recent global ransomware attacks. Various responses by the regulators in this regard include setting up of an Inter-disciplinary Standing Committee on Cyber Security by the RBI.

Assessment of Systemic Risk

India's financial system remains stable, while the concerns on banks' asset quality remain. The transition of credit intermediation from the banking sector to the non-banking sector though welcome, calls for increased monitoring and prudential regulation. The results of the latest systemic risk survey (Annex 1) conducted by the Reserve Bank during April-May 2017 indicated that among the major risk groups; global, macro-economic and institutional risks continued to be perceived as 'medium', while financial market risks were perceived as 'low'.