

Overview

Macro-financial Risks

Global Economy and Markets

The tapering in the US Federal Reserves' bond purchase programme is set to begin from January 2014. The initial reaction of financial markets to the announcement has been positive, having been anticipated and therefore factored-in. Fed's forward guidance on the policy rates has also had a reassuring impact. However, financial market volatility will be conditioned by the pace of tapering going forward.

Against this background, the interplay of growth-inflation dynamics between advanced economies (AEs) and emerging market and developing economies (EMDEs) (convergence in growth and divergence in inflation) may increase vulnerabilities for EMDEs. To reduce spillovers from AE monetary policy normalisation, EMDEs will have to strengthen national balance-sheets. High global liquidity amid persistently low interest rates in AEs has been pushing up asset prices.

Domestic Economy and Markets

The delay in tapering allowed India to bring about adjustment in the current account deficit (CAD) and build buffers by replenishing its foreign exchange reserves. However, macro-economic adjustment is far from complete, with persistence of high inflation amidst growth slowdown. Fall in domestic savings and relatively high fiscal deficit are other major concerns for India. Reviving Fiscal Responsibility legislation and a gradual reduction in government borrowings can complement financial market development and improve confidence in the economy.

Corporate performance continues to be weighed down by boom period expansions and excess capacities, amid shifting asset composition towards financial investments. House prices and outstanding loans for retail housing by housing finance companies have grown relatively fast during the last few years.

Inadequate social security coverage in India against a backdrop of changing demographics will pose challenges for expanding the pension system given the fiscal constraints. The NPS was created to serve the Government employees and private sector workers.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks

The risks to the banking sector have further increased during the past half-year. All major risk dimensions captured in the Banking Stability Indicator show increase in vulnerabilities in the banking sector. Banking Stability Measures, based on co-movements in banks' equity prices, also indicate that the distress dependencies within the banking system have risen during this period.

Contagion Risks in the Banking Sector

Network tools have been used to assess impact of contagion due to risk of credit concentration. Failure of a major corporate or a major corporate group could trigger a contagion in the banking system due to exposures of a large number of banks to such corporates. The analysis shows that interconnectedness in the banking sector could cause losses due to contagion, over and above the direct losses on account of the failure of large corporate groups.

Trends in Credit and Deposit Growth

In the recent quarters, credit growth has exceeded the growth in deposits. As a result, there has been a significant rise in the incremental C-D ratio.

Asset Quality Concerns

Asset quality continues to be a major concern for Scheduled Commercial Banks (SCBs). The key aspects of deterioration in asset quality are:

- A rising trend in Risk Weighted Assets (RWA) to total assets along with declining trend in Coefficient of Variation (CV) indicates that the

rise in proportion of risky assets in the total assets of SCBs is becoming more broad-based.

- The Gross Non-performing Assets ratio of SCBs as well as their restructured standard advances ratio have increased. Therefore, the total stressed advances ratio rose significantly to 10.2 per cent of total advances as at end September 2013 from 9.2 per cent of March 2013.
- The largest contribution to stressed advances comes from the PSU banks.
- The 'medium and large' sized industries contributed more towards stressed advances than 'micro & small' sized industries.
- Industries recorded the highest share in restructured standard advances and with relatively high GNPA's contributed the highest share of stressed advances in the banks' loans portfolio followed by Services. Retail segment fared much better in terms of GNPA and restructured standard advances ratios.
- Five sectors, namely, Infrastructure, Iron & Steel, Textiles, Aviation and Mining together contribute 24 percent of total advances of SCBs, and account for around 53 per cent of their total stressed advances.

To address various issues relating to asset quality, Reserve Bank, *inter alia*, has brought out a discussion paper on "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy".

Stress Tests

Macro stress tests on credit risk suggest that if the adverse macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further. However, under improved conditions, the present trend in credit quality may reverse during the second half of 2014-15 with the GNPA ratio expected to rise initially to around 4.6 per cent by September 2014

from 4.2 per cent as at end September 2013, which may subsequently improve to 4.4 per cent by March 2015.

Systemic Risk Survey

According to the results of Reserve Bank's latest Systemic Risk Survey, conducted during October 2013, global risks and domestic macro-economic risks were perceived to be the two most important factors affecting the stability of Indian financial system. On the domestic macro-economic front, deterioration in economic outlook is considered to be the most critical. Risk from domestic inflation, corporate leverage and household savings have also increased marginally. On the other hand, risks arising from CAD, fiscal, sovereign downgrade and infrastructure were perceived to have receded.

Regulation of Financial Markets, Institutions and Infrastructure

Too-Big-To-Fail and Shadow Banking

India stands committed to the implementation of the global regulatory reforms agenda and has made considerable progress on this front. Although firms and markets are beginning to adjust to the regulatory approach towards ending too-big-to-fail (TBTF), recent research indicates continued expectation of sovereign support to such institutions. In India, the process of identification of financial conglomerates and their joint supervision/ regulation have received a lot of attention. Some global reform measures, *e.g.* those related to shadow banking may need to be adopted selectively, based on their relevance to the domestic financial system.

Money Market Mutual Funds

Due to the interconnectedness with banks, liquidity pressure is felt by the money market mutual funds (MMMFs) whenever redemption requirements of banks are large and simultaneous. Regulatory measures taken to reduce the degree of interconnectedness seem to have been successful in reducing the liquidity risk in the system.

Financial Benchmarks

Although there have been no major instances of manipulation of market rates in India's domestic markets, the Reserve Bank has constituted a committee to conduct a review of the systems and procedures in place with regard to major financial benchmarks.

Some Issues in Indian Financial Markets

Action to create central repositories for the banking sector, corporate bond market and insurance sector has been initiated. This move is expected to break the information asymmetry in those markets.

India's domestic markets for derivatives have not taken off due to the absence of some of the basic building blocks. Efforts are on to address these issues.

It has also been observed that the equity prices of the companies in which the promoters had pledged significant portions of their shares, are relatively more volatile than the broader market during times of correction.

Payment and Settlement Systems

The payment and settlement system infrastructure in the country continued to perform without any major disruptions.

Financial Stability and Development Council (FSDC) and its Sub Committee

The Financial Stability and Development Council (FSDC) and its Sub Committee deliberated on various aspects that impinge on financial stability - macroeconomic scenario, both global and domestic and the developments in financial markets.