Overview

The Financial Stability Report (FSR) is published biannually and includes contributions from all the financial sector regulators. Accordingly, it reflects the collective assessment of the Sub Committee of the Financial Stability and Development Council (FSDC-SC) on risks to financial stability.

Macrofinancial Risks

The global recovery has been losing momentum in the second half of 2021, impacted by resurgence of infections in several parts of the world, supply disruptions and bottlenecks, persistent inflationary pressures and shifts in monetary policy stances and actions across systemic advanced economy (AE) central banks as also some emerging market economies (EMEs). Tightening of global financial conditions, superimposed on elevated domestic inflation has roiled EMEs, in particular. The US dollar posted large appreciations *vis-a-vis* EME currencies, which were also weakened by stubbornly rising energy prices. Capital flows to EME bond markets are showing signs of tapering off and flowing out, while equity flows have turned volatile. Realignment of interest rates in the process of policy normalisation could lead to discretionary shifts in portfolios among banks as well as recalibration of banking sector liabilities. More recently, Omicron has cast a shadow on global economic prospects.

Domestic Economy and Markets

On the domestic front, the second wave of the pandemic showed distinct signs of subsiding by July 2021. Localised restrictions have been eased and the engines of growth have started revving up, aided by progress in vaccination. During April-October 2021, all the deficit indicators of the central government exhibited improvement from their pre-pandemic levels. The borrowing programme has proceeded smoothly. The Indian corporate sector has gained strength and resilience through the pandemic and key financial parameters of listed non-financial private companies indicate improvement. Bank credit growth is showing signs of a gradual recovery, led by the retail segment, although flow of credit to lesser rated corporates remains hesitant. Micro, small and medium enterprises (MSMEs) as also the micro finance segment are reflecting signs of stress.

Financial Institutions: Soundness and Resilience

SCBs continued to bolster their capital - capital to risk-weighted assets ratio (CRAR) of SCBs reached 16.6 per cent in September 2021 - and their return on assets (RoA) and return on equity (RoE) were maintained in positive territory. While the asset quality of banks showed improvement, with the gross non-performing assets (GNPA) and net NPA (NNPA) ratios declining to 6.9 per cent and 2.3 per cent, respectively, their slippage ratio inched up in September 2021. The provisioning coverage ratio (PCR) increased from 67.6 in March 2021 to 68.1 per cent in September 2021.

Macro-stress tests for credit risk show that SCBs' GNPA ratio may increase from 6.9 per cent in September 2021 to 8.1 per cent by September 2022 under the baseline scenario and to 9.5 per cent under a severe stress scenario. The stress tests show that all banks would be able to comply with the minimum capital requirements even under severe stress scenarios.

The CRAR of urban co-operative banks (UCBs) stood at 12.9 per cent in September 2021 while that of NBFCs stood at 26.3 per cent.

Network analysis indicates that the total outstanding bilateral exposures among constituents of the financial system have been on an upswing since H1:2020-21, with SCBs having the largest share of bilateral exposures *albeit* still below pre-pandemic levels. In terms of inter-sectoral exposures, asset management companies/mutual funds (AMC-MFs), followed by insurance companies, remained the dominant fund providers in the system, while NBFCs were the biggest receivers of funds, followed by housing finance companies (HFCs). A simulated contagion analysis showed that losses due to failure of the five banks with the maximum capacity to cause contagion increased in September 2021 *vis-à-vis* March 2021, but they would not lead to the failure of any additional bank.

Regulatory Initiatives and Other Developments in the Financial Sector

The global regulatory environment continues to evolve and get refined in spite of the pandemic. Financial regulators are devoting attention to distilling the lessons learned from the pandemic, analysing the ripple effects of rollback of policy support measures and enhancing the resilience of the financial system. On the domestic front, Government and financial sector regulators continued with their efforts towards achieving a sustainable recovery and enhancing the resilience of the financial system.

Assessment of Systemic Risk

In the Reserve Bank's latest Systemic Risk Survey (SRS), all broad categories of risks to the financial system – global; macroeconomic; financial market; institutional; and general – were perceived as 'medium' in magnitude, but risks arising on account of global and financial markets were rated higher than the rest. Commodity prices, domestic inflation, equity price volatility, asset quality deterioration, credit growth and cyber disruptions were rated as the major risks.