# Overview

## Macro-Financial Risks

### Global Economy and Markets

Global economic recovery still seems to be far from being self-sustaining even as spillovers from large-scale monetary accommodation in advanced economies (AEs) are increasing the challenges for emerging market and developing economies (EMDEs). Monetary accommodation by major central banks had led to negative nominal yields in many AEs and subsequent swift and abrupt upward shifts in yields inflicted losses on bond holders. Leverage, in general, has increased since the global financial crisis though for countries where interest rates are close to zero or even negative, reducing debt may look less imperative. Developments on the Greek debt crisis front and uncertainty over the timing of rate increases by the US Federal Reserve remain immediate possible triggers for global financial market volatility.

### Domestic Economy and Markets

On the domestic front, there has been a significant improvement in the macroeconomic environment and going forward economic performance is expected to be better. However, managing expectations continues to be a challenge for policy makers as the recovery in business sentiment has not yet taken firm roots. External vulnerability has reduced and progress has been made on improving the quality of fiscal consolidation. Price pressures arising from possible sub-normal monsoon remains a significant risk to food and headline inflation. Concerns remain around falling profit margins and decreasing debt repayment capabilities of the corporate sector. While foreign portfolio flows to India have been strong during the past year, unexpected changes in AE monetary policy stances may lead to slowdown/reversal of such flows with implications for segments of financial markets, though India is better prepared to deal with the volatility, as compared to the previous episodes.

## Financial Institutions: Soundness and Resilience

### Scheduled Commercial Banks – Performance and Risks

The performance of scheduled commercial banks (SCBs) in terms of growth in business has moderated further during the period September 2014-March 2015. Furthermore, the stressed advances have shown a rising trend. The capital to risk-weighted assets ratio (CRAR) improved marginally . The public sector banks (PSBs) continued to record the lowest CRAR among the bank-groups. Profitability measured by return on assets and return on equity remained around the same level during the last two years.

While risks to the banking sector, as reflected by the Banking Stability Map, have moderated marginally since September 2014, concerns remain over the continued weakness in asset quality and profitability.

### Urban Co-operative Banks and Non-Bank Financial Companies

The asset quality of scheduled urban co-operative banks (UCBs) improved, whereas, asset quality of non-bank financial companies (NBFCs) continued to deteriorate.

### Stress Tests

#### *Macro Stress Tests for SCBs*

Macro stress test on the position as at end March 2015 suggests that current deterioration in the asset quality of SCBs may continue for few more quarters and PSBs may have to bolster their provisions for credit risk from present levels, to meet the 'expected losses' if macroeconomic environment deteriorates further under assumed stress scenario.

Stress tests on sectoral credit have revealed that the shocks to infrastructure sector, mainly the power and transport sub-sectors, would significantly impact the system.

## Financial Sector Regulation

The financial sector regulatory reforms in India are being driven by the domestic priorities, within the spirit of the global regulatory standards, even as the challenges in uniform implementation of the reforms are coming to the fore, in many jurisdictions. Notwithstanding the progress achieved on global regulatory agenda, there still is a need for continuously looking to make regulations more comprehensive, contingent, cost effective and 'cycle-proof' - aimed at creating stability 'through the cycle'. Considering that risk taking is inherent and essential in financial markets, the current Indian regulatory stance envisions a *balanced, predictable, institution-neutral, ownership-neutral and technology neutral regulatory regime* for the entire financial system.

### Banking sector

While the regulatory move towards encouraging greater market access and market discipline will help the development of domestic financial markets, the banking sector, especially the public sector banks (PSBs) will be expected to shoulder major responsibility to accelerate growth in the economy. The policy initiatives for improving the governance and management processes at PSBs, along with a reorientation of business strategy will help improve the performance of PSBs in the long run, even as they presently look to clean their balance sheets in the wake of regulatory impetus.

### Securities market

The concerns emanating from rapid rise in algorithm trading in recent years highlights the need for caution for India's securities markets. Significant regulatory steps have been taken with regard to illegal money-raising activities, insider trading and strengthening the risk management systems at depositories.

### Insurance sector

The agricultural insurance needs urgent focus in the wake of frequent episodes of weather related calamities and their impact, particularly on small and marginal farmers.

### Commodity derivative markets

There is a need for harmonising the regulation of the physical commodities market and strengthening the linkages between the derivatives markets and physical (cash) markets, mainly in agricultural commodities.

### Pension sector

The expected shifts in demography in coming decades call for attention on old age income security in particular for the unorganised sector – for which a new scheme has been announced by the union government.

## Assessment of Systemic Risk

### Systemic risk survey

According to the latest systemic risk survey (Annex 1) conducted by the Reserve Bank in April 2015 'global' risks and domestic macroeconomic risks continued to be perceived as major risk factors facing the Indian financial system.

### Assesment

Overall, India's relatively stronger macroeconomic fundamentals in terms of growth, inflation, current account and fiscal deficits provide a reasonable degree of resilience to Indian financial system in the event of spillover effects from global factors. However, with the continued uncertainty over global growth and in the absence of international monetary policy coordination, there can be no room for complacency.