Overview

Introduction

The Financial Stability Report (FSR) for India is being published biannually in June and December for the last three years. The FSR includes the contributions from all the financial sector regulators and is currently being approved by the Sub–Committee of the Financial Stability and Development Council (FSDC).

Structure of FSR

The first chapter of the FSR discusses macro-financial risks in the global and domestic economies and markets, providing a backdrop in which the financial system has been functioning. The second chapter of the report focusses on the soundness and resilience of financial institutions and discusses, amongst other things, the interconnectedness of the financial system. It presents the results of various stress tests conducted for assessment of resilience of scheduled commercial banks, scheduled urban cooperative banks and non-banking finance companies, to different types of risks. The chapter also includes coverage on insurance and pension sectors, which are important segments of the financial services sector. The last chapter gives an assessment in the progress of implementation of post crisis reforms proposed by G20/ Financial Stability Board, with specific reference to Indian position, and also includes other regulatory issues of systemic importance. The findings of the Systemic Risk Survey are presented at Annex 1. Methodology underlying some of the analytics used in the report is given at Annex 2.

Macro financial Risks

Global Economy and Markets

The announcement by Federal Reserve of the phased withdrawal from the bond buying programme has signalled the inevitability of eventual exit from the unconventional monetary policies adopted by major central banks. The risks which have been building up over the last five years of excess liquidity in the global system are now surfacing. The markets, especially in emerging economies need to be prepared for spells of high volatility and uncertainty going ahead. Global growth remains tepid and multipaced. Asset bubbles in housing might have been building up in certain parts of the globe.

Domestic Economy and Markets

The macroeconomic risks to Indian economy have increased over the last six months, mainly on the dimensions of domestic growth, external sector and corporate sector performance. Domestic supply bottlenecks, policy uncertainty, consequential dampened investment sentiment and slackening external demand contributed significantly to the slowdown, though fall in inflation and significant fiscal correction have provided some relief.

Current account deficit and its non- disruptive financing have emerged as major challenges from the perspective of macroeconomic stability. Various measures taken to dampen import demand for gold are taking hold and policy efforts are currently on to attract more stable long term capital through foreign direct investment (FDI) route.

The performance of Indian corporate sector has been subdued and in the emerging scenario, their increased external borrowing and unhedged foreign exchange exposures may further increase their vulnerabilities. On the fiscal front, there has been some credible improvement, reflecting in upgrade of outlook on India to 'stable' by one of the major credit rating agencies.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks

Risks to banking sector have increased since the publication of the last FSR in December 2012, mainly in terms of asset quality and profitability. The asset quality continues to remain under intense focus and prudential measures have been taken to step up the provisions on restructured accounts. The FSR also analyses the improved performance on parameters of credit and deposit growth, asset quality etc during the last quarter of the financial year and finds significant 'seasonality' in these parameters. The contraction in export credit during recent quarters is attracting the attention of policy makers. The growth in credit to micro and small enterprises (MSE) sector needs to be sustained.

Interconnectedness in the financial and banking systems

The Banking Stability Measures, based on co-movements in equity prices of listed banks, have shown some improvement in distress dependencies between banks. The network of the Indian financial system shows that the asset management companies and insurance companies have a high degree of exposure to the banking system. The liquidity contagion analysis brings out the risks from interconnectedness entrenched in the structure of the financial system.

Stress Tests

Macro stress tests indicate that if the current macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further. However, the comfortable position on the banks' capital adequacy front lends resilience as shown by the *top-down* stress testing exercises on various risks. The results of the *bottom-up* stress tests (sensitivity analysis) carried out by select banks, also testify to the general resilience of the banks to different kinds of shocks. This issue of FSR introduces the analysis of NPAs on the basis of Estimated Losses approach for assessment of provisioning and capital adequacy of banks. The results show that, while the present level of provisions is adequate, a gap may arise under severe stress scenario.

The stress tests on capital and liquidity aspects of the scheduled urban cooperative banks (SUCBs) reveal that the SUCBs may be impacted, under severe stress scenario. The stress tests on credit risks for NBFCs show that even under the severe stress scenario related to deterioration in asset quality, the capital adequacy ratios remain above the minimum required level.

Insurance and Pension Sectors

The new business premium of insurance sector continued to contract for the last two years. Single premium insurance policies account for a major part of the life insurance business, especially of the Life Insurance Corporation. New Pension System introduced by the Government of India with a view to develop the pension sector has shown significant growth in the subscriber base and corpus.

Financial Sector Regulation and Infrastructure

Implementation of reforms at global level

The uneven progress on implementation of agreed global reforms in various jurisdictions is accompanied by a concurrent rethinking on the architecture and desirable degree of financial regulation. While the needs of different financial systems are expected to be different in terms of regulatory emphasis, the trends towards home-bias in regulation may have consequences for functioning of international markets, with varied effects on different jurisdictions.

India's progress on reforms

India's progress on implementation of various globally agreed reforms is being monitored under the framework of FSDC, through its Sub Committee. Inter-agency implementation groups have been formed, with focus on specific areas of reforms.

Basel III

India's implementation plan for Basel III reforms is more stringent in terms of schedule as well as capital requirements, in keeping with the traditionally prudent approach and to make up for judgemental errors, if any, in computing the capital requirements. Indian banks are facing challenges in implementation of AMA approaches for computing capital charge for operational risks on issues related to internal governance, data availability and modelling of operational loss data etc.

OTC Derivatives

The implementation of reforms in OTC derivative markets in India is being taken up in a phased manner, with standardisation of products and introduction of centralised clearing in more segments of OTC market. The US and European laws dealing with OTC derivatives reform have raised concerns over possibilities of extra territorial regulatory jurisdiction which may lead to regulatory clashes and disruptions in market activity.

Supervision of Financial Conglomerates

Significant steps towards strengthening of the supervision of big financial groups have been taken in India, in recent period. The financial sector regulators have formalised a mechanism for co-operation in supervision for financial conglomerates and an Inter Regulatory Forum (IRF) has been set up, under the FSDC Sub Committee. Bilateral Memoranda of Understanding (MoU) have also been been signed with overseas supervisory bodies for improved cross border banking supervision and cooperation. Supervisory Colleges have been established for two big Indian banks.

Regulation of Shadow Banking

Significant regulatory measures have been taken to address the possibilities of liquidity risks emanating from money market and liquid mutual funds. The observed circularity in flow of funds between banks and mutual funds could lead to systemic risk in times of liquidity stress. The regulatory gaps observed in case of 'collective investment schemes' and some other methods through which various entities try to raise funds from public are being addressed through a coordinated approach, while seeking a more active role for the state governments and law enforcement agencies.

Consumer Protection

Instances of mis-selling of insurance policies, wealth management products and services and some other unhealthy practices at some banks have underscored the need for strengthening the consumer protection mechanism, adherence to KYC / AML guidelines and removal of certain distortions observed in the incentive framework.

The technology risks in times of increasing use of internet for various purposes, pose fresh challenges. The risks from obsolescence of existing technology platforms and outsourcing of business processes by banks need greater attention.

Financial Market Infrastructure

The financial market infrastructure, including the payment and settlement systems in the country has been functioning smoothly. There is a need for addressing the possible concentration risks from the exposure of the main two equity market clearing houses, to a common set of banks.

Systemic Risk Survey

According to the results of Reserve Bank's latest Systemic Risk Survey, conducted during April – May 2013, global risks and domestic macro-economic risks were perceived to be the two most important factors affecting the stability of Indian financial system. However, participants in the survey have expressed confidence in the stability of the Indian financial system.