Overview

Macro-Financial Risks

Global Economy and Markets

Global financial markets are showing signs of improved stability amidst a continuing easy monetary policy stance in many jurisdictions. Economic growth in advanced economies is finding traction, although it appears far from self-sustaining. Emerging geo-political risks, however, could unravel subdued vulnerabilities. Just as there was a need for global coordination in reducing the spread of adverse impacts from the global financial crisis, there is also a case for policy coordination in reducing spillovers from monetary policy action in advanced economies. On the other hand, emerging market and developing economies (EMDEs) need to strengthen their own macroeconomic fundamentals while building buffers against global uncertainties.

Domestic Economy and Markets

Moderation in consumer price inflation (CPI) and reduction in twin-deficits provide some breather. However, adverse growth-inflation setting obtained over the last two years which continue to affect saving-investment dynamics, poses a major challenge. Going forward, with the formation of a stable government, the prospects of recovery appear bright. However, supply side constraints need to be addressed to complement the Reserve Bank's efforts to contain inflation expectations. Moreover, a strong push to implementing policy is expected to provide the necessary impetus to the investment cycle.

Recent policy measures and timely interventions have proved to be effective in containing external sector risks but there is a need to work towards reducing structural current account imbalances. While capital expenditure, mainly for developing infrastructure, is vital for growth, fiscal consolidation also remains a policy imperative. A greater role for private sector investment in capital-intensive sectors is warranted. Activity in domestic equity markets continued to be dominated by foreign institutional investors (FIIs). While secondary markets are vibrant, the lull in the primary markets is not conducive for the investment climate. The need for a more developed corporate bond market was never stronger than now and facilitating its growth by removing hindrances should be one of the top policy priorities.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks – Performance and Risks

Stress on the banking sector has increased since the publication of the last FSR in December 2013, mainly on account of liquidity and profitability pressures, although asset quality and capital adequacy have seen a marginal improvement. The decline in the growth rate of credit and risk weighted assets (RWA) of scheduled commercial banks (SCBs), coupled with a decrease in Tier 1 leverage ratios indicates efforts at repairing balance sheets.

Banks showed some improvements in their asset quality, which were contributed to by lower slippage[1], a seasonal pattern of higher recovery and write-offs during the last quarter of the financial year and sale of non-performing assets (NPAs) to asset reconstruction companies (ARCs). Industries such as infrastructure, iron and steel, textiles, mining and aviation account for a significant share of total 'stressed' assets (NPAs and restructured advances) of banks, especially those in the public sector. This is also reflected in the relatively lower profitability of public sector banks (PSBs).

Stress Tests

Scheduled Commercial Banks

Macro stress tests show that the system level CRAR of SCBs remains well above the regulatory minimum

[1] Slippage from standard advances to non-performing asset (NPA) category.

even under severely adverse macroeconomic conditions while the 'expected loss' analysis indicates that the present level of provisions of SCBs may fall short in meeting the expected losses under such a (extreme but plausible) scenario.

Urban Co-operative Banks

Single factor sensitivity analysis for scheduled urban co-operative banks (SUCBs) shows that although the system level CRAR remained above the minimum regulatory required level, a large number of banks will not be able to meet the required level of CRAR under the assumption of doubling of GNPAs.

Non-Banking Financial Companies

Stress tests for non-banking finance companies (NBFCs) show that while there could be a shortfall in provisioning levels under stress scenarios, the higher CRAR level provides an additional cushion.

Interconnectedness and Contagion Risks

PSBs as a group remain the biggest overall net lender in the system, while new private sector banks and foreign banks continue to be relatively more dependent on interbank borrowings. The network analysis shows that banks with high 'interbank node risk' are seen to be the ones with large balance sheets, a substantial presence in the payment and settlement system and significant off-balance sheet activities, although the overall systemic importance of such banks is within comfortable range, at present. A contagion analysis shows that the failure of the biggest net borrower in the system causes the banking system to lose around 12 per cent of Tier I capital. However, the losses incurred by the banking system will be considerably low if an implicit state guarantee associated with PSBs is factored into the analysis.

Financial Sector Regulation and Infrastructure

Banking Sector Regulation

India is making steady progress in implementing global financial sector regulatory reforms while also taking into account domestic priorities. Challenges that have to deal with the asset quality and profitability of PSBs have brought the focus on PSBs' ownership patterns, governance structures and management processes. The spurt in the sale of NPAs to ARCs in the last two quarters and the increase in the restructuring of corporate sector advances point towards the need for a closer monitoring of the efficacy and effectiveness of such mechanisms. Efforts to de-stress the banking sector need to be complemented by necessary steps for developing bond markets. With the Indian government showing a greater resolve for fiscal consolidation, there is a strong case for encouraging PSBs to approach capital markets for meeting their additional capital requirements under pillars I and II of Basel III. This may require the PSBs to be subjected to the requirements of market discipline. Improvements in their valuations will provide an opportunity to raise requisite resources with minimum equity dilution.

Shadow Banking Sector in India

The shades of shadow banking in India's relatively underdeveloped financial markets are different, and unlike other major jurisdictions, the concerns in this regard mainly relate to a large pool of unregulated small entities with varying activity profiles. Given the low levels of financial literacy, there is a risk that the public may perceive them to be under some regulation. Also, technology-aided innovations in financial disintermediation in the form of crowd funding/P2P lending call for monitoring of such activities and regulatory preparedness. The increasingly significant financial market/treasury operations of large sized non-financial corporates may have implications for effectiveness of macro-prudential policy measures.

Regulation of the Securities and Commodities Derivatives Market

Mutual funds and other asset management activities do not carry the risks experienced in other jurisdictions. However, the relatively lower growth in trading volumes in the cash segment of equity markets compared to that in the derivatives market, especially options, makes it imperative to review the differences in transaction costs in different segments of equity markets. The functioning of the commodity derivatives market is expected to be strengthened with revised norms for corporate governance and the warehouse receipt system.

Insurance and Pension Sectors

Lending activities of insurance companies need to be monitored as a component of the overall lending in the system, under a prudential framework closely aligned with that for banks, to avert the possibility of any regulatory arbitrage. In view of the changing demographic profile of the Indian population and also its huge unorganized sector, the pension sector has the potential to play an important role. The fiscal implications of inadequate liability computation with respect to several defined benefit pension schemes in the government sector could be significant in the coming years.

Assessment of Systemic Risk

India's financial system remains stable, even though the banking sector, particularly the PSBs, is facing some major challenges. The results of the latest systemic risk survey (Annex 1) conducted by the Reserve Bank in April 2014 show that the banks' asset quality still remains under the 'high' risk category, along with domestic fiscal situation and global and domestic growth and inflation, among others.

Overall, there is urgency in addressing the adverse gowth-inflation dynamics and saving-investment balance. However, the improved political stability and expectations of a decisive and coordinated policy response augur well for the economy and the markets. But there can be no room for complacency given the domestic challenges and global uncertainties.