Overview

Macro-Financial Risks

Global Economy and Markets

While the first Fed rate hike since 2006 appeared to have been factored in by the markets, the pace of further increase could have a significant bearing on market behaviour. This along with the developments in China and sluggish global trade growth would shape the global economy going forward.

Domestic Macro-economic Challenges

Despite improved macro-economic fundamentals, sluggishness in domestic demand and private investment call for higher public investment at a time when government is committed to fiscal consolidation. The weaknesses in external demand has adversely affected exports even though current account deficit as a percentage to GDP has remained at comfortable levels. While the ratio of short term external debt to forex reserves and the ratio of volatile capital flows to forex reserves have been moderating, attracting capital flows to finance the current account deficit will require continuous thrust on structural reforms, unambiguous policy stance, especially in tax matters, and improving the ease of doing business. In the corporate sector, declining profitability, high leverage and low debt servicing capacity continue to cause concern with their attendant adverse impact on the financial sector, notwithstanding a marginal improvement observed during the first half of current financial year.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks – Performance and Risks

The business of scheduled commercial banks (SCBs) slowed as reflected in further decline in both deposit and credit growth. Between March and September 2015, the gross non-performing advances ratio increased, whereas restructured standard advances ratio declined. Sectoral data as of June 2015 indicates that 'industry' continued to record the highest stressed advances ratio of about 19.5 per cent, followed by 'services' at 7 per cent.

The capital to risk-weighted asset ratio (CRAR) of SCBs registered some deterioration during the first-half of 2015-16. Public sector banks (PSBs) continued to record the lowest CRAR among the bank groups. Profitability of SCBs deteriorated further.

Among other financial institutions, the asset quality of both scheduled urban co-operative banks (SUCBs) as well as non-banking financial companies (NBFCs) deteriorated during the first-half of 2015-16.

The banking stability indicator shows that risks to the banking sector increased since the publication of the previous FSR, mainly on account of deteriorating asset quality, lower soundness and sluggish profitability.

Interconnectedness and Contagion Risks

The network analysis indicates that the insurance companies followed by the mutual funds act as major fund providers in the inter-financial institutions market, while the SCBs followed by the NBFCs are the major fund-receiving entities. The contagion analysis shows that the failure of the top net borrower bank could result in a loss of 33.3 per cent of Tier-I capital of the banking system, under the joint solvency liquidity contagion, while the failure of the top net lender bank could result in a loss of 35.3 per cent of Tier-I capital.

Financial Sector Regulation

While global financial sector regulatory reform agenda is being implemented steadily, there is a need for better appreciation of cost-benefit matrix of these reforms across jurisdictions given the structurally different economies with varying

national priorities. With the emergence of newer and more disruptive technologies, the main risk drivers perhaps would have moved to areas that would be continuously challenging the regulators' acumen.

Banking sector

While steps taken for developing corporate debt markets in India are showing some results, the dependence on bank finance continues even as the banks, especially the PSBs face challenges on asset quality, profitability and capital. In addition to the improvement of governance processes through initiatives like 'Indradhanush', the PSBs may need to review their business models, and examine strategic decisions like capital structure and dividend policy.

Securities market

Indian capital markets regulation has kept pace with the requirements of changing business environment by, among other things, creating special platform for enabling the start-up companies to access the capital markets. The domestic institutional investors, especially the mutual funds, are observed to be providing a stabilising support against the possible volatility due to foreign portfolio investment flows. Subsequent to the merger of Forward Markets Commission (FMC) with the Securities and Exchange Board of India (SEBI), in October 2015, guidelines on the comprehensive risk management framework have been issued to align and streamline the risk management framework across national commodity derivatives exchanges in India.

Insurance sector

The insurance business model encompassing both insurers and reinsurers has specific features that differentiate it from the banking system and make it a source of stability in the financial system.

Pension sector

The national pension system (NPS) is showing steady growth, and the Atal Pension Yojana (APY) aims to mitigate challenges faced by people in the unorganised sector.

Financial market infrastructure

Financial market infrastructure in the country has been generally functioning efficiently. Significant regulatory measures have been taken for strengthening the resilience of clearing corporations for equity markets and central counter party in other key financial markets.

Assessment of systemic risk

Systemic risk survey

The results of the latest systemic risk survey (Annex 1) conducted by the Reserve Bank in October 2015 show that the 'global risks' continued to be perceived as major 'high' risk factor facing the Indian financial system, while domestic macroeconomic risks moved down to 'medium' risk category.

Assessment

India's financial system remains stable and the relatively stronger macroeconomic fundamentals lend resilience to face the still prevailing uncertainty and emerging risks in the global economy and financial markets. However, the policy makers and stakeholders will need to remain watchful about the potential adverse impact of possible developments in global scenario including sharp increase in international oil and commodity prices, increased volatility in financial markets and further slow- down in global trade.

On the domestic front, risks arising from erratic climatic conditions, limited policy space, corporate performance, asset quality of financial institutions and low investment growth, among other factors, could pose challenges.