Overview

Macro-Financial Risks

Global economy and Markets

The global growth outlook for 2018 and 2019 remains steady although the underlying downside risks have risen. The gradual monetary policy normalisation in advanced economies (AEs) as also the uncertainty in global trade regime may adversely affect capital flows to emerging markets (EMs) and exert upward pressure on EM interest rates and corporate spreads. In the meanwhile, commodity prices, particularly oil, have softened mostly driven by excess supply of US shale oil, uncertainty about Chinese demand and on supply concerns from Iran turning out softer than anticipated.

Domestic Economy and Markets

On the domestic front, growth of gross domestic product (GDP) showed slight moderation in Q2:2018-19 while inflation remains contained. Fiscal consolidation remains important for financial stability as global financial conditions turn adverse. The impact of oil prices feeding into input costs remains uncertain with potential implications for India's terms of trade. In the domestic financial markets, structural shifts in credit intermediation and the evolving interconnectivity between banks and the non-banks call for greater vigilance.

Financial Institutions: Soundness and Resilience

Credit growth of scheduled commercial banks (SCBs) improved in September 2018, driven largely by private sector banks (PVBs). The asset quality of banks showed an improvement with the gross non-performing assets (GNPA) ratio of SCBs declining from 11.5 per cent in March 2018 to 10.8 per cent in September 2018. Industry analysis shows that stress is rising in mining, food processing and construction sectors.

Under the baseline scenario, GNPA ratio may decline from 10.8 per cent in September 2018 to 10.3 per cent in March 2019. Sensitivity analysis indicates that 18 SCBs, including all public sector banks under Prompt Corrective Action (PCA-PSBs), may fail to maintain the required CRAR under a 2 SD shock to the GNPA ratio, unless capital infusion takes place and banks improve their performance.

An analysis of portfolio of Micro, Small and Medium Enterprises (MSMEs) shows that the performance of PSBs in the MSME segment trails that of other intermediaries *viz.*, private sector banks and non-banking financial companies (NBFC). This is both in terms of inherent as well as realised credit risk underscoring the need to improve credit appraisal skills.

Analysis of the financial network structure for the period September 2017 - September 2018 reveals a shrinking inter-bank market and increasing bank linkages with asset management companies-mutual funds (AMC-MFs) for raising funds, and with NBFCs/Housing Finance Companies (HFCs) for lending. Contagion analysis for the banking sector has been carried out using two different approaches : one in which PSBs' implicit sovereign guarantee is taken into account (no default case) and the other in which the default triggers for PSBs are similar to the PVBs. The significant difference between the results of the two approaches reflects potential amplification of solvency/liquidity losses caused by PSB defaults in the absence of implicit sovereign backing.

Financial Sector: Regulation and Developments

Following the global financial crisis (GFC), bank capital regime appears to have increased systemic resilience. In the global financial market, transition to a post-LIBOR world remains a work in progress. On the domestic front, the Reserve Bank initiated several policy measures to deepen the government securities (G-Sec) and Repo markets. In the capital market, investment through Systematic Investment plans (SIPs) in mutual funds remains a bright spot. The Securities and Exchange Board of India (SEBI) has taken several steps to further strengthen the surveillance and integrity of the derivatives segment, mutual funds and commodity derivatives market besides enhancing disclosure and transparency standards for credit rating agencies (CRAs).

The insolvency and bankruptcy regime, which came into effect in 2016, has been providing a market-driven, time-bound process for insolvency resolution of a corporate debtor, thereby helping financial institutions to clean up their balance sheets. Most importantly, it is aiding a paradigm shift in the extant credit culture and discipline. PFRDA continues to bring more and more citizens under the pension net. With the initiation of the process to identify Domestic Systemically Important Insurers (DSII), implementation of risk-based capital (RBC) and Operationalisation of CERT-Fin, IRDAI is trying to strengthen the resilience of the Insurance sector. Engagement with Fintech and Suptech is increasing. The challenge for the regulator is to balance efficiency with prudential measures to mitigate risks to be able to harness the opportunities offered by Fintech.

Assessment of Systemic Risk

According to the survey results while financial market risks are perceived as a high-risk category affecting the financial system global risks, risk perception on macroeconomic conditions and institutional positions are perceived as medium risks affecting the financial system. Among the institutional risks, the asset quality deterioration of banks, risk on account of additional capital requirement and cyber risk continued to be perceived as high-risk factors.