Overview

Macro-Financial Risks

The global economy is facing a sharp and broad-based contraction as COVID-19 takes its toll on top of already sluggish and slowing macroeconomic conditions. Resolute and wide-ranging actions by central banks and governments have restored a semblance of normalcy in financial markets, but the recovery depends on a host of factors, and especially on the intensity and duration of the pandemic and the discovery of a vaccine. Global geopolitical tensions, overleveraged non-financial sectors - particularly elevated debt levels among governments, businesses and households -, the ongoing losses of jobs and incomes impart heightened uncertainty to the outlook.

Domestic Economy and Markets

On the domestic front, the near-term economic prospects appear severely impacted by lockdown induced disruptions to both supply and demand side factors, diminished consumer confidence and risk aversion. While financial sector regulators and the Government have taken policy measures to ensure financial intermediation functions normally, and distress faced by disadvantaged sections of society is mitigated, the down side risks to short term economic prospects are high. Policy measures have so far kept financial markets from freezing up, and eased liquidity stress facing financial institutions and households. Consequently, borrowing costs have ebbed and illiquidity premia have shrunk. Nonetheless, risk aversion and lackluster demand have impeded the fuller flow of finance from both banks and non-banks into the economy.

Financial Institutions: Soundness and Resilience

Credit growth (y-o-y) of scheduled commercial banks (SCBs)[1], which had considerably weakened during the first half of 2019-20, slid down further to 5.9 per cent by March 2020 and remained muted up to early June 2020. This moderation was broad-based across all bank groups.

The capital to risk-weighted assets ratio (CRAR) of SCBs edged down to 14.8 per cent in March 2020 from 15.0 per cent in September 2019; the gross non-performing assets (GNPA) ratio fell to 8.5 per cent from 9.3 per cent and the overall provision coverage ratio (PCR) improved to 65.4 per cent from 61.6 per cent over this period.

Macro stress tests for credit risk indicate that the GNPA ratio of all SCBs may increase from 8.5 per cent in March 2020 to 12.5 per cent by March 2021 under the baseline scenario. If the macroeconomic environment worsens further, the ratio may escalate to 14.7 per cent under very severe stress.

In terms of network analysis, the total outstanding bilateral exposures among constituents of the financial system narrowed during 2019-20. In terms of inter-sectoral exposures, asset management companies/mutual funds (AMC-MFs), followed by insurance companies, were the biggest fund providers in the system, while non-banking financial companies (NBFCs) were the biggest receiver of funds, followed by housing finance companies (HFCs). AMC-MFs recorded a sharp decline in their receivables from the financial system, while public sector banks (PSBs) and insurance companies experienced an increase. Payables of NBFCs and HFCs increased marginally.

The size of the inter-bank market continued to shrink which, along with better capitalisation of PSBs, has led to a reduction in exposure to contagion losses that could result from a hypothetical idiosyncratic failure of a bank/ NBFC/ HFC and macroeconomic distress.

[1] SCBs, for the purpose of this analysis, only include public sector banks, private sector banks and foreign banks. Analysis is based on Reserve Bank's Supervisory Returns which cover only their domestic operations.

Regulatory Initiatives in the Financial Sector

In India, financial sector regulators have taken initiatives spanning monetary stimulus and regulatory reliefs to offset COVID-19's impact. Significant regulatory actions have been put in place to ease operational constraints due to the lockdown as also for maintaining market integrity and resilience in the face of severe risk aversion by market participants. Looking ahead, as the focus shifts from pandemic-proofing large sections of society to post-pandemic unwinding of stimulus and support packages in a calibrated manner, the challenge would be to establish normalcy without disrupting markets and the health of financial intermediaries.

Assessment of Systemic Risk

The Indian financial system remains stable, notwithstanding the significant downside risk to economic prospects. According to the latest systemic risk survey, all major risk groups, *viz.,* global risks, risk perceptions on macroeconomic conditions, financial market risks and institutional positions were perceived as 'high', affecting the financial system. Among macroeconomic risks, risks to domestic growth and fiscal housekeeping were perceived to be 'very high', while risks on account of reversal/slowdown in capital flows, corporate sector vulnerabilities, real estate prices and household savings were perceived to be 'high'.