# Overview

The Financial Stability Report (FSR) is published biannually and includes contributions from all the financial sector regulators. Accordingly, it reflects the collective assessment of the Sub–Committee of the Financial Stability and Development Council (FSDC-SC) on risks to financial stability.

## Macro-Financial Risks

This FSR, the second of the biannual publications for the year 2020-21[1], is being released at a time when the global economy is still suffering from the pain inflicted by the COVID-19 pandemic, though a fragile and hesitant journey to normalcy is struggling to gain traction across countries, buffeted by second waves of the virus including fear of more virulent strains. Policy actions, which in the initial phase of the pandemic, were geared towards restoring normal functioning and mitigating stress, are now getting increasingly oriented towards supporting the recovery and preserving the solvency of businesses and households. Capital flows to emerging economies have seen a sharp rebound with India emerging as a preferred habitat. Even as the positive news on vaccine development has underpinned optimism on the outlook, hopes have been marred by the adverse developments referred to earlier, which are particularly threatening macroeconomic and financial prospects across Europe, the US and some other countries.

## Domestic Economy and Markets

On the domestic front, while policy measures have ensured the smooth functioning of markets and financial institutions, managing market volatility amidst rising spillovers has become challenging. Movements in certain segments of the financial markets are not in sync with the developments in the real sector. Aggregate banking sector credit remained subdued, pointing to vestiges of risk aversion even as aggregate demand in the economy is mending and reviving. In particular, credit flows to the manufacturing sector have been lukewarm at a time when output of the sector is emerging out of a prolonged contraction. The focus of the policy efforts is shifting from provision of liquidity and guarantees to supporting growth – including consumption and investment. Although a recovery in economic activity from the lows of March and April 2020 is underway, it is far from being entrenched and output remains below pre-pandemic levels. Congenial financial conditions have been put in place to support the recovery. The overarching objective is to mitigate the impact of COVID-19 and strengthen the return to sustainable and inclusive growth with macroeconomic and financial stability.

## Financial Institutions: Soundness and Resilience

Bank credit growth (Y-o-Y), which had declined to 5.7 per cent in 2019-20, remains sluggish; on the other hand, deposit growth has remained robust in the double digits, reflecting precautionary saving in the face of high uncertainty.

Return on assets (RoA) and return on equity (RoE) for SCBs have improved across all bank groups and capital to risk-weighted assets ratios (CRARs) improved by 110 bps over March 2020 levels to 15.8 per cent in September 2020. Gross non-performing assets (GNPA) and net NPA (NNPA) ratios, which were edging down from September 2019 levels, fell further to 7.5 per cent and 2.1 per cent, respectively, by September 2020. The overall provision coverage ratio (PCR) improved substantially to 72.4 per cent from 66.2 per cent over this period. These

[1] The previous issue of FSR was released on July 24, 2020.

improvements were aided significantly by regulatory dispensations extended in response to the COVID-19 pandemic.

Macro-stress tests[2] for credit risk show that SCBs' GNPA ratio may increase from 7.5 per cent in September 2020 to 13.5 per cent by September 2021 under the baseline scenario. If the macroeconomic environment deteriorates, the ratio may escalate to 14.8 per cent under the severe stress scenario. These projections are indicative of the possible economic impairment latent in banks' portfolios. Stress tests also indicate that SCBs have sufficient capital at the aggregate level even in the severe stress scenario but, at the individual bank level, several banks may fall below the regulatory minimum if stress aggravates to the severe scenario. The need of the hour is for banks to assess their respective stress situations and follow it up with measures to raise capital proactively.

At the aggregate level, the CRAR of scheduled urban co-operative banks (SUCBs) deteriorated from 9.70 per cent to 9.24 per cent between March 2020 and September 2020. NBFCs' credit grew at a tepid pace of 4.4 per cent on an annual (Y-o-Y) basis as compared with the growth of 22 per cent a year ago.

Network analysis indicates that the total outstanding bilateral exposures among constituents of the financial system grew marginally after witnessing a sharp fall as at end-June 2020. SCBs continued to have the largest bilateral exposure in the Indian financial system in September 2020. As regards inter-sectoral exposures, asset management companies/mutual funds (AMC-MFs), followed by insurance companies, remained the most dominant fund providers in the system, while NBFCs were the biggest receiver of funds, followed by housing finance companies (HFCs).

The continuing shrinking of the inter-bank market as well as better capital position of banks led to decline in risk levels due to contagion effects.

### Regulatory Initiatives and Other Developments in the Financial Sector

The Reserve Bank, other financial sector regulators and the government have undertaken extraordinary measures to mitigate the impact of the pandemic. Several innovative measures were rolled out to ease balance sheet stress for borrowers and lending institutions. Alongside these pandemic induced actions, the pace of ongoing efforts to address systemic gaps and to develop and strengthen various parts of the financial system, did not slow down.

### Assessment of Systemic Risk

In the latest systemic risk survey (SRS), respondents rated institutional risks, which comprise asset quality deterioration, additional capital requirements, level of credit growth and cyber risk, among others, as 'high'. All other major risk groups, *viz.*, global risks, macroeconomic risks and financial market risks were perceived as being 'medium' in magnitude. This represents a clear shift from the April/May 2020 survey results in which all the above groups were rated as 'high' risk.

[2] FSR for mid-year presents stress test projections for next March and end-year FSR gives the projections for next September.