

Overview

The Financial Stability Report (FSR) is a half-yearly publication, with contributions from all financial sector regulators. It presents the collective assessment of the Sub Committee of the Financial Stability and Development Council on current and emerging risks to the stability of the Indian financial system.

Global Macrofinancial Risks

Global growth has proven more resilient than expected despite trade tensions, geopolitical risks, and uncertainty around economic policy, supported by front-loaded trade, fiscal measures, and strong AI-related investment. Nonetheless, risks to the outlook remain skewed to the downside due to still elevated uncertainty, high public debt, and the risk of a disorderly market correction.

Financial markets appear strong on the surface but show growing underlying vulnerabilities. Sharp rise in equities and other risk assets, high hedge funds' leverage, expanding opaque private credit markets and growth of stablecoins all heighten global financial system fragilities. Ample liquidity is supporting risk-on sentiment across asset classes, but a sharp correction - especially if AI optimism fades - could spill over to the broader financial system, given rising interconnectedness.

Domestic Macrofinancial Risks

Despite persistent global challenges, India's economy continues to grow strongly on the back of robust domestic demand. Benign inflation, fiscal consolidation, and prudent macroeconomic policies have enhanced economic resilience. The domestic financial system remains sound, supported by strong balance sheets, easy financial conditions, and low market volatility.

The economy and the financial system, however, faces near-term risks from external uncertainties - geopolitical and trade related. These factors could increase exchange rate volatility, dampen trade, reduce corporate earnings, and lower foreign investment. A sharp correction in US equities could influence domestic equities and tighten financial conditions. However, the economy and financial system have strong buffers to withstand adverse shocks.

Financial Institutions: Soundness and Resilience

The health of the scheduled commercial banks (SCBs) continued to remain robust with strong capital and liquidity buffers, improving asset quality and stable profitability. Stress tests results reaffirmed the resilience of banks to withstand losses under adverse scenarios and maintain capital buffers well above the regulatory minimum.

The primary (urban) cooperative banks (UCBs), with some exceptions, remain healthy with sound capital buffers and continued strength in profitability, despite softening in net interest margin. Overall, the sector was found to be resilient under stress tests.

Capital position of the non-banking financial companies (NBFCs) remained strong, and their asset quality continued to improve while profitability stayed stable. Stress tests results showed, barring a few outlier NBFCs, aggregate capital position would remain well above regulatory requirements under adverse shocks. Stress tests results for mutual funds and clearing corporations affirmed their resilience to adverse shocks. The insurance sector continues to display balance sheet resilience, supported by adequate capital buffers, steady capital accretion and solvency ratios that remain above prescribed regulatory thresholds at the aggregate level.

Regulatory Initiatives in the Financial Sector

Amid persistent economic uncertainty and ongoing structural transformations in global finance, financial sector regulators have continued to strengthen regulatory frameworks and enhance supervisory attention, particularly with respect to G-SIBs, the interconnectedness between banks and NBFIs, and liquidity risk management. International standard-setting bodies are also advancing measures for the regulation of crypto and digital assets, with a focus on addressing emerging financial stability risks arising from the interlinkages between tokenised

asset classes and crypto-asset markets, and the reserve holdings of stablecoin issuers.

At the domestic level, financial sector regulators have continued to focus on strengthening the resilience of the system by enhancing transparency frameworks, improving governance and accountability standards, strengthening customer and investor protection, and improving the ease of doing business. Another key initiative has been a fundamental reorganisation of the regulatory instructions that is expected to enhance clarity, ease of access, and reduce compliance burden for regulated entities.