Overview

Macro-Financial Risks

The global economy confronted a number of uncertainties – a delay in the Brexit deal, trade tensions, whiff of an impending recession, oil-market disruptions and geopolitical risks - leading to significant deceleration in growth. These uncertainties weighed on consumer confidence and business sentiment, dampened investment intentions and are likely to remain a key drag on global growth. Predictably, lower interest rates and easy monetary policies are boosting leverage globally, with the indebtedness of emerging market (EMs) governments and households showing a distinct increase, besides supporting asset prices and capital flows to EMs.

Domestic Economy and Markets

On the domestic front, aggregate demand slackened in Q2:2019-20, further extending the growth deceleration. While the outlook for capital inflows remains positive, India's exports could face headwinds in the event of sustained global slowdown, but current account deficit is likely to be under control reflecting muted energy price outlook. Various policy announcements by the Government coupled with the Reserve Bank's accommodative stance are expected to provide an enabling environment to bolster economic performance in the medium-term, though short-term pressures remain. Reviving the twin engines of consumption and investment while being vigilant about spillovers from global financial markets remains a critical challenge going forward.

Financial Institutions: Soundness and Resilience

Scheduled commercial banks'[1] (SCBs) credit growth remained subdued at 8.7 per cent year-on-year (y-o-y) in September 2019 although private sector banks (PVBs) registered double digit credit growth of 16.5 per cent. SCBs' capital adequacy ratio improved significantly to 15.1 per cent in September 2019 after the recapitalisation of Public Sector Banks (PSBs) by the Government. SCBs' gross non-performing assets (GNPA) ratio remained unchanged at 9.3 per cent between March and September 2019. Provision coverage ratio (PCR) of all SCBs rose to 61.5 per cent in September 2019 from 60.5 per cent in March 2019 implying increased resilience of the banking sector.

Macro-stress tests for credit risk show that under the baseline scenario, SCBs' GNPA ratio may increase from 9.3 per cent in September 2019 to 9.9 per cent by September 2020 . This is primarily due to change in macroeconomic scenario, marginal increase in slippages and the denominator effect of declining credit growth.

As per network analysis, total bilateral exposures between entities in the financial system registered a marginal decline in quarter ended September 2019. Among all the intermediaries, private sector banks (PVBs) saw the highest y-o-y growth in their payables to the financial system, while insurance companies recorded the highest y-o-y growth in their receivables from the financial system. Commercial paper (CP) funding amongst the financial intermediaries continued to decline in the last four quarters.

[1] Analyses are based on the Reserve Bank's Supervisory Returns which only cover SCBs' domestic operations, except in the case of data on large borrowers which is based on banks' global operations. SCBs include public sector banks, private sector banks and foreign banks.

The size of the inter-bank market continued to shrink with inter-bank assets amounting to less than 4 per cent of the total banking sector assets as at end-September 2019. This reduction, along with better capitalisation of PSBs led to a reduction in contagion losses to the banking system compared to March 2019 under various scenarios relating to idiosyncratic failure of a bank/non-banking finance company (NBFC)/housing finance company (HFC) and macroeconomic distress.

Financial Sector: Regulation and Developments

While significant progress has been made globally in improving banks' resilience through the adoption of multiple macroprudential tools to tailor policy responses, perceived sources of vulnerabilities have moved from banking to non-banking financial intermediation, corporate indebtedness and asset market illiquidity which require policy response.

On the domestic front, the Reserve Bank initiated policy measures to introduce a liquidity management regime for NBFCs, to improve the banks' governance culture, for resolution of stressed assets and the development of payment infrastructure. Adoption of a revised prudential framework on stressed assets is making slow progress owing to a hold-up at the resolution plan (RP) level. Given the complexity of the new accounting standards introduced in the NBFC sector, the subjective interpretation of Ind AS across financial firms requires attention.

The Securities and Exchange Board of India (SEBI) has taken a number of steps to improve the financial markets including a revised risk management framework of liquid funds, revised norms for investment and valuation of money market and debt securities by mutual funds (MFs), revised norms for credit rating agencies (CRAs), facilitating new commodity derivative products and setting up institutional trading platforms (ITPs) on stock exchanges to promote start-ups.

The Insolvency and Bankruptcy Board of India (IBBI) continues to make steady progress in the resolution of stressed assets. The Insurance Regulatory and Development Authority of India (IRDAI) has taken initiatives for growth of InsurTech and strengthening insurers' corporate governance processes. The Pension Fund Regulatory and Development Authority (PFRDA) continues to bring more citizens under the pension net.

Assessment of Systemic Risk

India's financial system remains stable notwithstanding weakening domestic growth. According to the survey results all major risk groups *viz.*, global risks, risk perceptions on macroeconomic conditions, financial market risks and institutional positions were perceived as medium risks affecting the financial system. However, the perception of domestic growth risk, fiscal risk, corporate sector risk and banks' asset quality risk increased between the earlier survey (April 2019) and the current survey (October 2019). About 32 per cent of the respondents felt that the Indian banking sector's prospects are going to improve marginally in the next one year while 25 per cent of the respondents felt that the prospects are going to deteriorate marginally. Participants were of the opinion that resolution of the legacy bad assets under the Insolvency and Bankruptcy Code (IBC) is essential to enable the banking system to support the aspirations of economic growth.