Overview

Macro-Financial Risks

Global Economy and Markets

Global growth outlook for 2018 remains positive despite some recent softness. Spillover risk from advanced financial markets to emerging markets, however, has increased. Tightening of liquidity conditions in the developed markets alongside expansionary US fiscal policy and a strong US dollar have started to adversely impact emerging market currencies, bonds and capital flows. Firming commodity prices, evolving geopolitical developments and rising protectionist sentiments pose added risks.

Domestic Economy and Markets

On the domestic front, while economic growth is firming up, conditions that buttressed fiscal consolidation, inflation moderation and a benign current account deficit over the last few years are changing, thereby warranting caution. In the domestic financial markets, structural shifts are altering the pattern of credit intermediation and impacting market interest rates. These developments call for greater vigilance on the domestic macroeconomic front to reinforce financial stability.

Financial Institutions: Soundness and Resilience

The stress in the banking sector continues as gross non-performing advances (GNPA) ratio rises further. Profitability of scheduled commercial banks (SCBs) declined, partly reflecting increased provisioning. While this has added pressure on SCBs' regulatory capital ratios, the provisioning coverage ratio has increased. Credit growth of SCBs picked up during 2017-18 notwithstanding sluggish deposit growth.

Macro-stress tests indicate that under the baseline scenario of current macroeconomic outlook, SCBs' GNPA ratio may rise from 11.6 per cent in March 2018 to 12.2 per cent by March 2019. The system level capital to risk-weighted assets ratio (CRAR) may come down from 13.5 per cent to 12.8 per cent during the period.

Macro-stress tests on public sector banks under prompt corrective action framework (PCA PSBs) suggest worsening of their GNPA ratio from 21.0 per cent in March 2018 to 22.3 per cent by March 2019, with 6 PCA PSBs likely experiencing capital shortfall. However, the capital augmentation plan announced by the government will go a long way in addressing potential capital shortfall, as also play a catalytic role in credit growth at healthier banks. In parallel, the PCA framework, by addressing the vulnerabilities of weaker banks will help in improving the health of the banking sector. In a way, the entire thrust of the current PCA framework is to prevent further capital erosion and more importantly, to strengthen them to the point of resilience so that they can restart their normal operations as soon as possible. Furthermore, if undertaken promptly and well, governance reforms would not only improve the financial performance of banking sector but also help reduce operational risks.

Network analysis reveals a reduction in the size of the interbank market coupled with a marginally higher level of interconnectedness. Contagion analysis of the banking network indicates that if the bank with the maximum capacity to cause contagion losses fails, it will cause a solvency loss of about 9.0 per cent of the Tier-I capital of the banking system.

Financial Sector Regulations and Developments

Global regulators have finalised the regulatory ecosystem with the adoption of post-crisis reform package. On the domestic front, a regulatory stance inducing a proactive legacy impairment clean up and the corporate resolution mechanism of Insolvency and Bankruptcy Code, 2016 is leading to a market-based time-bound resolution of insolvencies. Given the escalation of operational risk, a more proactive approach addressing embedded operational risk, especially in PSBs, as also calibrating risk taking in vulnerable banks will help in reducing systemic risk. The Reserve Bank has put in place a framework for taking enforcement action in an objective, consistent and non-partisan manner and has initiated enforcement actions on a wide range of contraventions.

The increasing trend of financial savings in mutual funds continues. SEBI has permitted liquidity enhancement schemes (LES) in commodity derivative contracts. The recent regulatory initiatives in the insurance sector aim at broad-basing the investor base. Initiatives in the pension sector aim to rationalise requirements for appointment as Retirement Advisors, as also ease partial withdrawal requests from pension investors. The overriding shadow of cyber risk, adoption of innovative technologies like Fintech and data analytics for financial intermediation have created new frontiers in regulatory and supervisory challenges.

Assessment of Systemic Risk

India's financial system remains stable. The recent policy initiatives have reinforced the underlying regulatory and institutional framework of the financial sector. According to survey results, participants assigned a moderate probability to the realisation of global risks, domestic macroeconomic risk, institutional and market risks over a six month horizon. 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.