Overview

Macro-Financial Risks

Global Economy and Markets

The global recovery remains fragile amidst weak and uneven growth, a slowdown in world trade and prevailing uncertainties in financial and commodities markets. At the same time, unintended side effects of current ultra-easy monetary policies being pursued in many advanced economies are becoming evident, even as their effectiveness in stimulating growth is yet to be firmly established.Moreover, the increasing uncertainty about the extent to which such policies will be prolonged without any clear signs of an exit strategy seems to be adding to the concerns.

Domestic Economy and Markets

Indian economy at this juncture stands out amongst emerging market cohorts in terms of growth and investment potential. However, gross fixed capital formation needs a fillip while maintaining robust trends in consumption to sustain higher levels of growth. With the Government's commitment to continue on the path of fiscal discipline, the efforts on containing the revenue deficit and rationalising subsidies need to be reinforced. India's external sector indicators show a relatively stronger position. However, a faster growth in India's oil import in terms of volume in recent years makes it imperative to be alert to the risks of commodity cycle reversals.

While the prediction of a normal monsoon augurs well for 2016-17, the agriculture sector needs coherent policy measures to address sustained food price pressures and the overall rural distress. While stress in the corporate sector showed some signs of moderation in 2015-16, the risks of lower demand and weaker debt servicing capacity continue.

With increasing impact of prevailing uncertainties and dynamics in the rest of the world on India, continuing on the path of sound domestic policies and structural reforms becomes even more important.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks – Performance and Risks

Risks to India's banking sector have increased since the publication of the last Financial Stability Report (FSR) in December 2015, mainly on account of a further deterioration in asset quality and low profitability. While the credit and deposit growth of scheduled commercial banks (SCBs) slowed significantly during 2015-16, their overall capital to risk-weighted assets ratio (CRAR) level increased between September 2015 and March 2016. The risk-weighted assets (RWA) density declined during this period.

The gross non-performing advances (GNPAs) rose sharply to 7.6 per cent of gross advances in March 2016 from 5.1 per cent in September 2015, largely reflecting re-classification of restructured advances to NPAs following an asset quality review (AQR). Consequently, the overall stressed advances rose only marginally to 11.5 per cent from 11.3 per cent during the period, due to a reduction in restructured standard advances ratio from 6.2 per cent in September 2015 to 3.9 per cent in March 2016.

Stress Tests

Scheduled Commercial Banks

The macro stress tests suggest that under the baseline scenario, the GNPA ratio may rise to 8.5 per cent by March 2017 from 7.6 per cent in March 2016. If the macro situation deteriorates in the future, the GNPA ratio may increase further to 9.3 per cent by March 2017. Under such a severe stress scenario, the system level CRAR of SCBs may decline to 11.5 per cent by March 2017 from 13.2 per cent as of March 2016.

Urban Co-operative Banks

The system level CRAR of SUCBs remained above the minimum regulatory requirement except under the extreme scenario. However, individually, 30 out of 52 SUCBs will not be able to meet the required CRAR levels under the extreme scenario.

Non-Banking Financial Companies

Stress tests for non-banking financial companies (NBFCs) show that the CRAR at the system level was only marginally affected and remained well above the regulatory minimum required level of 15 per cent. However, the CRAR of a few NBFCs may fall below minimum required level, under the extreme scenario of GNPAs increasing by 3 standard deviation.

Financial Sector Regulation and Infrastructure

Banking Sector Regulation

Internationally, apart from the focus on the measures related to improving the capital and liquidity position of banks, the policies aimed at promoting public confidence and upholding the safety and soundness of the banking system with emphasis on issues of transparency and accountability assume a greater degree of significance.

As Indian banks are currently focusing on balance sheet repair, various measures have been taken by the Government to address the issues related to distressed industrial sectors. The Reserve Bank has also undertaken measures to enable banks to take prompt steps for early identification of asset quality problems, timely restructuring of viable assets and recovery or sale of unviable assets as also to strengthen the lenders' ability to deal with stressed assets.

Regulation of the Securities and Commodities Derivatives Market

While India's equity markets are fairly developed with a large number of listed companies, activity in the equity market shows concentration in few stocks and is dominated by a few institutional participants. As regards the corporate bond market, SEBI's framework providing an electronic book mechanism for issuance of debt securities on private placement basis is expected to result in improved efficiency, transparency in price discovery as well as reduction in cost and time taken for such issuances.

With the regulatory impetus, the commodity derivatives market is poised to evolve with new products and new categories of participants leading to better liquidity and more efficient price discovery. The recent initiative of Government in setting up the National Agriculture Market (NAM) - to create a unified and integrated national market for agricultural commodities will help in streamlining the underlying markets and enabling uniform spot prices.

Insurance and Pension Sectors

While a robust reinsurance program protects the balance sheets of primary insurance companies against unexpected losses and improves risk assessment, there is a need to assess the resilience of reinsurance companies in the face of increasing concentration of contingent liabilities in a few reinsurance entities.

The move towards adopting risk based supervision by the pension sector regulator is expected to ensure efficient allocation of supervisory resources.

Assessment

India's financial system remains stable, even though the banking sector is facing significant challenges. As global uncertainties and transiting geopolitical risks impact India, continuation of sound domestic policies and structural reforms remain the key for macroeconomic stability.