

Overview

Macrofinancial Risks

Global

The outlook for global growth continues to be grim. Global growth forecasts have been lowered by major global agencies. Much of the Euro Area and Japan are experiencing negative growth while growth in the US is still low. The continuance of the Euro Area Sovereign Debt Crisis and uncertainty over the US fiscal cliff are major downside risks to global growth and financial stability. Efforts to deal with the crisis are underway in Europe. For Emerging and Developing Economies (EDEs), the threat of spillovers remains significant in view of the depressed outlook for global trade and volatile capital flows. Although inflation pressures appear to be moderating, elevated food and commodity prices remain contingent risks, especially for economies facing domestic supply constraints. A major risk to the outlook stems from political economy considerations that could impede, delay or erode resolute policy action and the consequence could be deepened financial stress and heightened risk aversion.

Domestic

The overall macroeconomic risks in the Indian financial system seem to have increased since the publication of the previous Financial Stability Report (FSR) in June 2012. Decline in domestic growth coupled with relatively high inflation, fall in domestic savings, particularly household financial savings, fall in investment demand and moderation in consumption have increased the risks to macroeconomic stability. In addition, high current account deficit, stressed fiscal situation, increasing leverage and falling profitability of the corporate sector have emerged as pertinent issues for macroeconomic stability.

Fiscal Assessment

The central government's gross fiscal deficit (GFD) up to October 2012 constituted about 72 per cent of the budgeted amount for the whole year as against 74 per

cent during the corresponding period of previous year. There could be some shortfall in tax and non tax revenue of the government during the current year on account of economic slowdown. Also there could be some overshooting of government expenditure.

External Sector

Stress on the external front remains elevated. Although, as compared to the previous quarter, the current account deficit to GDP ratio has fallen, it still remains high. Gold imports continue to account for a large part of the CAD. Other external sector vulnerability indicators also show increased stress. Volatile capital flows could make CAD financing a challenge.

Financial Markets

Risks in the Indian financial markets fell marginally in the period under review. The liquidity deficit in the financial system increased in Q3 of 2012-13 after having eased during Q2 of 2012-13. Long and short term treasury yields remained largely range bound. The primary market in equities which was relatively subdued during early part of the year showed some signs of revival in the recent period. Sentiments in the secondary market have improved on increased FII inflows. However, a significant portion of the capital market issues were concentrated in bonds of banks and financial institutions, reducing their disintermediation function. There could potentially be an outflow from the equity market if the US fiscal cliff risk materialises stoking risk aversion.

Households

The household sector has traditionally been a stabilising factor in the Indian economy. However, there are signs of increasing stress in this sector with a fall in household financial savings; households have been shifting away from financial assets into physical assets and valuables such as gold.

Corporate Sector

The corporate sector has also been showing signs of increased stress. Ability of corporates to service

borrowing with present level of profits has fallen since 2009-10 and it is currently below the levels of 2008-09. Leverage of corporates exposed to the infrastructure sector has increased. Until recently, the primary equity market was dormant and this could, among other factors, have led to increasing leverage of the corporate sector.

Systemic Risk Survey

Systemic risk survey indicates that global issues such as the fall in global growth and sovereign risk/contagion are perceived to be prominent risks for the financial system. On the domestic front, increasing fiscal deficit and deterioration in growth outlook have emerged as important risk factors.

Financial Institutions: Soundness and Resilience

Banking Sector Risks

The risks to the banking sector have been increasing in recent years. Tight liquidity, deteriorating asset quality and reducing soundness are the major contributors to the decline in stability of the banking system. However, a marginal improvement in the banking stability indicator during the last two quarters is primarily because of better liquidity conditions.

Banking Stability Measures

The probability of distress of the entire banking system seems to have reversed its upward trend and registered a marginal decline in the recent period. Various indicators of distress dependencies in the banking system reveal that there has been no significant change in the risk over the last few quarters.

Network Analysis

The analysis of the network of the Indian financial system finds that the inter linkages in the system are strong. Interconnectedness in the financial system in India arises from both funding dependencies and direct credit exposures especially among banks, on the one hand, and insurance companies, mutual funds and non-banking financial companies (NBFCs), on the other. An assessment of the impact of the liquidity contagion in the Indian banking system has been attempted in this issue of the FSR. There has been no

major shift in the pattern of interconnectedness or contagion risks in the system in the recent periods.

Scheduled Commercial Banks

Capital Adequacy and Asset Quality

The overall capital adequacy ratio has deteriorated since March 2012 though it remained well above the regulatory minimum. The decline in CRAR was more pronounced for the public sector banks. In addition, asset quality of banks has seen considerable deterioration during the half year ended September 2012.

Restructuring of Advances

Restructuring of loans, particularly of big ticket loans under the corporate debt restructuring (CDR) mechanism, has recently come under closer scrutiny due to the steep rise in the number and value of such advances. Of late, the growth in restructured advanced has outpaced the growth in gross advances of the banking system.

Profitability

Profitability of the banking sector has increased in the recent past, partly, due to a fall in growth of interest expenditure relative to interest income. The profit after tax has grown at 36.8 per cent at end September 2012, reaching close to the growth rate of 37.4 per cent observed in the period before the global financial crisis.

Financial Sector Regulation and Infrastructure

Implementation of Global Reforms

The global regulatory reform initiatives launched in wake of the global financial crisis are at various stages of implementation, where consistency across jurisdictions becomes critical to ensuring that opportunities for regulatory arbitrage do not emerge.

Basel III Implementation

Final guidelines for Basel III implementation have been issued in India. Banks in India are relatively well placed for migration to the new capital regime. However, the recent deterioration in asset quality as well as proposed changes in provisioning norms could pose challenges for banks.

Advanced Approaches under Basel II

Use of complex models for capital calculations pose challenges even as several banks are gearing up to migrate to advanced approaches under Basel II. Associated validation and accreditation processes will assume criticality in ensuring that complex modeling is not used to optimistically calculate risk weights resulting in dilution of capital or other regulatory requirements.

Banking Frauds

Losses incurred by banks in India due to frauds are on the increase. These trends, as well as several high profile cases of frauds in banks globally, have focused attention on the importance of operational risk capital. In the Indian context, however, there are formidable challenges in measuring the extent of operational risks given the lack of historical data on operational loss events.

Shadow Banking

The emergent policy framework for the shadow banking system aims to mitigate potential systemic risks across the globe while recognising the useful economic role played by them. The non-banking financial system in India is within a regulatory perimeter but there are some gaps in terms of regulatory coverage and data availability, which are being looked into jointly by all regulators.

Financial Market Infrastructure

The country's financial market infrastructure has been functioning smoothly. Potential risks posed by procyclicality of margin movements in the CCIL settlements and various equity exchanges, and exposures of equity market central counterparties (CCPs) to the settlement banks will need to be monitored. There are challenges in migrating all OTC derivative transactions to central clearing given lack of standardisation, sufficient liquidity and readily available pricing information in some products/markets. In India, a trade repository for OTC derivative products has been launched. Guaranteed clearing of foreign exchange forward transactions in the US\$ /INR segment has been mandated.

Financial Inclusion

Globally, the triad of Financial Inclusion, Financial Literacy and Consumer Protection has been recognized as intertwining threads in pursuit of financial stability. In India, the financial sector regulators have been working towards furthering financial inclusion and improving financial literacy through concerted efforts, which are featured in this issue of FSR.

The Financial Stability Report December 2012 includes inputs from GOI, SEBI, IRDA and PFRDA.