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Report on Trend and Progress of Banking in India 2014-15 and Financial Stability Report December 2015

The Reserve Bank of India today released the statutory Report on Trend and Progress of Banking in India 2014-15 (RTP) as also the twelfth issue of the Financial Stability Report (FSR). The RTP presents the performance and salient policy measures relating to the banking sector including that of the co-operative banks and non-banking financial institutions during 2014-15. The FSR gives an assessment of risks to financial stability as also the resilience of the financial system.

I. The highlights of the RTP are as follows:

Perspective and Policy Environment

- The global macro-financial risks shifted from advanced to emerging economies with the latter facing pressures from weakening prospects of growth, falling commodity prices and strengthening of the dollar. However, the Indian economy appeared quite resilient, given a modest recovery in the economy, declining inflation and buoyant capital flows that helped in maintaining the external sector balance.

- The regulatory and supervisory policy responses during the year *inter alia* included the initiatives for de-stressing the banking sector, reforming and recapitalisation of the public sector banks (PSBs), strengthening the liquidity standards of the banks, monitoring the buildup of leverage in the banking system, convergence with the international accounting standards, policies relating to licensing and expansion of UCBs and making the banking sector more inclusive.

Operations and Performance of Scheduled Commercial Banks

- The performance of the Indian banking sector remained subdued as it experienced a slowdown in balance sheet growth in 2014-15. While the PSBs registered deceleration in credit growth, the private sector banks (PVBs) and foreign banks (FBs) showed higher credit growth. Retail loan portfolio of the banks continued to grow at around 20 per cent during 2014-15.

- Reflecting the overall trend, credit growth to priority sector also declined during 2014-15.

- Notwithstanding the increase in profit growth vis-à-vis the previous year, the return on assets (RoA), a common indicator of financial viability, did not show any improvement in 2014-15.

- While the PSBs accounted for 72 per cent of total banking sector assets, they accounted for only 42 per cent in total profits during 2014-15, with the PVBs surpassing the PSBs in the share of total banking sector profits. The deterioration in the asset quality of banks in general, and PSBs in particular, continued during the year.

Developments in Co-operative Banking

- Improvements in the sector have been slow-paced and limited to certain segments of the cooperative system. Even though there has been a turnaround in the financial stability indicators of the state level short-term co-operative credit institutions, asset quality concerns remain for the long-term institutions.

- The UCBs performed well in terms of return on equity (RoE). However, the gross non-performing advances (GNPAs) ratio witnessed an increase in 2014-15.

Non-Banking Financial Institutions

- The consolidated balance sheet of the all India financial institutions (AIFIs) expanded by 9 per cent during 2014-15 reflecting moderation from double-digit expansion in the previous couple of years.

- Loans and advances extended by non-banking financial companies-non-deposit accepting-systemically important (NBFCs-ND-SI) posted significant growth of 15.5 per cent during 2014-15. The GNPAs of the NBFCs-ND-SI showed a marginal improvement and were primarily concentrated in infrastructure sector, transport operator segment, and medium and large scale industries. On the other hand, asset quality of non-banking financial companies- deposit accepting (NBFCs-D) deteriorated as both gross and net NPAs increased during 2014-15.

II. The highlights of the Financial Stability Report, December 2015 are as follows:

Macro-Financial Risks

- While the first Fed rate hike since 2006 appeared to have been factored in by the markets, the pace of further increase may have a significant bearing on market behaviour. This along with the developments in China and sluggish global trade growth would define the global economy going forward.

- While India’s macro-economic fundamentals are relatively stronger, domestic demand and private investment are still not picking up, underscoring the need to step up public investments. Although India’s current account balance has benefitted from the fall in international crude prices and reduction in gold imports, exports have been adversely affected due to weak external demand.

- While the ratio of short term external debt to forex reserves has been moderating, attracting robust capital flows to finance the current account deficit will require continuous thrust on structural reforms and improving the ease of doing business.

- In the corporate sector, declining profitability, high leverage and low debt servicing capacity continue to cause concern with their attendant adverse impact on the financial sector, notwithstanding a marginal improvement observed during the first half of current financial year.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks – Performance and Risks

- The business of scheduled commercial banks (SCBs) slowed as reflected in further decline in both deposit and credit growth. Between March and September 2015, the gross non-performing advances ratio increased, whereas restructured standard advances ratio declined. Sectoral data as of June 2015 indicates that 'industry' continued to record the highest stressed advances ratio of about 20 per cent, followed by 'services' at 7 per cent. The capital to risk-weighted asset ratio (CRAR) of SCBs registered some deterioration during the first-half of 2015-16.
- Among other financial institutions, the asset quality of both scheduled urban co-operative banks (SUCBs) as well as non-banking financial companies (NBFCs) deteriorated during the first-half of 2015-16.
- The banking stability indicator shows that risks to the banking sector increased since the publication of the previous FSR, mainly on account of deteriorating asset quality, lower soundness and sluggish profitability.

Financial Sector Regulation

- While global financial sector regulatory reform agenda is being implemented steadily, there is a need for better appreciation of cost-benefit matrix of these reforms across jurisdictions given the structurally different economies with varying national priorities.

Banking sector

- While steps taken for developing corporate debt markets in India are showing some results, the dependence on bank finance continues even as the banks, especially the PSBs face challenges on asset quality, profitability and capital. In addition to the focus on governance processes through initiatives like 'Indradhanush', the PSBs may need to review their business models, and examine strategic decisions like capital planning and dividend policy.

Securities market

- Indian capital markets regulation has kept pace with the requirements of changing business environment by, among other things, creating special platform for enabling the start-up companies to access the capital markets. The domestic institutional investors, especially the mutual funds, are observed to be buffering the possible volatility due to foreign portfolio investment flows. Subsequent to the merger of Forward Markets Commission (FMC) with the Securities and Exchange Board of India (SEBI), guidelines on the comprehensive risk management framework have been issued to align and streamline the risk management framework across national commodity derivatives exchanges in India.

Insurance sector

- The insurance business model encompassing both insurers and reinsurers has specific features that differentiate it from the banking system and make it a source of stability in the financial system.

Pension sector

- The national pension system (NPS) is showing steady growth, and the Atal Pension Yojana (APY) aims to mitigate challenges faced by people in the unorganised sector.

Overall Assessment

- India’s financial system remains stable and the relatively stronger macroeconomic fundamentals lend resilience to face the still prevailing uncertainty and emerging risks in the global economy and financial markets. However, the policy makers and stakeholders will need to remain watchful about the potential adverse impact of developments in the global scenario particularly increased volatility in financial markets and further slowdown in global trade.
- On the domestic front, risks arising from erratic climatic conditions, limited policy space, corporate performance, asset quality of financial institutions and low investment growth, among other factors, could pose challenges.

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