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Report on Trend and Progress of Banking in India 2015-16 and Financial Stability Report December 2016

The Reserve Bank of India today released the statutory Report on Trend and Progress of Banking in India 2015-16 (RTP) as also the fourteenth issue of the Financial Stability Report (FSR).

The RTP, a statutory publication, 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 the financial year 2015-16. The FSR, brought out on behalf of the Sub-Committee of the Financial Stability and Development Council (FSDC), gives an assessment of risks to financial stability as also the resilience of the financial system.

The publication “Statistical Tables Relating to Banks in India (STRBI) 2015-16” is also simultaneously web-released with RTP 2015-16.

I. Highlights of the RTP 2015-16:

Perspective and Policy Environment

- During 2015-16, the performance of most emerging market economies (EMEs) was marked by severe domestic imbalances emanating from economic slowdown and downturn in credit growth coupled with rising stress in corporate and financial sectors. India stood out in terms of higher economic growth although the banking sector was under stress primarily on account of asset quality concerns.
- The regulatory and supervisory policy responses during the year *inter alia* included asset quality review (AQR) of banks, financial restructuring of large accounts under the Scheme for Sustainable Structuring of Stressed Assets (S4A), Large Exposures Framework to contain concentration risks, draft guidelines for the Net Stable Funding Ratio (NSFR) and rationalisation of ownership limits in private sector banks.

Operations and Performance of Scheduled Commercial Banks

- The performance of the Indian banking sector remained subdued during 2015-16 amidst rising proportion of banks’ delinquent loans, consequent increase in provisioning and continued slowdown in credit growth. However banks’ retail portfolios registered double-digit growth during the year.
- During 2015-16, SCBs’ interest earnings and non-interest incomes were adversely affected, which led to a more than 60 per cent drop in net profits for the banking sector. Banks’ return on assets (RoA) and return on equity (RoE) showed a substantial decline as compared to the previous year even as the public sector banks (PSBs) reported negative RoA.

Developments in Co-operative Banking

- During 2015-16, there was a moderation in the growth of balance sheets of urban co-operative banks (UCBs). Their profitability indicators and asset quality also deteriorated. There was, however, an improvement in asset quality across all rural co-operatives even as most of them registered a decline in net profits.

Non-Banking Financial Institutions

- The non-banking financial companies (NBFC) sector registered a significantly higher credit growth during 2015-16 in comparison with credit growth of commercial banks. The asset quality of the NBFC sector has been deteriorating since 2012 although the NPAs of NBFCs remained relatively lower than that of the banking sector.
- The Reserve Bank formulated a new category of NBFCs as NBFC-account aggregators (AAs) in September 2016 aimed at facilitating a consolidated view of individual investors' financial asset holdings, especially when the entities fall under the purview of different financial sector regulators.

Financial Inclusion: Policy and Prospects

- The recent policy initiatives with respect to financial inclusion included revision of priority sector guidelines, operationalisation of trading in priority sector lending certificates (PSLCs), advising banks for setting up of board approved financial inclusion plans for 2016-19, implementation of some of the recommendations of the Committee on Medium-term Path on Financial Inclusion, reconstitution of Financial Inclusion Advisory Committee, rolling out of National mission for Capacity Building of bankers for financing MSME sector, revising the guidelines of functioning of financial literacy centers.

II. Highlights of the December 2016 issue of FSR:

Macro-Financial Risks

- Global financial markets continue to face elevated levels of uncertainty notwithstanding the resilience to the outcomes of Brexit referendum and the US election. A negative feedback loop arising from productivity and global trade slowdowns and rising protectionism is adding to the pessimistic outlook on global recovery even as the uptick in US interest rates poses a significant risk to emerging market economies.
- While the spillover of global events to the domestic economy may continue to be significant, reduced policy uncertainty, along with tax and legislative reforms will help in realising the benefits from the strong macroeconomic fundamentals. The measures such as transition to the nationwide goods and services tax (GST) and the withdrawal of legal tender status of specified bank notes (SBNs) could potentially transform the domestic economy, notwithstanding some inconvenience to public and the momentary adverse impact on growth. While the financial performance of the corporate sector has improved in 2016-17, the risk of lower turnover remains.
- In the external sector, the narrowing of the current account deficit partly reflects the external spillovers in the form of sluggish trade growth. The decline in the flow of remittances is also a concern. Going ahead, capital flow, more than trade, is likely to influence the exchange rate.

Financial Institutions: Soundness and Resilience

Scheduled Commercial Banks – Performance and Risks

- The banking stability indicator (BSI) shows that the risks to the banking sector remained elevated due to continuous deterioration in asset quality, low profitability and liquidity. The business growth of scheduled commercial banks (SCBs) remained subdued with public sector banks (PSBs) continuing to lag behind their private sector peers. System level profit after tax (PAT) contracted on y-o-y basis in the first half of 2016-17.
- The asset quality of banks deteriorated further between March and September 2016. PSBs continued to record the lowest capital to risk-weighted assets ratio (CRAR) among the bank groups with negative returns on their assets.
- The GNPA (gross non-performing advances) ratio of SCBs increased to 9.1 per cent in September 2016 from 7.8 per cent in March 2016, pushing the overall stressed advances ratio to 12.3 per cent from 11.5 per cent. The large borrowers registered significant deterioration in their asset quality.
- The macro stress test shows that GNPA ratio of SCBs may increase further under assumed baseline macro scenarios. The PSBs may record the highest GNPA ratio and lowest capital to risk-weighted asset ratio (CRAR) among bank-groups although the CRAR at the system as well as bank-group levels is expected to remain above the regulatory required minimum.
- Asset quality of scheduled urban co-operative banks (SUCBs) deteriorated. Asset quality of the non-banking financial companies (NBFCs) also worsened.
- The degree of interconnectedness in the banking system measured by the connectivity ratio showed a declining trend. SCBs were the dominant players accounting for nearly 59 per cent of the total bilateral exposures followed by NBFCs. On a net basis, asset management companies managing mutual funds (AMC-MFs) followed by the insurance companies were the biggest fund providers in the system while NBFCs followed by SCBs were the biggest receivers of funds.

Financial Sector Regulation

- With the implementation of global regulatory reforms most of the major international banks have become more resilient in terms of capital and liquidity. However, risks of divergence from the demanding global standards amidst discriminatory treatment of foreign financial institutions seem to have increased. Globally, some risks inherent in banks may be getting transferred to other segments of the financial markets due to increased regulatory scrutiny and elevated capital requirements for banks.
- While regulatory measures on partial credit enhancement will support the corporate bond market in India, the guidelines on market mechanism and large exposures will help in reducing banks’ exposures to large corporates.
- The macroprudential and other regulatory measures are expected to enhance transparency in the functioning of financial markets and empower customers with wider product-choices and more effective mechanism for grievance redressal.
- The Securities and Exchange Board of India (SEBI) has taken several measures that include tightening of insider trading norms and enhancing transparency in the policies and procedures adopted by credit rating agencies (CRAs).

- The guidelines issued by Insurance Regulatory and Development Authority of India (IRDAI) seek to address operational aspects such as monitoring the foreign direct investment in insurance sector, approval of share transfer, and ceiling of holdings on various classes of investors, among others.

- The National Pension System (NPS) continued to gain traction in terms of the number of subscribers as well as assets under management (AUM). Introduction of two new life cycle funds and creation of a separate asset class for alternate investment are expected to provide more options to investors in pension schemes.

Overall, India's financial system remains stable although banks, particularly the public sector banks, continue to face significant levels of stress.

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