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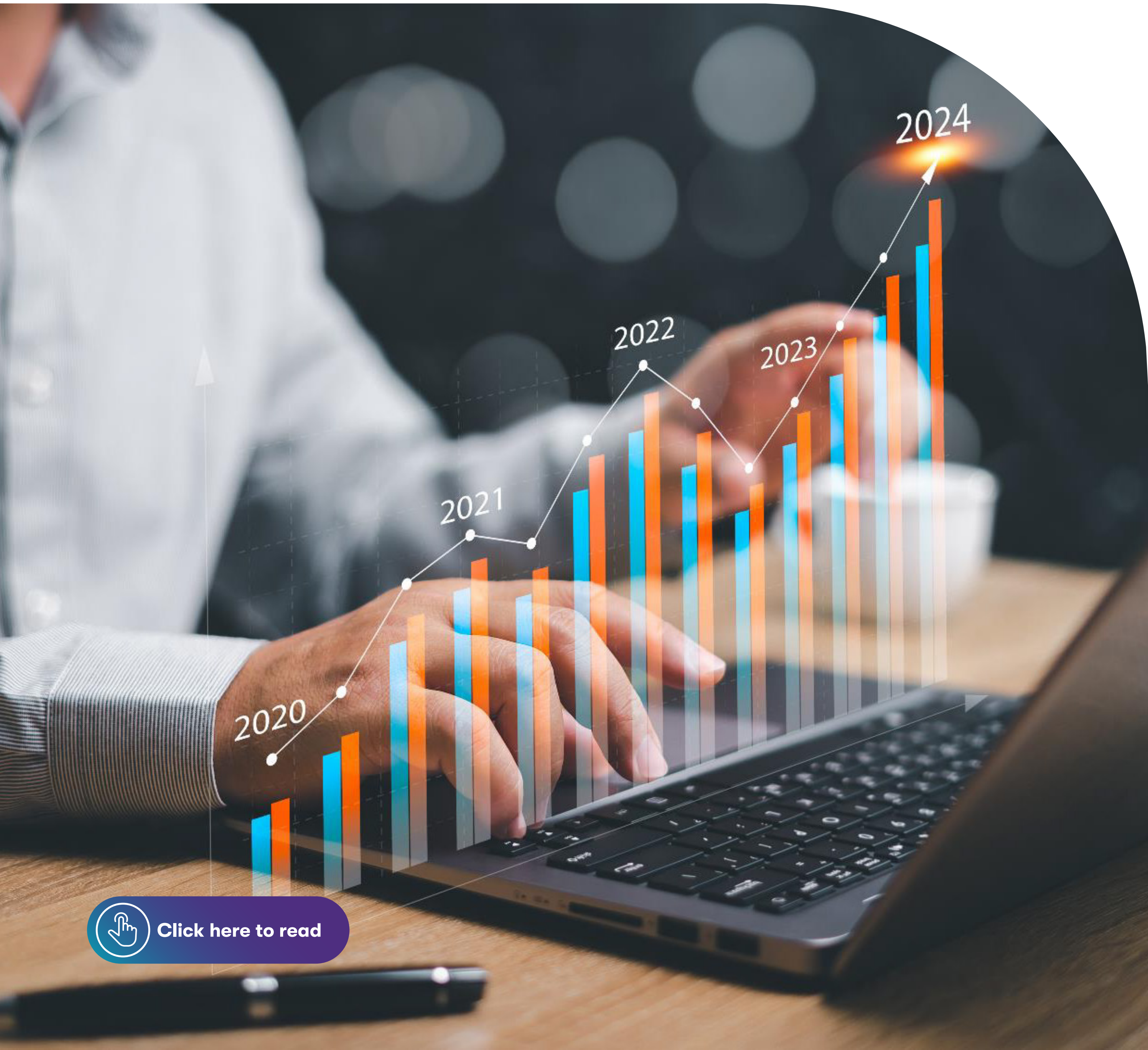
RBI Regulatory Banking Insights

June 2024



Preface

In June, the Indian economy was flourishing, and showing robust growth and resilience. This economic upturn is being supported by the return to office of the same government. The International Monetary Fund (IMF) has raised its GDP growth forecast for India to 7% for the fiscal year 2024-25.. However, some potential hurdles lie ahead like the widening gap between bank deposit growth and credit growth.. On a brighter note, India's inclusion in the MSCI index is expected to provide a significant boost to the bond market. Inclusion in the MSCI index exposes Indian bonds to a much larger pool of global investors. This can lead to a significant inflow of foreign capital into the Indian bond market. Additionally, global uncertainties continue as major elections in Europe and the US could have far-reaching economic and political consequences.

Moreover, inflation is emerging as a growing concern. While official figures are yet to be released, there are indications of rising prices for essential commodities, especially food items. The upcoming RBI monetary policy meeting in August will be keenly watched for any adjustments to interest rates or other policy measures. While the overall economic outlook remains positive, managing inflation and ensuring job creation in rural areas will be crucial challenges for the Government and the RBI in the next few months.

The current account deficit (CAD) is expected to remain under control, although potential fluctuations in global oil prices could pose some challenges.

The focus on infrastructure spending is likely to continue, with the Government potentially announcing new projects in areas like transportation, energy, and digital infrastructure. The newly elected government's roadmap for affordable housing initiatives may be unveiled, providing insights into policy direction and potential benefits for the real estate sector.

The world of finance is on the cusp of a significant transformation with the rise of Central Bank Digital Currencies (CBDCs). India, a country at the forefront of digital payments, is actively exploring this new frontier through pilot projects for both retail (e-Rupee) and wholesale (e-W) digital currencies. The success of these pilots will be instrumental in determining the future trajectory of digital currency adoption in the country.

The RBI is expected to announce a new set of regulations aimed at further strengthening the financial system. These could include measures to enhance cybersecurity, improve risk management practices, and promote enhance transparency. The success of the recently launched pilot projects for retail (e-Rupee) and wholesale (e-W) digital currencies will be closely evaluated. Expansion plans and wider adoption strategies might be announced based on these evaluations.

This document covers the impact and brief on some of the key regulatory updates introduced by the RBI to strengthen the financial sector in June 2024. On 7 June 2024, the RBI updated its Master Direction - RBI Interest Rate on Deposits Directions, 2016. These changes are due to the change in the definition of bulk deposits. Additionally, on 21 June 2024, the RBI issued a notification on the Priority Sector Lending – Amendments to the Master Directions. The RBI is offering extra credit for loans to underserved districts and simplifying reporting for some banks, while clarifying which small businesses qualify for these loans.

We also share our view of the RBI's 29th issue of the Financial Stability Report (FSR) released on 27 June 2024, which indicates a positive outlook for the Indian financial system. Despite global economic challenges, Indian banks and financial institutions are healthy with strong capital buffers and falling non-performing assets. Stress tests show the system can withstand potential risks, and non-banking financial companies (NBFCs) also remain stable.

01

Impact assessment of regulatory changes in June 2024

Amendment to Master Direction - RBI Interest Rate on Deposits Directions, 2016

RBI/2024-25/40 DoR.SPE.REC.No.24/13.03.00/2024-2025

Release date: 07th June 2024

Applicability

The provisions of these Directions shall apply to every Scheduled Commercial Bank {including Regional Rural Banks (RRBs)}, Small Finance Banks, Payment Banks and Local Area Banks1. These directions shall not be applicable to operations of foreign branches of Indian banks.

Background and objective

Prior to 2016, the Reserve Bank of India (RBI) directly set the interest rates that banks could offer on various types of deposits (savings accounts, fixed deposits etc.). This limited competition among banks and offered customers fewer choices. The Master Direction - Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 aimed to deregulate interest rates on rupee deposits in India. This deregulation had several objectives:

Promote competition

By allowing banks to set their own interest rates, the RBI hoped to encourage competition among banks for deposits. This could lead to potentially higher interest rates for depositors.

Improve price discovery

Deregulation allows market forces to determine the appropriate interest rate for different types of deposits.

Enhance bank autonomy

Banks gained more flexibility in managing their liabilities (deposits) based on their individual needs and market conditions.

This deregulation has led to a more dynamic interest rate environment in India. Banks now offer a wider range of deposit products with varying interest rates. However, it also placed the onus on depositors to compare rates and choose the bank offering the best deal.

Bulk deposits are large deposits made by a single entity, typically exceeding a certain threshold set by the RBI. Bulk deposits provide a reliable source of long-term funds for banks, which they can use to finance loans and other activities. Knowing a large sum is available for a set period helps banks manage their liquidity better. The Reserve Bank of India (RBI) issued an amendment to revise the definition of “bulk deposits” in the Master Direction - RBI (Interest Rate on Deposits) Directions, 2016.

Key changes

The amendment revises the definition of "bulk deposit" for the following types of banks:

Scheduled Commercial Banks (excluding RRBs) and Small Finance Banks

Deposits of Rs 3 crore (30 million rupees) or more are now considered bulk deposits. (Previously, the threshold was Rs 2 crore or more)

Regional Rural Banks and Local Area Banks

Deposits of Rs 1 crore (10 million rupees) or more are now considered bulk deposits. (Previously, the threshold was only applicable to regional rural banks)

Impact assessment

Increased flexibility for banks

This amendment likely grants these banks more control over interest rates offered for larger deposits. Also, inclusion of local area banks for bulk deposits.

Higher interest rates & competition

Banks may now compete by offering more attractive rates for larger deposits. This could lead to increased competition between banks, especially for larger deposits.

Priority sector lending: Amendments to the Master Directions

RBI/2024-25/44 FIDD.CO.PSD.BC.No.7/04.09.01/2024-25

Release date: 21st June 2024

Applicability

This amendment applies to all commercial banks (including regional rural banks), small finance banks, local area banks and primary (urban) cooperative banks (excluding salary earners' banks) in India.

Background and objective

The Indian economy has a large rural population and a significant number of small and medium businesses. These sectors are crucial for national development but often face challenges in accessing formal credit. The RBI (Reserve Bank of India) issued the Master Directions – Priority Sector Lending (PSL) to ensure that banks allocate a specific portion of their credit towards these critical sectors. This policy aims to achieve several objectives:

Promote inclusive growth

By making credit more accessible to underserved sectors, the RBI aims to encourage financial inclusion and economic development across the country.

Support priority sectors

The PSL guidelines direct banks to lend to sectors considered crucial for national development, such as agriculture, small businesses, microfinance, and social infrastructure (e.g., education, housing).

Balanced credit distribution

PSL targets encourage banks to lend beyond established businesses and urban centers, directing credit towards rural areas and smaller enterprises.

The RBI sets specific PSL targets for banks as a percentage of their total outstanding advances. Banks must meet these targets by lending to borrowers in the designated priority sectors. The Master Directions also define the eligibility criteria for loans to be classified under PSL. This ensures transparency and consistency in how banks categorize their lending.

Meeting PSL targets can sometimes put pressure on banks' profitability, especially if the lending rates in priority sectors are lower than those offered to other borrowers. Ensuring the effective utilization of PSL funds for their intended purposes requires proper monitoring and evaluation.

Overall, the Master Directions – PSL play a significant role in directing credit flow towards sectors critical for India's economic growth and social development.

Key changes

Differential weightage for PSL in districts

- Banks will receive a higher weightage (125%) for incremental PSL loans in districts with lower per capita PSL (less than INR 9,000) to incentivize lending in these areas (effective from FY 2024-25).
- Conversely, they will receive a lower weightage (90%) for incremental PSL loans in districts with higher per capita PSL (more than INR 42,000) to discourage excessive concentration in already well-served areas.
- New district lists are included and will be valid until FY 2026-27.

Clarification on MSME

The definition of MSMEs for PSL classification now explicitly refers to the RBI's Master Direction on Lending to MSMEs. The master direction is amended to clarify the below:

The Reserve Bank of India has issued guidelines to banks to streamline credit flow to Micro and Small Enterprises (MSEs) during their life cycle, particularly in times of financial distress. Banks are required to review and adapt their lending policies to include provisions such as standby credit facilities, additional working capital, mid-term reviews of credit limits, and timely credit decisions (within 14 working days for loans up to ₹25 lakh). Additionally, banks must display credit-related information, including timelines and document checklists, prominently on their websites to facilitate easy access to credit for MSEs.

The Reserve Bank of India has directed banks to establish a structured mechanism to monitor credit growth in the Micro and Small Enterprises (MSE) sector, comprising five key components: a Credit Proposal Tracking System (CPTS) for online tracking and acknowledgement of loan applications, an indicative checklist of required documents, monitoring of loan application disposal and pendency, written communication of rejection reasons, and a comprehensive performance management information system (MIS) for regular evaluation and review of credit flow to the sector.

The Cluster Approach aims to promote credit-linkage in identified clusters of Micro, Small, and Medium Enterprises (MSEs) by lead banks, who will assess credit requirements, create awareness, and facilitate skill development initiatives. The credit needs of clusters will be incorporated into branch/block level plans, aggregated into District Credit Plans, and ultimately, Annual Credit Plans. Convenor banks will display the list of clusters on their portals, update it semi-annually, and disclose credit extended to clusters quarterly, ensuring focused attention and proactive measures to improve financial services in underbanked clusters.

Simplified reporting for UCBs

Urban Cooperative Banks (UCBs) no longer need to submit separate reports on PSL data (Statements I & II). They can use the simplified RBI Filing of Supervisory Returns reporting format.

Impact assessment

This amendment aims to achieve a more balanced distribution of credit across districts by incentivising lending in underserved areas and preventing an over-concentration of resources in districts that are already well-served. Banks may shift their focus towards priority sectors in low PSL districts to meet their targets.

MSMEs may benefit from easier access to credit due to the clearer definition. This clarification is expected to improve the flow of credit to MSEs, particularly during financial distress, by ensuring timely credit decisions and better access to credit-related information. The Cluster Approach aims to ensure focused attention on the credit needs of MSE clusters, promoting credit-linkage and improving financial services in underbanked areas.

UCBs will benefit from reduced reporting burden and streamline reporting requirements, allowing for more efficient operations.

These changes reflect a strategic shift towards more equitable credit distribution, enhanced support for MSMEs, and operational efficiency for banking institutions.

02
Our view on Financial Stability Report June 2024

Our view on Financial Stability Report (FSR), June 2024

Published on 27th June 2024

Background

The Financial Stability Report (FSR) is a half-yearly publication issued in June and December, with contributions from all financial sector regulators. It assesses the current and potential risks to the stability of the Indian financial system. The FSR is crucial for maintaining a healthy financial system in India. It helps identify potential vulnerabilities and guides policymakers in taking necessary actions to mitigate risks and promote financial stability. The FSR aims to achieve several objectives:

Evaluate financial system health

The report assesses the overall health and resilience of the Indian financial system, including capital adequacy, asset quality, and risk management practices.

Identify risks and vulnerabilities

The FSR identifies potential internal and external threats to financial stability.

Inform policy decisions

The report's findings help guide the RBI and other policymakers in formulating financial regulations and taking necessary steps to mitigate risks.

Promote transparency

The FSR increases transparency by providing the public with insights into the health of the financial system.

Some of the key highlights of the FSR June 2024 are as below:

Macrofinancial risks

While the global economy shows signs of improvement, the report highlights potential risks like inflation, high public debt, geopolitical tensions, overvalued assets in some markets, climate change threats and cyberattacks.

Indian financial system

The report finds the Indian financial system to be sound and stable, supported by strong macroeconomic fundamentals and healthy financial institutions. Inflation is moderating, foreign reserves are strong, and government finances are improving, boosting business and consumer confidence. Indian banks are in a good position with improved profitability, declining non-performing assets, and strong capital buffers.

Stress tests

Stress tests indicate that the Indian financial system is resilient even under adverse economic scenarios. Other financial sectors (UCBs, NBFCs, insurance) also show signs of stability in stress tests.

Regulatory initiatives

The report highlights global and domestic regulatory efforts aimed at promoting financial stability and addressing emerging risks like digitalisation and climate change. Focus areas include:

- Protecting banks from overreliance on non-banking institutions
- Addressing risks from digital finance
- Improving assessments of climate-related financial risks
- Strengthening cybersecurity

A recent survey by the FSR indicates a "medium" risk level for all major categories threatening Indian financial stability. Market participants are generally optimistic about the domestic financial system, with reduced concern about global risks. However, geopolitical tensions, potential tightening of global financial conditions, and capital outflows remain key near-term concerns.

Our view on the possible changes in policy related matters upon review of the Financial Stability Report is outlined ahead.

https://www.rbi.org.in/Scripts/FsReports.aspx

Our analysis on FSR

The June 2024 FSR presents a positive outlook for the Indian financial system. However, it acknowledges potential global risks and emphasises the importance of continued vigilance and proactive policymaking. Following are the possible themes for policy changes in the future:

Loan and deposit growth

The RBI may introduce measures to balance loan and deposit growth rates, ensuring credit growth does not outpace deposit growth and preventing liquidity crunches.

Liquidity and interest rate risks

The RBI may review and refine the Liquidity Coverage Ratio (LCR) framework and introduce guidelines for managing interest rate risk in the banking book.

Cybersecurity and IT-related risks

The RBI may issue guidelines for improving IT governance, technology systems, and infrastructure resilience, and mitigating third-party risks.

Digital frauds

The RBI may introduce measures to strengthen customer onboarding, transaction monitoring, and education to prevent digital frauds.

Third-party risks

The RBI may issue guidelines for strong governance and oversight mechanisms in third-party relationships for both IT and non-IT services.

Unsecured retail credit

The RBI may introduce measures to ensure prudent lending practices in unsecured retail credit, including limits on unsecured exposures.

Conduct-related issues

The RBI may issue guidelines for fair conduct and practices, including transparent loan contracts, adequate disclosures, and responsible recovery practices

Transition financing

The RBI may introduce initiatives to address climate-related financial risks, including innovative transition financing models and disclosure frameworks.

Private credit markets

The RBI may introduce measures to monitor and regulate private credit markets, addressing potential financial stability concerns.

Self Regulatory Organisations (SROs) framework

The RBI may introduce different categories to promote SROs in order to oversee and regulate different categories of regulated entities. SROs will support in monitoring the conduct of their member entities (such as financial institutions, brokerages, or professional associations). By handling certain regulatory functions, SROs ease the workload of government regulators. This allows regulators to focus on critical issues.

These policy changes may aim to address the current issues and emerging risks in the Indian banking and financial sector, ensuring a resilient and inclusive financial system. Our detailed perspective on the FSR Report and their impact is outlined ahead.

https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/FEMODERNBFSI190720240E94451FEAF0428D8CF5A82B2B92171F.PDF

I. Macrofinancial risks

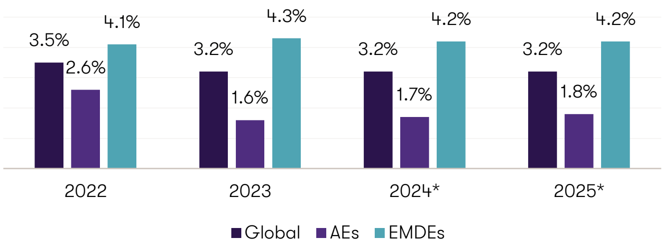
Introduction

This chapter discusses global financial risks and the resilience of the Indian economy. Despite global challenges, the Indian economy is exhibiting robust growth due to strong macroeconomic fundamentals and healthy financial institutions. This chapter also details various global macrofinancial risks, including elevated public debt, stretched asset valuations, stress in the commercial real estate sector, risks from private credit, and cyber risk. While India's financial system is robust, the chapter acknowledges downside risks to the economic outlook, including global slowdown, geopolitical tensions, and slack in the rural economy.

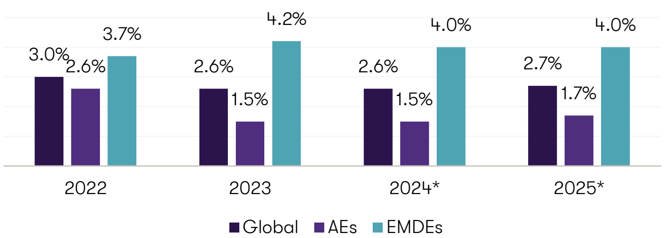
Key takeaways and our analysis

Global backdrop

Global growth forecast- a. IMF



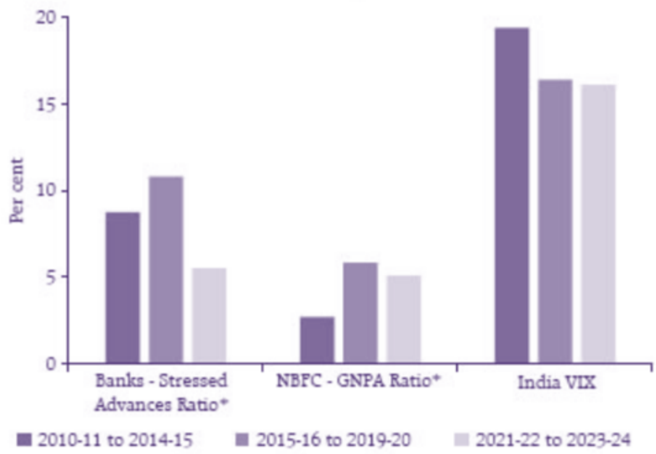
Global Growth Forecast- b. World Bank



* Forecasts
Source: RBI Financial Stability Report June 2024

- As the charts on Global Growth Forecast- IMF & World Bank indicate, The International Monetary Fund (IMF) projects global growth to remain steady at 3.2% in 2024. 0.3 percentage points higher than in its October 2023 World Economic Outlook update. In contrast, the World Bank has a more subdued outlook, projecting growth to be around 2.6% this year.
- Inflation remains a concern for many countries. Central banks around the globe are prioritizing reducing inflation to target levels. However, their efforts face several hurdles: persistent inflation in service sectors, upcoming elections in many countries, recent rises in commodity prices, and ongoing geopolitical tensions

Financial systems soundness



Note:
1. Average ration computed based on end-March figure of respective financial year.
2. FY 2020-21 (pandemic) not included.
3. Stressed advances include gross non-performing assets and restructured standard advances
Source: RBI Financial Stability Report June 2024

- The chart on Financial system soundness indicate that, banks stressed advances ratio has reduced significantly from 2015-20 in 2021-24 (even lower than 2010-15) which indicates a smaller portion of loans are at risk of default, i.e., the bank is less likely to face losses from unpaid debts. This translates to a more stable financial position.
- Additionally, NBFC- NPA Ratio is reduced from 2015-20 levels however it is still higher than 2010-15 levels. A lower GNPA ratio demonstrates NBFCs' ability to manage credit risk effectively. In their pursuit of maintaining a low GNPA, NBFCs might become stricter in their loan approval processes.
- Furthermore, the India VIX (India Volatility Index) reflects the market's expectation of volatility in the coming year. A decline in the VIX often coincides with a rising stock market. Investors tend to be more confident and willing to invest in a less volatile environment, which can drive stock prices upwards supporting overvaluation bubble in market. If the VIX falls significantly, it might enter "oversold territory," meaning investors are overly complacent. This could be followed by a sudden correction in the market.

Macrofinancial development and outlook

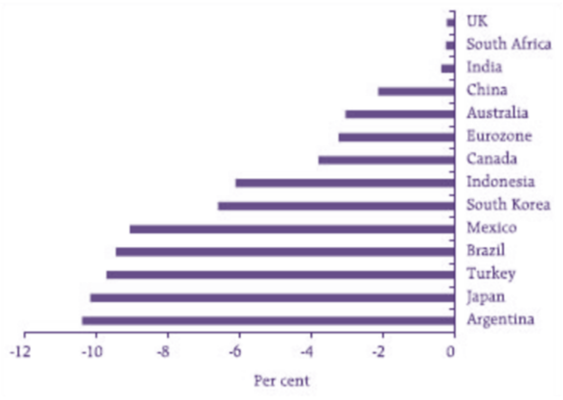
There is a recent alignment between market expectations and policy stances. Financial conditions remain stable with equity markets reaching new highs. The reduction of central bank balance sheets has been measured so far. The medium-term outlook is characterised by weak productivity and retreat in globalisation, with global growth expected to decline.

Global macrofinancial risks

Several near-term risks have receded, but global financial system continues to face uncertainty. Key risks include elevated public debt, stretched asset valuations, stress in the commercial real estate sector, private credit risks, and cyber risk.

- Elevated public debt- The global public debt has increased significantly, raising concerns about sustainability. High debt levels and narrowing interest rate-growth rate differential pose a threat. Emerging and low-income countries are particularly vulnerable to rising interest rates.
- Stretched asset valuations- Financial markets have remained buoyant with rising asset prices. Stretched valuations could lead to stress if sudden shocks occur. The growing importance of non-bank institutions increases potential risks. Investors are flocking to the USD due to the expectation of higher interest rates in the US compared to other countries, including India. As per the below chart on Change in Major currencies against USD, the value of the US dollar (USD) has been holding steady against the Indian rupee (INR) recently.

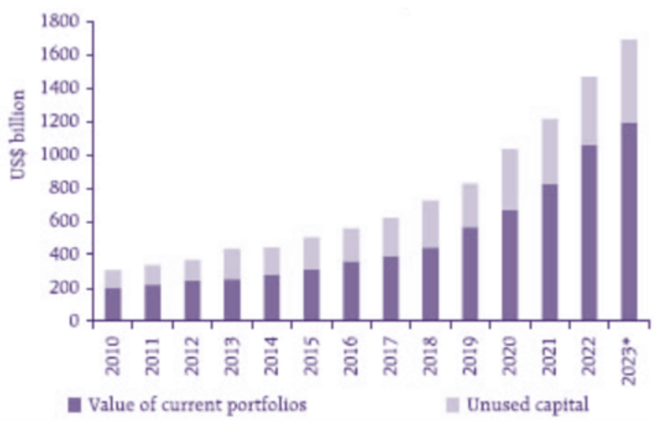
Changes in Major currencies against USD (2024 YTD)



Note: As on June 14,2024
Source: RBI Financial Stability Report June 2024

- Stress in the Commercial Real Estate Sector- Commercial real estate prices have declined sharply across countries. Banks with high exposure to commercial real estate are more vulnerable.
- Geopolitical Risks- Recent geopolitical conflicts have heightened risks to the global economy. These risks can disrupt trade, increase inflation, and dampen investor sentiment.
- Risks stemming from Private Credit- As per the below chart on Size of private credit market, it shows that private credit has grown rapidly and is now a major source of corporate financing. The rapid growth and opacity of private credit can create systemic vulnerabilities. Unlike traditional bank loans, private credit is not subject to the same regulations. Investors, including insurance companies and pension funds, could face significant losses in event of a downturn. The lack of data on this growing market makes it even harder to monitor potential risks.

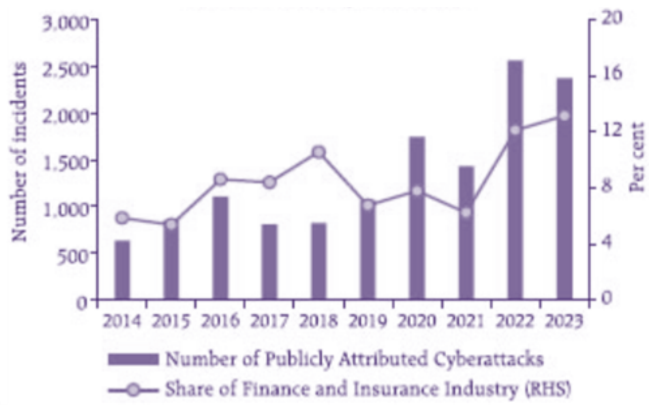
Chart: Size of private credit market



Note: *Data upto June 2023.
Source: RBI Financial Stability Report June 2024

- Cyber risk- The increasing digitalisation of financial services has led to a rise in cyberattacks as can be seen from the chart below on the number of cyberattacks peaked in 2022 and 2023. Cyberattacks can disrupt financial markets and cause systemic risks

Global Cyberattacks



Source: RBI Financial Stability Report June 2024

Domestic backdrop

The Indian economy is the fastest-growing major economy globally. Real GDP growth is rising, inflation is moderating, and the external sector is improving. The Indian banking system is well-buffered with strong capital and liquidity ratios.

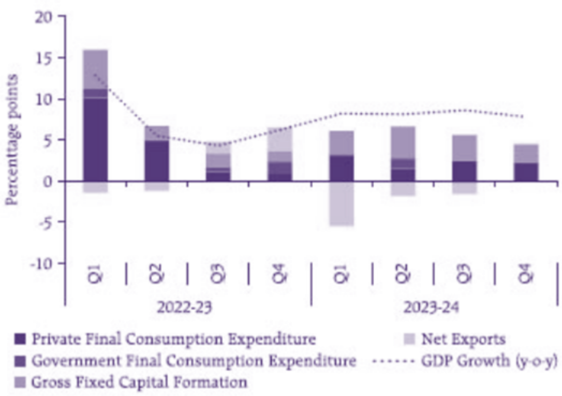
Domestic macrofinancial risks

The Indian economy is expected to sustain resilient growth. India's economic performance is driven by domestic demand and has strong buffers against global shocks.

Domestic growth and inflation

- Real GDP is projected to grow by 7.2% in 2024-25. Headline inflation is expected to ease to the target of 4%. Several factors like rising domestic demand, high business confidence, and increased investment are driving a positive near-term economic outlook. Downside risks to the growth outlook include global slowdown, geopolitical tensions, and slack in the rural economy.
- As per the chart below, Net exports peaked in Q1 2023-24 showing increase in Imports. This can lead to slower economic growth and potentially fewer jobs. However, the net exports reduced by Q4 2023-24 with decline in imports. FY 2023-24 has shown an increasing gross fixed capital formation (GFCF) which is a key strategy for boosting long-term economic growth. A reduction in private financial consumption from FY 2022-23, also known as a decline in consumer spending can be due to economic downturn, rising unemployment, increased debt burden and stagnant wages.

Contribution to GDP Growth



Source: RBI Financial Stability Report June 2024

External sector

- The resilience of the external sector has supported India's overall macroeconomic stability. The current account surplus is expected to remain positive. Capital flows are expected to remain strong due to India's positive economic outlook.
- Despite a challenging global economic climate, India remains a magnet for investors. Foreign portfolio investment (FPI) inflows surged in 2023-24, reaching the second-highest level ever at USD 44.6 billion. However, FPI flows have turned negative so far in the current fiscal year (up to 12 June 2024), at (-) USD 3.9 billion.
- There was a positive turnaround in external commercial borrowings (ECB) in 2023-24, reversing the net outflows of the previous year. Notably, both rupee-denominated and foreign currency denominated non-resident deposit schemes registered inflows throughout 2023-24. Foreign direct investment (FDI) flows moderated, partly due to an increase in repatriations from India.

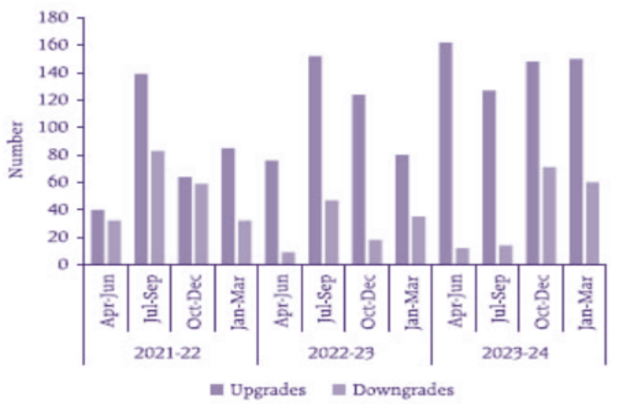
Foreign exchange market

India's foreign exchange market has shown resilience in a period of global volatility. The Indian rupee (INR) has remained stable, as reflected in various indicators like real effective exchange rates, the exchange market pressure (EMP) index, and volatility indicators (implied volatility and onshore-offshore spreads)

Corporate sector

The corporate sector is resilient with strengthening balance sheets and steady earnings. Interest expenses have gone up slightly, but a healthier debt structure has maintained a stable interest coverage ratio. The positive outlook is further supported by credit rating agencies, which have seen more upgrades than downgrades as per the chart below on the trend in credit rating actions. There has been a slight uptick in downgrades in the second half of the current fiscal year, but overall trend is positive.

Trend in credit rating actions



Source: RBI Financial Stability Report June 2024

Government finance

India's government finances are on a strong track. The national deficit is declining, with a projected fall from 5.6% of GDP in 2023-24 to 5.1% in 2024-25. This is due to a focus on spending more on long-term growth areas like infrastructure instead of everyday government operations. As a result, the government's debt burden is expected to decline from 58.4% of GDP to 57.1% in the coming year.

Central Government Finances – Key deficit Indicators

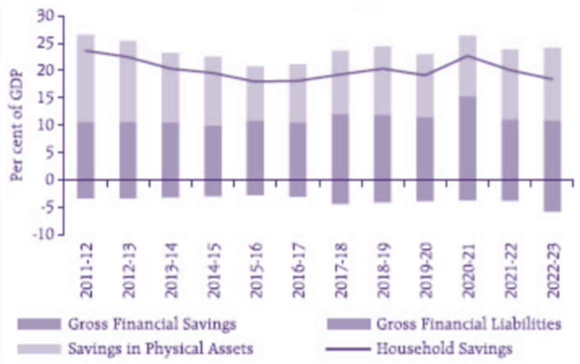
Item	2020-21	2021-22	2023-23	2023-24(PA)	2024-25(PA)
Revenue Deficit	7.3	4.4	4.0	2.6	2.0
Gross Fiscal Deficit	9.2	6.7	6.4	5.6	5.1
Primary Deficit	5.7	3.3	3.0	2.0	1.5

Note: PA: Provisional Accounts; BE: Budget Estimate
Source: RBI Financial Stability Report June 2024

Household finance

India's household savings rate has dipped as per the chart below on household savings. While households remain the main savers, their preference has shifted towards physical assets over financial instruments. This trend, along with rising debt, means there's less money saved for future needs. Household financial savings peaked during the pandemic but have since declined, with more going towards physical assets. On the flip side, household debt is on the rise, fueled by loans for both consumption and investment. While most borrowers have good credit ratings, the overall debt level warrants close attention due to the decline in savings.

Household savings



Source: RBI Financial Stability Report June 2024

Money and capital markets

System liquidity has increased, leading to lower money market rates and government bond yields. As per the table on Nifty Benchmark Indices, the Indian stock market outperformed emerging market peers due to strong fundamentals and investor inflows. The Nifty 50 returned nearly 29% in local currency. Mid and small-cap stocks outperformed large-caps, raising concerns about a potential bubble. Retail participation in stock options and futures grew significantly. While this improves price discovery, it also raises investor risk. Regulators are taking steps to mitigate these risks. Foreign portfolio inflows surged in 2023-24 but turned negative in the current fiscal year. Geopolitical tensions remain a risk factor for foreign investors.

Returns of Nifty Benchmark Indices (per cent)

CAGR	Nifty 50	Nifty Midcap 150	Nifty Smallcap 250	Nifty Microcap 250
1-year	29	56	63	85
2-years	13	26	23	37
3-years	15	25	28	42

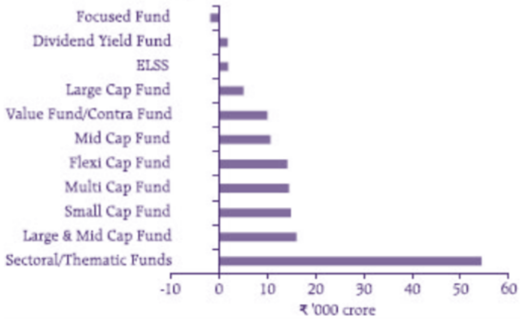
Note: CAGR w.r.t. March 31, 2024.
Source: RBI Financial Stability Report June 2024

Mutual Funds

The Assets Under Management (AUM) of the Indian mutual fund industry grew by 35.5% during 2023-24, driven by a surge in investments in equity-oriented schemes. Within the equity category, sectoral and thematic funds attracted considerably higher inflows compared to regular equity funds during December 2023 to May 2024 as can be seen from the chart on net inflows in open ended schemes below.

This can be attributed to investor interest in specific sectors. The growth of debt fund AUM was slower compared to equity funds. Systematic Investment Plans (SIPs) are a popular investment option, and they are playing a key role in increasing mutual fund investments. SIP contributions currently form nearly 20% of the total AUM of the domestic mutual fund industry.

Equity-oriented Schemes



Source: RBI Financial Stability Report June 2024

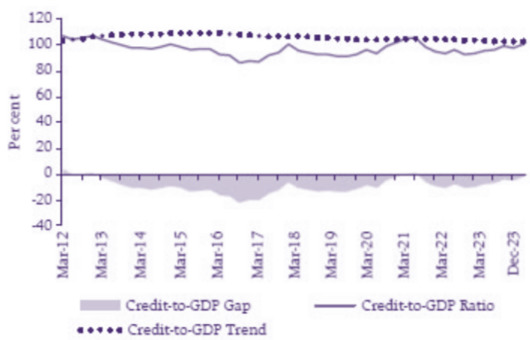
Banking stability indicator

The Banking Stability Indicator (BSI) shows improved overall stability due to stronger capital levels, higher earnings, and a decline in bad loans. Profitability remained strong despite a slight decline compared to September 2023.Efficiency weakened due to increased staff costs and cost-to-income ratio. Liquidity buffers remain adequate despite a marginal decrease in the liquidity coverage ratio.

Banking system

- The Indian Banking system showed improved asset quality with declining bad loans (NPAs). It has strong profitability driven by high margins and credit demand. Banks have a healthy capital buffers with CRAR and CET1 ratios exceeding regulatory minimums. Further, we have rising loan demand, particularly in retail and services sectors.
- The Indian banking system is in a good position overall, but there are some emerging risks that need to be monitored. The widening C-D gap (as can be seen from the chart below) and rising unsecured retail loans in bad debts could impact banks' ability to lend and generate profits in the future. Regulatory measures to curb lending to NBFCs appear to be working, but the long-term impact needs to be assessed. Banks also need to manage the potential impact of rising interest rates on their investment portfolios.

Credit-to-GDP Gap

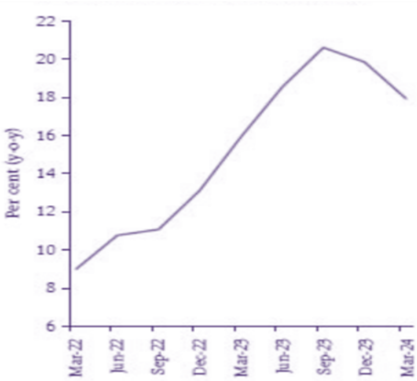


Source: RBI Financial Stability Report June 2024

NBFCs

The NBFC sector experienced slower growth in the second half of 2023-24 as per the chart below on Growth in NBFC Lending. This is likely due to stricter regulations on consumer lending and bank lending to NBFCs. Despite this slowdown, NBFCs remain financially healthy with strong capital buffers, improved asset quality, and good profitability. However, a small number of NBFCs with low capital buffers are growing rapidly, posing a potential risk to the overall system if not closely monitored. However, banks are becoming more resilient to potential problems in the NBFC sector.

Growth in NBFC Lending (y-o-y)



Note: * based on the sample of select NBFCs
Source: RBI Financial Stability Report June 2024

Consumer credit

The report highlights delinquency concerns in the consumer credit space. Borrowers who have availed personal loans below the amount of Rs. 50,000 are at 90+ dpd, with highest delinquency level witnessed in Small Finance Banks followed by NBFCs- Fintech, NBFCs, Public Sector Banks, Private Banks and Foreign Banks. Also, vintage delinquency, which is the percentage of accounts that have become delinquent anytime within 12 months of origination, remains high at 8.2% in the personal loan category. This suggests that while consumer credit is a major driver of the banking sector, close monitoring is needed to ensure its sustainable growth.

Housing Sector

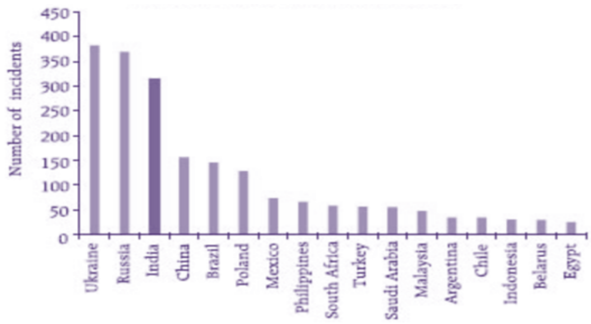
The Indian housing market is showing signs of stabilization after a period of sluggishness. While national price growth is modest, sales are up, and unsold inventory is decreasing. Housing loan growth remains steady, and despite rising mortgage rates, delinquencies are manageable. The commercial real estate sector is also showing some improvement, with loan growth accelerating, though the base is still low.

Cyber Risk

The report highlights cyber risk as a major vulnerability for India's financial system. Cyberattacks are on the rise, and institutions like banks are considered "high risk" for cyber threats. To combat this, awareness campaigns and stronger cybersecurity measures are being implemented.

The analysis reveals that smaller banks (UCBs) are most susceptible to high-risk cyber incidents. Social engineering attacks are most common, but data breaches and ransomware are growing concerns. A major risk lies in the reliance on shared IT service providers. A cyberattack on one provider could cripple multiple institutions. The Reserve Bank has issued regulations to mitigate this risk and improve reporting of cyber incidents. Overall, the increasing use of digital financial services necessitates robust cybersecurity for all institutions. The Reserve Bank is actively monitoring and taking action to ensure operational resilience and prevent disruptions caused by cyberattacks.

Number of cyberattacks in EMDES*



Note: * Based on publicly attributed cyberattacks between 2014 and 2023
Source: RBI Financial Stability Report June 2024

The Financial System Stress Indicator (FSSI)

The Financial System Stress Indicator (FSSI) shows a positive trend, with overall stress levels declining in the second half of 2023-24. This improvement is driven by a less stressed government debt market, lower foreign exchange volatility, and a sounder banking system. However, the NBFC sector shows signs of rising stress, with declining capital ratios and increasing borrowing costs. This highlights a potential risk area that needs monitoring.

Conclusion

The Indian financial industry is well-positioned due to the strong domestic economy. However, global risks and potential asset bubbles require close monitoring by regulators and financial institutions. Embracing technological advancements while managing cyber risks will be crucial for future growth.

II. Indian financial system

Introduction

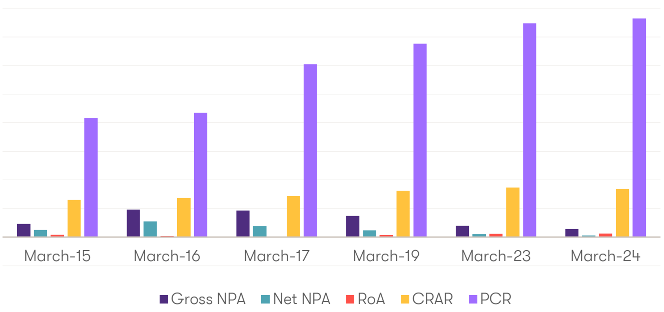
The financial sector remains stable and resilient with the improvement in asset quality, reduction in NPA, higher capital adequacy ratio. This chapter analyzes the performance of Indian financial institutions in terms of asset quality, capital adequacy, profitability, and resilience.

Key takeaways and our analysis

Banks

Asset quality improved with GNPA and NNPA ratios at record lows. Credit growth remained robust, driven by personal loans and lending to the service sector. Capital adequacy ratios exhibited mean reversion, with PSBs displaying better convergence than PVBs and FBs. Profitability increased due to a rise in net interest income, trading income, and a decline in provisioning needs. Stress tests showed resilience - even under severe scenarios, all banks could meet capital requirements.

Banking System Soundness Indicators



Source: RBI Financial Stability Report June 2024

As per chart on Banking System Soundness Indicators above, we can see that since March 2015, the gross NPA was in an increasing trend until March 2019, and thereafter a significant decrease can be see in the GNPA. The Net NPA was also in an upward trend in March 2015 and 2017, and thereafter it started to decline and in March 2024, it is only 0.6. The RoA initially was decreasing until March 2019, and now it is in an upward trend and as of March 2024, it is at 1.3. The CRAR is also above the minimum requirements which itself explains the capability of banks to bear the losses. The PCR is also in an upward trend and is at a good level which explains that the Banks can set off their losses in case of loans they have extended.

The above figure explains it very well that as of March 2024, regarding the resilience of the banking industry to tackle the situations of losses, improved books on account of gross as well as net NPA's, the PCR ratios and CRAR which the Banks have kept to handle any future uncertain situations.

The above figure explains it very well that as of March 2024, regarding the resilience of the banking industry to tackle the situations of losses, improved books on account of gross as well as net NPA's, the PCR ratios and CRAR which the Banks have kept to handle any future uncertain situations.

- Credit quality analysis- Improvement in asset quality was broad-based across sectors, with the highest impairment ratio remaining in agriculture. GNPA ratio for all categories of personal loans reduced across bank groups. Asset quality of the large borrower portfolio improved, with a decline in their share of total GNPAs.
- Capital adequacy- The CRAR remains at 16.8% which is well above the minimum regulatory requirement of 9%. The CRAR of PSBs stood at 15.5%, in case of PVBs and FBs, the CRAR declined a bit in comparison to March 2023 and stood at 17.8% and 18.5%, respectively. CRARs increased, while PVBs and FBs with higher risk-weighted assets saw a decline due to regulatory measures. Stress tests revealed that even under a severe scenario, the capital ratios would be above the minimum regulatory requirement.
- Earnings and Profitability- SCB's net interest income and profit after tax increased on account of a rise in trading income and lower provisioning requirements. Profitability remained high as reflected in RoE and RoA ratios. The ROA and ROE stood at 1.3% and 13.08%, respectively for SCBs.
- Macro Stress Tests- These tests assessed the resilience of SCB's balance sheets to unforeseen economic shocks. The results showed that SCBs are well-capitalized and can withstand adverse economic conditions.
- Sensitivity Analysis- This analysis assessed vulnerabilities to credit, interest rate, equity, and liquidity risks under various stress scenarios. Even under severe credit risk shocks, the system-level capital ratios would remain above the minimums. Interest rate risk analysis revealed that a significant parallel upward shift in the yield curve could put a strain on capital adequacy for some banks.

Conclusion

The Indian financial sector exhibited improvements in asset quality, capital adequacy, and profitability. Stress tests demonstrated the resilience of SCBs and NBFCs to withstand economic shocks. The asset quality continues to improve with strong balance sheet and financials. However, certain risks, like interest rate fluctuations, require continuous monitoring.

III. Regulatory initiatives in the financial sector

Introduction

Across the globe there have been various challenges that the economies have faced be it risk from climate changes, financial uncertainties, cyber threats etc. and the policymakers have maintained their pace to cope up with such uncertainties by introducing various regulatory and supervisory initiatives in the form of regulations, guidance notes and guidelines.

The RBI in Chapter III of the Financial Stability Report talks about initiatives that have been taken globally and in India to improve the strength and proficiency of the financial system.

Key takeaways and our analysis

Global regulatory initiatives

FinTech and financial stability

The rise of digitalization has led to the emergence of FinTech, which encompasses technologies like DLT, APIs, cloud computing, AI, and ML. These technologies have significantly impacted the financial intermediation process, leading to new business models and increased reliance on third-party technology providers.

While FinTech offers benefits such as improved financial services, it also introduces risks. Banks are using AI/ML cautiously, particularly in customer-facing services and revenue generation. The Basel Committee on Banking Supervision's report highlights the need to balance the benefits of new technologies with the potential risks they pose to the financial services provided by banks.

Digitalization has introduced new vulnerabilities and amplified existing risks, leading to strategic risks for banks that must adapt to a digital environment. This adaptation has increased reputational and operational risks, especially with the denser interconnectivity among financial entities, which could lead to higher contagion and procyclical behavior during stress times.

Effective monitoring of evolving risks and a responsible approach to innovation are crucial. Banks and supervisors must safeguard data, implement robust risk management processes, and build technological expertise to assess and mitigate risks from new technologies and business models.

Global regulatory bodies are examining the developments in Decentralised Finance (DeFi) due to concerns about its rapid growth and implications for financial stability. The United States is considering the FIT21 Act to provide market certainty and legal recognition to digital assets, while the SEC has approved the trading of ETPs based on select cryptocurrencies to ensure a level playing field and customer protection.

In essence, FinTech is both an opportunity and a challenge for financial stability. It requires a careful balance between embracing innovation for enhanced financial services and managing the associated risks to maintain a stable financial environment.

Banking and financial stability

The Basel Committee on Banking Supervision (BCBS) implemented revisions to the Basel 'Core Principles' which inter-alia covers:

- Assessment of financial risks;
- Corporate governance and risk management guidelines; and
- Supervisory powers and responsibilities.

The revised 'Core Principles' defines 'climate-related financial risks' and adjustments to the requirements for scenario analysis and stress testing to facilitate a more flexible and proportionate application by supervisors.

The BCBS in its consultative document aimed at discouraging window-dressing behaviour in the global systematically important bank (G-SIBs). BSBS found that the existing G-SIB framework is prone to manipulation which results in consequences for financial sector resilience and resource efficiency as well as broader unintended significances for financial stability and monetary policy. The document details the potential measures to address the short comings in the framework.

Banking is the backbone of financial stability. The BCBS's revisions to the Basel 'Core Principles' and the consultative document on the G-SIB framework reflect a comprehensive approach to ensuring that banks operate in a manner that supports a stable financial system, capable of withstanding economic shocks and contributing to sustainable economic growth.

Cyber security and financial stability

Cybersecurity is crucial for financial stability in our globally connected financial systems. Recognizing this, the G7 Cyber Expert Group conducts regular exercises to enhance the coordination and communication capabilities of its members in response to significant cyber incidents. In April 2024, they completed a drill simulating a major cyberattack across all G7 financial infrastructures.

Furthermore, the European Systemic Risk Board (ESRB) is proactive in bolstering system-wide cyber resilience. They've published a report examining the tools used to manage systemic cyber crises, focusing on Information Management, Coordination and Emergency Protocols.

These initiatives are part of a broader macroprudential strategy to ensure the financial system can withstand and recover from cyber threats, thereby maintaining overall financial stability.

Domestic regulatory initiatives

Operational risk management and operational resilience

The Reserve Bank of India has issued a 'Guidance Note on Operational Risk Management and Operational Resilience' to align the domestic regulatory guidance with global best practices including BCBS principles on the Operational Risk Management and Operational Resilience. The three pillars upon which it has been built is:

- Prepare and Protect;
- Build Resilience; and
- Learn and Adapt.

Together they are consisting of 17 principles.

Voluntary transition of small finance banks to universal banks

RBI has issued guidelines for 'on-tap' licensing of small finance banks (SFBs) providing a transition path to become a universal bank. To bring better clarity, the guidelines stipulate certain eligibility criteria for an SFB to transition into a universal bank.

Credit/investment concentration norms – credit risk transfer

To ensure uniformity and consistency across the NBFC sector, middle layer (NBFC-ML) and base layer (NBFC-BL) entities have been permitted to offset their exposures with eligible credit risk transfer instruments, which was previously allowed to upper layer (NBFC-UL) entities. There is no concentration limit prescribed for NBFC-BL, however, they are advised to put in place a Board approved policy for credit/investment concentration limits for both single borrower/party and single group pf borrowers/parties.

Framework for dealing with D-SIBs

The Reserve Bank has conducted a review of the assessment methodology stipulated for identification of the D-SIBs, taking into consideration the functioning of the framework since its inception, international developments and the experience of other countries in implementing the D-SIB framework. Accordingly, revisions have been implemented for the 'payments' sub-indicator under the 'substitutability' indicator, modifications in data requirements under 'interconnectedness' and 'complexity' indicators, to ensure a comprehensive representation of D-SIBs.

Conclusion

Throughout the year, the RBI remained committed to advancing cutting-edge payment and settlement systems in India, aligning with the Payments Vision Document 2025 and its key pillars: integrity, inclusion, innovation, and internationalisation. Several initiatives were launched to achieve these objectives, including efforts to expand the global presence of UPI and RuPay. Furthermore, significant enhancements were made to e-Kuber and payment systems, alongside a comprehensive overhaul of major internal applications. Embracing best practices in cyber hygiene, the RBI prioritised IT infrastructure security. Initiatives were also initiated to establish a cloud facility, aiming to bolster security, integrity, and privacy within the Indian financial sector. Looking ahead, plans are underway to establish a state-of-the-art next-generation data centre, ensuring scalability, meeting evolving IT landscape demands, and mitigating region-specific risks.

IV. Systemic risk survey

Introduction

The Reserve Bank of India (RBI) conducted its 26th Systemic Risk Survey (SRS) in May 2024 to assess expert opinions on risks faced by the Indian financial system. This survey included regular questions and additional inquiries on the impact of prolonged high-interest rates and the sustainability of recent credit growth.

Key takeaways and our analysis

Overall risk

The survey shows a general improvement in risk perception. All major risk categories (global, macro-financial, institutional) are now considered 'medium' risk.

Global risks

Concerns about global spillovers, advanced economy monetary tightening, and funding risks have decreased. However, commodity price risks remain high.

Domestic risks

Climate risk is a growing concern and is now classified as 'high' risk. Other domestic risks, like inflation and current account deficit, have shown improvement.

Financial market risks

Foreign exchange and liquidity risks have eased, but equity price volatility and interest rate risks have increased, with equity volatility entering the 'high' risk zone.

Institutional risks

Cyber risk remains a significant threat ('high' risk). Risks from asset quality deterioration and operational risks have moderated, while banks' interest rate risk exposure has lessened.

Systematic Risk Survey: Major Risk Groups

Major Risk Groups	Nov-23	May-24	Change in Risk Perception
A. Global risks	6.0	5.6	Decline
B. Macroeconomic risks	5.4	5.2	Decline
C. Financial market risks	5.8	5.8	Unchanged
D. Institutional risks	5.4	5.4	Unchanged

Risk Category

Above 8-10	Above 6-8	Above 4-6	Above 2-4	0-2
Very High	High	Medium	Low	Very Low

Source: RBI Financial Stability Report June 2024

Confidence in financial stability

More respondents expressed confidence in the stability of both global and Indian financial systems compared to the previous survey.

Impact of global instability

Most panelists expect the Indian economy to be somewhat impacted by global financial instability in the second half of 2024 (H2:2024).

Banking Sector Outlook

Nearly 90% of respondents are optimistic or neutral about the banking sector's prospects in the next year. Asset quality is expected to remain stable or improve slightly. Credit demand is anticipated to rise due to factors like economic growth and government spending.

Impact of higher interest rates

Almost three-quarters of respondents expect the global central banks' policy of maintaining high interest rates for a longer period (higher for longer) to affect the Indian economy to some extent.

Credit growth sustainability

A significant portion believes the recent credit acceleration is somewhat sustainable, but concerns exist about consumer loan quality and asset quality.

Conclusion

The Indian financial system shows signs of improvement with lower overall risk perception. However, emerging threats such as geopolitical risks, tightening global financial conditions, and rising commodity prices require close monitoring. The banking sector outlook remains positive, but potential risks from high equity volatility and interest rates need to be considered.

03
Other notifications in June 2024

Other notifications June 2024

Foreign Exchange Management (Overseas Investment) Directions, 2022 - Investments in overseas funds

(Release date – 07 June 2024)

The Reserve Bank of India (RBI) has amended the Foreign Exchange Management (Overseas Investment) Directions, 2022, to provide more flexibility for Indian investors investing in overseas funds. Previously, investments were only allowed in "units" of overseas investment funds. Now, investments can be made in "any other instrument" (e.g., shares, bonds) issued by these funds. Unlisted Indian companies can now invest in overseas funds through International Financial Service Centers (IFSCs), subject to specific limits. (Previously, only listed companies and individuals could invest).The amendment clarifies that "duly regulated" overseas investment funds include those regulated through a fund manager. This will essentially broaden the options for Indian investors looking to diversify their overseas investments.

Export-Import Bank of India (Exim Bank)'s Government of India-supported Line of Credit of USD 23.37 mn to the Government of the Co-operative Republic of Guyana (GO-GUY), for procurement of two Hindustan 228-201 aircraft from Hindustan Aeronautics Ltd.

(Release date – 11 June 2024)

The Reserve Bank of India (RBI) has issued a notification regarding a Line of Credit (LoC) extended by the Export-Import Bank of India (Exim Bank) to the Government of Guyana. This notification is for Category-I Authorized Dealer (AD) Banks in India. They can inform their exporter clients about this LoC and advise them to contact Exim Bank for details. Key points are as follows: 1. Amount: USD 23.37 million; 2. Purpose: Procurement of two Hindustan 228-201 aircraft from Hindustan Aeronautics Ltd. (HAL) by Guyana; 3. Effective Date: 8 April 2024; 4. Disbursement Deadline: 48 months after project completion; Other Conditions: At least 75% of the contract value must be fulfilled by Indian goods and services. Exporter can use own resources or foreign currency accounts for any required commission payments.

International Trade Settlement in Indian Rupees (INR) – Opening of additional Current Account for settlement of trade transactions

(Release date - 11 June 2024)

The Reserve Bank of India (RBI) has expanded the functionality of special current accounts for international trade settlements in rupees. Previously, these accounts were only for outward payments (exports). Now, authorized dealer banks can also use them to settle import transactions for their clients. This provides greater flexibility for businesses engaged in international trade using Indian rupees.

Exclusion of "Nagar Urban Co-operative Bank Limited" from the Second Schedule of the Reserve Bank of India Act, 1934

(Release date - 11 June 2024)

The "Nagar Urban Co-operative Bank Limited" is no longer listed in the Second Schedule to the Reserve Bank of India Act, 1934.

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