

## Preview

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## Financial Stability is Non-Negotiable

Financial stability is the sine qua non for sustainable growth. Most central banks have been publishing Financial Stability Reports (FSR) since the Global Financial Crisis. The broad format for FSR has been macro-financial risks to the economy, balance sheet soundness of regulated entities (REs), and systemic risk assessment through macro stress tests, sensitivity analysis, and network analysis. The Reserve Bank of India (RBI) has been publishing its half-yearly FSR since March 2010. The RBI's December 2025 FSR presents an in-depth analysis of India's financial system resilience. Based on the same report, this review highlights the overall strength of India's financial system and reflects on concerns flagged by RBI, which the REs cannot afford to ignore.

### Macro-Financial Risks

According to the IMF, global growth is resilient, but risks to the outlook remain skewed to the downside, mainly due to a) elevated global uncertainties, b) high public debt-to-GDP ratio, and c) stretched asset price valuation, led by Artificial Intelligence-heavy tech stocks, such as Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla (magnificent seven). The concentration risk has been high as global asset prices, including gold and silver prices, are at an unsustainable level, mainly contributed by the unprecedented rise in the asset prices of the magnificent seven. Ample global liquidity is supporting risk-on sentiment across asset classes.

India's financial system faces near-term risks from external uncertainties, primarily geopolitical and trade-related, which may lead to volatility in capital flows/exchange rates, weaker trade, lower corporate earnings, and a growth slowdown. However, the domestic macroeconomic and financial system has adequate buffers - resilient growth, benign inflation, fiscal consolidation, low external current account deficit (around 1% of GDP), adequate foreign exchange reserves, and a sound financial system. External vulnerability indicators such as external debt-to-GDP ratio (19.2% in September 2025), debt service ratio (6% of exports), reserve cover (11 months' imports) and declining net international investment position (6.8% of GDP), etc., are robust. There is no macroeconomic imbalance in the economy. Moreover, the balance sheets of the household and corporate sectors are healthy, which safeguards against default risks. Both the government and regulators are taking preventive measures to insulate the economy from global headwinds. The stress level of the Indian financial system has been declining since 2022-23 as balance sheets of REs remain sound.

### Soundness of Bank Balance Sheets

The balance sheets of scheduled commercial banks (SCBs) are healthy by most parameters. Gross NPAs, which were above 9% in March 2019, came down steadily to 2.2% in September 2025, with net NPAs dwindling from close to 4% to 0.5% during the same period. The CRAR (capital to risk-weighted assets ratio) of SCBs persistently improved from 14.3% in March 2019 to 17.4% in March 2025, before marginally falling to 17.2% in September 2025, well above the regulatory minimum of 9%. The provision-coverage ratio also improved from 60.5% to around 76% during the same period. The liquidity coverage ratio remains elevated over 131%, compared to the regulatory requirement of 100%. Despite the balance sheet soundness, the net interest

margin (NIM) was under pressure, leading to a slowdown in profit growth in the September 2025 quarter. This is natural during a declining phase of a monetary policy cycle, as outstanding deposits are repriced only at maturity, while outstanding loans, which are linked to external benchmark-based lending rates (around 65% at the system level), are repriced immediately. Nevertheless, the overall stability of the banking sector has been robust. This has been captured by RBI's banking stability indicator index, which declined from 0.6 in March 2016 to 0.3 in March 2025, well below the last 40-quarter average of 0.4. Other segments of the financial system also indicate resilient balance sheets.

### Systemic Risk Assessment

Macro stress tests revealed that the aggregate CRAR of 46 major SCBs may marginally decline to 16.8% under the baseline scenario, to 14.5% under Adverse Scenario 1 (gradual growth slowdown) and 14.1% under Adverse Scenario 2 (sharp growth slowdown) by March 2027. No bank will fall short of the regulatory minimum capital requirement. Credit risk sensitivity analysis, which supplements macro stress tests, indicates that under (most unlikely) severe stress scenario (2 standard deviation shock to GNPA's), the system level CRAR may deplete by 380 basis points (bps) to 13.3%, and 6 banks may breach the regulatory minimum capital requirement. As India's credit concentration risk is low, the system level CRAR may decline by 90 bps and 130 bps, respectively, if the top three individual borrowers/group borrowers of each bank default, while no bank will breach the minimum CRAR. Moreover, the credit concentration risk index of the top 100 borrowers has been falling. Similar shocks are applied to other factors - interest rates, equity prices, and deposits, one at a time - which reveal relatively less risky outcomes. According to the network analysis, although contagion risks may erode Tier 1 capital modestly, no bank will breach the regulatory minimum CRAR.

### Key Areas of Concerns

The key areas of concern flagged by RBI mostly relate to pressure on NIM, asset quality of unsecured credit, rise in non-housing retail loans, and asset-liability management. NIM has been under pressure as the share of CASA (Current Account and Savings Account) in total deposits is falling, while the share of floating-rate loans is rising. Banks must improve efficiency and protect their bottom-line through non-interest income. Besides agriculture, delinquency has been high in unsecured credit, particularly in credit card outstanding, which banks should not ignore. Moreover, non-housing retail loans (55% of total household borrowings) are a major concern as the bulk of such loans are used for consumption. Potential default risks are high due to the rising household debt-to-GDP ratio and their exposures to risky investments. Within the broad guidelines on asset liability management, private sector banks reported high slippage and write-offs. Moreover, amid intense competition from non-banks, banks face a structural liquidity shortage, despite the RBI's proactive liquidity management, as bank credit growth has significantly surpassed deposit growth. Despite sound external parameters, Indian rupee is under pressure as net capital inflows have been inadequate to finance the current account deficit.

**Editor**

## RBI Proposes FREE-AI in the Financial Sector

The Reserve Bank of India released the Framework for Responsible and Ethical Enablement of Artificial Intelligence (FREE-AI) Committee Report on August 13, 2025. The FREE-AI Report is a comprehensive blueprint for responsible, ethical, and innovative use of Artificial Intelligence (AI) in the Indian financial sector, aimed at regulated entities such as banks, NBFCs, fintechs, and payment system operators.

Based on seven guiding principles (Sutras), the Committee has recommended a forward-looking approach, containing 26 actionable recommendations under six strategic pillars. Highlights of the said report are as follows:

### Key Highlights

- **Seven Guiding Principles:** The framework is based on seven overarching principles - trust, people first, innovation over restraint, fairness and equity, accountability, explainability and transparency, and safety, which are intended to guide the adoption and use of AI across the financial system.
- **Six Strategic Pillars:** Implementation of the Report is grouped under six strategic pillars - infrastructure, policy, capacity building, governance, protection, and assurance.
- **No standalone AI regulation:** The RBI does not propose a separate regulatory framework for AI. Instead, AI related risks are to be addressed within the existing regulatory architecture governing information technology, cybersecurity, outsourcing, digital lending, and consumer protection.
- **Board level governance:** Regulated entities are encouraged to adopt a board approved AI policy that clearly defines accountability for AI deployment, oversight, and risk management across the entire AI lifecycle.

- **Enhanced consumer protection:** The framework places strong emphasis on transparency in AI driven decision making, including appropriate disclosures to customers regarding the use of AI and ensuring access to robust grievance redressal mechanisms.

- **AI risk management and audits:** Existing processes for model risk management, audits, and product approvals are recommended to be strengthened and explicitly extended to cover AI and generative AI models.

- **AI incident reporting:** The framework proposes the introduction of AI specific incident reporting mechanisms, covering issues such as model failures, bias, hallucinations, and ethical risks, in alignment with international best practices.

- **Innovation enablement measures:** Measures to support responsible innovation include the development of shared AI infrastructure, targeted capacity building initiatives, and the establishment of an AI innovation sandbox, with particular emphasis on enabling smaller entities to experiment responsibly.

Overall, the proposed framework seeks to strike a balanced approach between fostering financial innovation and maintaining systemic stability. It signals the RBI's intent to facilitate broader adoption of artificial intelligence in the financial sector, while ensuring robust governance structures, effective consumer protection, and appropriate supervisory oversight.

For details, please see the FREE-AI Report at RBI's website (<https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1306>).

## RBI Issued Commercial Banks - Concentration Risk Management Amendment Directions, 2025

On December 4, 2025, the Reserve Bank of India issued Commercial Banks - Concentration Risk Management Amendment Directions, 2025. The Direction aims to enhance regulatory precision around the classification and treatment of exposures of foreign bank branches in India to their Head Offices (HOs) and related entities. It has also tightened prudential oversight of intra group exposures and strengthened safeguards governing the use of credit risk mitigation techniques. Together, these measures are intended to bolster the robustness, consistency, and risk sensitivity of banks' large exposure management practices.

### Key Highlights

- **Tightening of intra-group exposure exemptions:** The amendment clarifies that exposures of Indian branches of foreign banks to their Head Offices or to overseas branches and subsidiaries of the Head Office will no longer be eligible for intra-group exposure exemptions under the Large Exposure Framework (LEF).

- **Application of counterparty limits of HO exposures:** Such exposures to the Head Office and its overseas branches are required to be aggregated and subjected to the applicable LEF counterparty limits, consistent with requirements for both, global systemically important banks (G-SIBs) and other banks.

- **Gross basis exposure measurement:** The Direction mandates that all exposures between Indian branches of foreign banks and their Head Offices, whether cleared through a central counterparty or otherwise, be calculated on a gross basis, effectively removing any scope for netting arrangements in exposure computation.

- **Broader use of Credit Risk Management (CRM) offsetting:** The LEF-CRM framework is extended to allow off-setting of gross exposures (beyond non-centrally cleared derivatives) of foreign bank branches in India to their Head Offices, subject to adherence to specified regulatory conditions.

- **Enhanced disclosure requirements:** Amounts earmarked as credit risk mitigation for offsetting exposures to Head Offices are required to be explicitly disclosed in the capital schedule of the balance sheet and excluded from regulatory capital and other statutory requirements.

Overall, transparency amendments are clarificatory and prudential in nature, aimed at closing regulatory gaps in the treatment of intra-group and Head Office exposures, improving transparency, and strengthening concentration risk management under the LEF.

These amendments shall come into force from April 1, 2026, with banks permitted to adopt them earlier, if they choose.

For details, please see RBI's Notification dated December 4, 2025 (<https://www.rbi.org.in/Scripts/NotificationUser.aspx?id=13196&Mode=0>).

## RBI Amends Priority Sector Lending Framework

On January 19, 2026, the Reserve Bank of India released the Priority Sector Lending - Targets and Classification (Amendment) Directions, 2026, introducing targeted refinements to the PSL Directions, 2025. These amendments primarily focus on enhancing the clarity of sectoral classification standards, tightening the regulatory expectations around reporting and verification requirements, and improving the regulatory treatment of on lending, securitisation, and co lending exposures.

While the overarching framework and sectoral architecture of priority sector lending remain intact, the updated provisions sharpen operational definitions and supervisory requirements.

### Key Highlights

- **Clarification of ANBC computations:** Adjusted Net Bank Credit (ANBC) calculations has been aligned with updated RBI norms on resource-raising, capital adequacy and exposure frameworks, including clearer treatment of incremental FCNR(B)/NRE deposits and off-balance sheet positions.
- **PSL targets refined for select bank categories:** Priority sector targets and sub targets have been rationalised, with revised treatment for lending to medium enterprises, social infrastructure and renewable energy.
- **Guidance on grandfathered loans for SFBs:** Detailed instructions clarify how loans transferred from NBFCs/MFIs to SFBs are to be included or excluded in ANBC and PSL calculations.
- **Stricter checks for securitisation and loan transfers:** Banks are permitted to rely on external auditors' certifications, along with sample checks, to ascertain the priority sector status of underlying portfolios in securitisation and loan transfer transactions.
- **Expanded and clarified on-lending framework:** PSL eligibility for bank lending to NBFCs, MFIs, HFCs, and National Co-Operative Development Corporation (NCDC) for on-lending has been refined, with enhanced disclosure, certification and caps to prevent double-counting of PSL benefits.

- **NCDC on lending newly permitted:** Bank credit to NCDC for on lending to co operative societies for PSL eligible activities is now allowed for sanctions from January 19, 2026, subject to certification and reporting norms.

- **Rationalisation of eligible categories:** Certain provisions relating to export credit, microfinance loans, social infrastructure, housing and weaker sections have been updated to align with revised RBI master directions and definitions.

- **Updates to district classification:** Select districts have been removed from the lists of districts with comparatively high or low PSL credit, affecting the application of differential weights in PSL achievement.

Overall, the January 2026 amendments are largely clarificatory and procedural in nature, reinforcing supervisory oversight and data integrity, while maintaining continuity and the broader priority sector lending framework.

For details, please see RBI's Notification dated January 19, 2026 (<https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT196DF499F3F5D91451DAEFC8AB3989C951C.PDF>).

## 1. Major Weekly Indicators

As on week ended (2025)	07-Nov	14-Nov	21-Nov	28-Nov	05-Dec	12-Dec	19-Dec	26-Dec	02-Jan	09-Jan	16-Jan	23-Jan
Liquidity (Injection (+)/ Absorption (-)) (₹ trillion)	-2.47	-2.48	-1.57	-1.82	-2.38	-1.73	-0.75	0.52	-0.72	-0.35	-1.35	-1.01
Weighted Average Call Money Rate (%)	5.40	5.37	5.41	5.45	5.37	5.19	5.37	5.43	5.43	5.37	5.36	5.43
91-Day Treasury Bill (Primary) Yield (%)	5.45	5.43	5.38	5.36	5.35	5.27	5.28	5.26	..	5.31	5.34	5.49
182-Day Treasury Bill (Primary) Yield	5.59	5.57	5.56	5.52	5.53	5.48	5.50	5.48	..	5.54	5.6	5.66
364-Day Treasury Bill (Primary) Yield	5.59	5.57	5.56	5.53	5.55	5.49	5.50	5.54	..	5.58	5.63	5.72
10-Year G-Sec Par Yield (FBIL) (%)	6.51	6.53	6.56	6.55	6.55	6.66	6.67	6.65	6.69	6.71	6.75	6.74
INR-US\$ Spot Rate	88.71	88.74	88.64	89.46	89.92	90.39	90.20	89.83	90.12	90.14	90.65	91.62
Forex Reserve (USD Billion)	687.03	692.58	688.10	686.22	687.26	688.95	693.32	696.61	686.8	687.19	637.33	709.41
Brent Crude Spot Price (USD/Barrel)	63.72	63.45	62.78	64.07	64.42	62.11	61.35	60.24	61.98	65.11	66.97	68.16
10-Year US Treasury Yield to Maturity (%)	4.11	4.14	4.06	4.02	4.14	4.19	4.16	4.14	4.19	4.18	4.24	4.24
Gold Spot Price (₹/10 gram) (in Lakhs)	1.21	1.24	1.25	1.27	1.30	1.34	1.34	1.40	1.36	1.39	1.43	1.56

Source: Reserve Bank of India, U. S. Energy Information Administration, Federal Reserve Board, Bloomberg

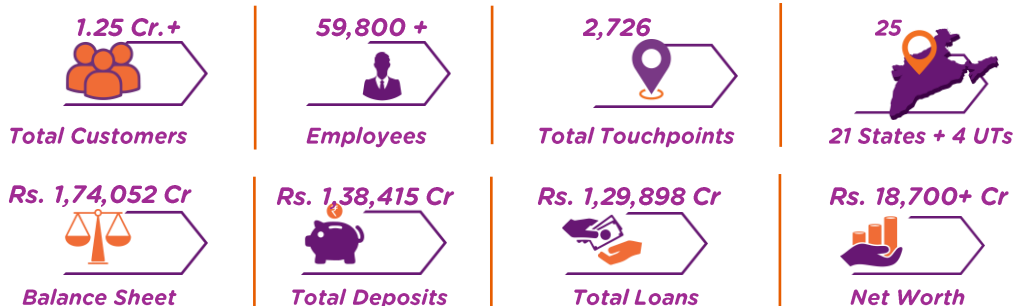
## 2. Select Monthly Indicators

Monthly	Jan '25	Feb '25	Mar '25	Apr '25	May '25	Jun '25	Jul '25	Aug '25	Sep '25	Oct '25	Nov '25	Dec '25
Reserve Money (₹ Trillion)	46.53	47.12	48.29	48.61	49.63	49.24	48.88	49.15	48.59	48.34	48.14	47.99
Broad Money (₹ Trillion)	266.93	269.13	272.87	276.31	279.90	282.30	281.40	283.09	283.50	289.98	291.36	298.01
Consumer Price Index Inflation (Y-o-Y % Change)	4.26	3.61	3.34	3.16	2.82	2.10	1.61	2.07	1.44	0.25	0.71	1.33
Index of Industrial Production (Y-o-Y % Change)	5.20	2.70	3.90	2.60	1.90	1.50	4.30	4.10	4.60	0.40	7.20	7.8
Gross GST Collection (₹ Trillion)	1.96	1.84	1.96	2.37	2.01	1.85	1.96	1.86	1.89	1.96	1.70	1.75
Trade Balance (USD Billion)	-4.96	3.08	-3.40	-8.59	-6.12	-2.57	-10.90	-10.89	-13.32	-24.24	-7.14	-2.36
Weighted Average Term Deposit Rate of SCBs (%) - Monthly average												
Fresh Term Deposits	6.56	6.49	6.65	6.34	6.11	5.75	5.61	5.56	5.60	5.57	5.59	5.67
Outstanding Term Deposits	7.02	7.02	7.03	7.10	7.07	7.00	6.92	6.87	6.82	6.78	6.73	6.68
Weighted Average Lending Rate of SCBs (%) - Monthly average												
Fresh Loans	9.31	9.40	9.35	9.26	9.20	8.62	8.81	8.74	8.50	8.64	8.71	8.28
Outstanding Loans	9.87	9.80	9.77	9.70	9.69	9.44	9.38	9.32	9.26	9.24	9.2	9.06

Source: Ministry of Statistics and Programme Implementation, Ministry of Commerce & Industry, Reserve Bank of India, Central Board of Direct Taxes

Note : Reserve Money and Broad Money data are outstanding as of the last Friday of each month.

## 3. Major Parameters of AU Small Finance Bank as on 31<sup>st</sup> December 2025



For detailed data, go to our website [www.au.bank.in](http://www.au.bank.in)