Shyamala Gopinath: Addressing the regulatory perimeter issues – Indian experience

Remarks by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the Ninth Annual International Seminar on Policy Challenges for the Financial Sector, co-hosted by The Board of Governors of the Federal Reserve System, The IMF, and The World Bank on "*Emerging from the Crisis – Building a Stronger International Financial System*", Washington DC, 3-5 June 2009.

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The regulatory perimeter or boundary issue has been engaging the attention of policy makers internationally for quite some time but it was not a central issue associated with the current crisis. Paradoxically the origins as well the severity of impact of the crisis were concentrated in the most heavily regulated institutions. However, in my view, the real issue lay in not recognizing and addressing the dynamic inter-connectedness between entities across regulated, unregulated and lightly regulated domains perpetuated through high leverage. It was a systemic crisis and attributing it to any single component of the system would only be an incomplete assessment.

Borrowing from the field of natural ecosystems, sustainability of a complex flow system depends on the optimal balance between efficiency and resilience of its network. While the financial system was considered to be very efficient, the inherent elements for ensuring resilience were obviously inadequate. At the heart of this self-feeding financial ecosystem were entities which had access to liquidity, the banks, which acted as the fulcrum around which the system moved. It is therefore not surprising that the system collapsed once this fulcrum became vulnerable. The peripheral entities, though, were as much an integral part of the system and need to be recognized as such.

The basic premise that I will be elaborating upon in my remarks today is that as far as systemic stability is concerned, it is more important to focus on the interconnected linkages amongst all major entities within the system, whether regulated or unregulated. Extending regulatory boundary is a very valid issue to be examined for its own sake, to address the specific contextual concerns. But once having decided the perimeter, it is extremely important to have a framework for hardwiring the perimeter. This is important as regulation creates incentives for certain activities to move beyond the boundary.

One of the issues with just focusing on extending the perimeter, apart from issues clearly enunciated in the literature, relates to heterogeneity of regulatory foci across various segments. The boundary itself varies for different regulatory clusters – the focus of a banking regulator would be entirely different from that of a securities regulator, from that of an insurance regulator etc. and all of which may be different from the focus required for regulation of markets. If the entire financial system is looked as a single ecosystem, then inspite of the inherent differences between the various market players, it should be possible to identify the macro drivers of the whole system, the network flows. Using this perspective, it becomes evident that just focusing only on the perimeter would be missing an integral component that may need regulatory attention.

Current crisis – perimeter issues

As mentioned earlier, the origins of the current crisis lay within the heavily regulated institutions. The impact of the crisis, however, was exacerbated by dynamic interconnectedness between entities across regulated, unregulated and lightly regulated

sectors. As some of the recent reports have pointed out, the two concerns relating to "outside perimeter" entities that contributed to the current crisis were: (i) maturity transformation being undertaken by these entities, which traditionally used to be a function of banks; and (ii) the systemic leverage resulting out of the hugely leveraged positions of these entities, either through direct borrowing from banks or through the funding markets.

The central issue in both the above is the interaction between the unregulated entities and the formal regulated funding channels, essentially banks and money markets. The maturity transformation primarily entailed heavy reliance by these entities on short term funds for funding long term assets. The prudential framework for banks placed a significant reliance on management of these ALM mismatches but the unregulated entities, such as SIVs didn't have any oversight and as a business model, ran huge ALM mismatches. The model just broke down when the funding markets started seizing.

Many of the entities, like hedge funds, were consciously left unregulated because of the fact that they managed only private capital pools where the issue of investor protection was not relevant. However, what was not appreciated was the systemic risks these entities were posing on account of the huge leverage positions these were carrying through either the formal banking channel or the funding markets, particularly repo markets. The seamless efficiency thought to be provided by close integration of the underlying asset markets and repo markets proved to be just a chimera. The disaggregated exposures of the regulated clusters at any point of time to the unregulated entities were not available and as the markets collapsed, such exposures became evident.

Another critical aspect which was again brought forth during this crisis was the market behaviour and impact of entities, some of them unregulated, having huge trading books and dynamically hedging their huge portfolios. The market makers in the derivative and structured product markets need to normally hedge their portfolio risks, which has a direct impact on the underlying markets. In normal times, such individual action does not have a systemic impact. However, in times of crisis when the views become absolutely uni-dimensional, a large number of such big players tend to hit the market on the same side and the resultant impact on the underlying market is huge. It could, thus, be argued that the efficient markets enabled the unregulated cluster to acquire systemic proportions and reinforced its connectedness with the regulated cluster.

The Indian experience

India is unique in this regard as it has a formalized structure for generic non bank finance sector with heterogeneous sub-segments. There some 13000 non banking finance companies (NBFCs) whose assets comprise around one-tenth of the banking sector. The NBFCs in India comprises heterogenous types of financial institutions including All-India financial institutions, development finance institutions, non banking finance companies, etc, with each one of them having its roots at a particular stage of development of the financial sector. All-India financial institutions (AIFIs), and development finance institutions (DFIs), which were largely an offshoot of development planning in India, were created for long-term financing with some of them having sectoral/regional focus. Non-banking financial companies (NBFCs), on the other hand, are mostly private sector institutions, which have carved their niche in the Indian financial system.

The basic regulatory framework

The Indian financial system is a predominantly bank intermediated system and accordingly regulation over banks has worked as the basic systemic lever. The non-banking space comprises of heterogeneous entities but not all are regulated by the RBI. Broadly speaking, the RBI regulates all such companies taking public deposits and those non-deposit taking entities involved in asset financing, providing loans and investments. Other non-banking

entities such as housing finance companies, mutual funds, insurance companies, stock broking companies, merchant banking companies, venture capital funds etc. are regulated by the respective sectoral regulator and are exempted from the NBFC regulations.

Regulation of Non-Banking Finance Companies in India was considered necessary as far back as the sixties as an adjunct to the monetary and credit policy of the country and protection of depositors' interest. The emphasis of regulation was on protection of the interest of depositors and as such directions issued by RBI dealt with acceptance of deposits and matters relating thereto. The unfettered growth of deposits and institutions accepting them outside banking system in the nineties was a matter of concern. Further in the absence of any prudential norms or ceilings, several non-bank finance companies made poor investment choices, leading to high level of NPAs, liquidity crunch and consequent significant default in repayment of deposits. Therefore, some further regulatory action was taken including registration of these companies, for which the statutory powers were given to the RBI through the RBI (Amendment) Act in January 1997**.** The Act provided for registration of all NBFCs; nevertheless the RBI focused mainly on depositor protection and put in place stringent regulatory requirements for these entities.

With the growth of the financial system, it gradually came to be realized that even non-deposit taking entities, which were mostly in asset financing and loan business, could pose systemic risks on account of their interactions with the formal banking system and market based financing. Moreover, many such entities in this lightly regulated segment were essentially indulging in regulatory arbitrage – what was not permitted for banks was happening through this channel. It was therefore decided in 2006 to put in place an elaborate prudential framework for such identified entities having systemic implications.

A gradually calibrated regulatory framework was created to address the issue of systemic risk, which included prudential capital requirements, exposure norms, liquidity management, asset liability management, creation of entity profile and reporting requirements, corporate governance and disclosure norms for non banking finance companies defined as systemically important.

It was recognized early on that mere acceptance of public deposits would not capture the systemic importance of the entities and hence the focus was shifted to acceptance of public funds in any form. So, any entity that is accessing public funds, whether through deposits, inter corporate deposits, debt instruments such as NCDs or CPs, or bank loans, was considered interconnected entity and hence treated as a source of potential risk. The ultimate objective was that such interconnectedness should not result in transmission of risk to banks or the payment and settlement system.

In the Indian context, what has provided a huge systemic advantage is the fact that the regulation of key financial markets – money market, Government securities market, forex market and credit market – vests with the banking regulator i.e. the RBI. Thus the channels of interconnectedness between banks and other financial sector entities are not beyond the regulatory purview. From a financial stability perspective, the above framework has proved to be a sound model.

Some of the specific provisions which illustrate the effectiveness of the above framework in addressing the inter-connected linkages are briefly mentioned below:

- Prudential limits on bank exposures (funded and non-funded) to non-bank finance companies – individual as well as aggregate;
- Restrictions on bank financing to non-bank finance companies against collateral of shares or for on-lending to capital market intermediaries;
- Prudential limits on bank exposures to equity markets includes exposure to capital market intermediaries such as brokers;
- Prudential regulations on inter-bank exposures of banks to reduce systemic risk;

- Participation in the overnight unsecured money market limited to banks and primary dealers;
- Lending/borrowing by non-banks in the overnight market allowed only through repos or against collateral of government bonds;
- Securitisation guidelines issued to banks in 2006 which provided for, inter alia, credit enhancements to be deducted from capital, profit/premium from sale to be amortised over the life of the securities issued, liquidity support to attract 100 per cent risk weight.

Addressing the inter-connectedness – few pipeline issues

The securities firms/investment banks are regulated by the securities regulator, the Securities and Exchange Board of India (SEBI) but such regulation primarily focuses on transparency and discipline in market practices. As these entities are normally not doing fund based business which would require prudential regulation, a decision had been taken that entities registered with SEBI need not normally be registered with RBI. While these entities form part of a separate regulatory cluster, their inter-linkages with the other regulated clusters or other unregulated entities may need to be examined particularly if such entities also undertake fund based business. Therefore a constant evaluation is required of the functioning of institutions under different regulators to address regulatory gaps.

While mutual funds are regulated from investor protection angle by the securities regulator, the systemic implications of the inert-linkages became apparent in the post-Lehman scenario of severe risk aversion and liquidity crunch. RBI had to announce a special 14 day repo at for a notified amount of Rs.20,000 crore to enable banks to meet the liquidity requirements of Mutual Funds. The real issue was the over reliance of the money market mutual funds on short term funds placed by the large corporates and banks with redemption facilities on par with current accounts of banks. It has now been decided to jointly work with the securities regulator to identify and address the macro-prudential concerns arising from the current framework.

Private Equity/venture capital activity is not a regulated activity *per se*. However, the issue of bank involvement with such funds has come into focus recently in India. The G30 recommends the large systemically important banking institutions should be restricted in undertaking proprietary activities that present high risks and serious conflicts of interest. Sponsorship and management of co-mingled private pools of capital should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Keeping in view the reputational risk involved in such activities, the Reserve Bank had mandated maintenance of certain level of economic capital in some of the cases approved in the recent past. Importantly, all exposures of a bank to a venture capital fund are treated as capital market exposure and counted for the regulatory limit.

A revised regulatory framework – key considerations

The broad features of a possible framework to capture the above inter-linkages are outlined below.

(i) Specification of the nature of connectedness between entities that may be considered inducing vulnerabilities in the system;

(ii) Identification, from the haze of the unregulated cluster, the class of entities considered to be either having significant direct connectedness with the regulated clusters or having a significant presence in any market segment where regulated entities are also present;

(iii) Putting in place a reporting system to capture the interconnected flows within the identified sub-system – the regulated clusters and the unregulated entities on a regular basis;

(iv) Prescription of a prudential framework – and this is the key – for the regulated clusters to contain the risks arising from this connectedness.

(v) For the unregulated entities, the most significant aspect would be to contain their leveraging capability in general across major market segments, particularly the funding markets. A simple quantitative limit would be the best suited.

(vi) Some systemically significant entities, though, may still need a formal prudential regulatory structure, including capital adequacy requirement.

From a policy perspective, the critical points would be the last two – having effective regulation over the regulated entities, while restraining leverage capabilities of the unregulated/lightly regulated entities. In our case, it proved to be an effective combination since banks' exposure to such entities could be regulated through absolute exposure norms or even tweaking the risk weights applicable to such exposures.

I realize the problem would be much more involved in predominantly market based financial systems where direct bank linkages are not very obvious. But even in such regimes, as has been clearly demonstrated, the indirect linkages of banks were enmeshed in the maze. That is why it would be important to ensure that the markets too should not provide leverage capabilities to such entities beyond a limit.

Contingency liquidity provision

The recent crisis has again brought to the fore the role of a lender of last resort (LOLR), the extent of central bank intervention and the entities to which such intervention can be extended. The question as to under what circumstances and to what extent should safety nets be extended to non-deposit taking institutions has been widely debated.

The basic underpinning of the LOLR philosophy internationally has been that any institution whose failure is conclusively decided to cause broader systemic instability needs to be supported in the interregnum. As long as banks were the only institutions fulfilling this criterion, the case was straightforward. However, with the development of global financial markets and growth on non-banks as alternate media of financial intermediation, the decisions were not so simple as the recent experience has clearly shown.

In India, while there is no provision for the Reserve Bank of India to lend directly to any non-bank entities, except a few specified ones, there have been specific instances of workable arrangements being devised in the interest of broader stability to provide liquidity support to some institutions/sectors indirectly. In respect of non-banking finance companies, in the post-Lehman fallout there was severe systemic liquidity crunch and even the non-banking finance sector were stressed. It was apprehended that in a scenario of asymmetrical information and general risk aversion of banks, the strains in non-banking finance sector could eventually pose a systemic risk. It was then decided to provide liquidity to those systemically important NBFCs facing temporary liquidity mismatches through an SPV. The key part was that the liquidity was provided to the SPV by the RBI through purchase of fully government guaranteed bonds. Further, this facility was only meant to tide over temporary liquidity mismatches and not for balance sheet expansion. The aggregate quantum for the facility was around Rs. 200 billion (USD 4 billion) and the interest rate was the LOLR rate for banks.

Similarly in case of mutual funds, who were faced with severe redemption pressures, it was decided to have a facility for lending to banks through a 14-day repo to enable the banks to meet the temporary liquidity needs of mutual funds.

As regards protection of depositor interests, a comprehensive prudential framework is already in place for all deposit taking companies. Stringent capital adequacy and leverage requirements, exposure norms, and disclosure have been prescribed as part of a structured regulatory framework. Statutorily, such companies are required to invest at least 10 per cent of their outstanding deposits in unencumbered Government bonds. Further, NBFCs have to ensure that at all times there is full cover for public deposits maintained by them. All such companies accepting/ holding public deposits are required to create a floating charge on their statutory liquid assets in favour of their depositors through the mechanism of “Trust Deed”.

Conclusion

The issue of extending the regulatory perimeter has to be a balancing act and it needs to be carefully nuanced in terms of intended objectives. The thrust of regulation may need to be borne by the regulated clusters – particularly deposit taking institutions. However, for the unregulated cluster, the key issues would be to contain their ability for systemic leverage – both directly through banks or indirectly through funding markets and to subject them to an effective reporting arrangement for their inter-linkages with the regulated clusters. From a systemic stability perspective, it would be equally, if not more, important to focus on the interconnectedness of the regulated and unregulated/lightly regulated entities.