Shyamala Gopinath: Philosophy and practice of financial sector regulation – space for unorthodoxy

Speech by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the FSA Turner Review Conference, London, 2 November 2009.

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It is a privilege to be invited to share my thoughts at this conference. The contribution of FSA in setting the terms of the debate in the aftermath of the crisis has been very significant and crucial. The clarity, conviction and clinical sharpness of arguments one encounters while reading the Turner review ask of us a very fundamental question – how could the world not have expected this crisis? How could the policy regimes world over, barring a few exceptions, failed to even recognize what now seems to be obvious? Perhaps it had to do with the force and might of the reigning doctrinaire regarding financial markets.

Post crisis, there was a natural effort to understand and assess the nature of various inexactitudes which had earlier been missed and incorporate these into the policy frameworks. Phrases such as systemic risk oversight and macro-prudential regulation have become the new touchstones for a repaired regulatory framework. There is a renewed effort to redefine the regulatory philosophy and principles around a different mould. The danger is in this organic mould continuing to derive its legitimacy from the pre-crisis framework. Hopefully, a crisis of such magnitude would not fail to provide the necessary impetus and support for departure of a more fundamental nature. I realize the huge challenge for this, given the sheer weight of the academic work of nearly four decades in the field of finance and the entrenched orthodoxy around it. To bring out any paradigm shift would require an equally weighty intellectual case for an alternative model. Yes, this crisis could provide a trigger for that process but as history shows us, paradigm shifts of such magnitude do not follow a set path.

It would however be imprudent to ignore the basic lesson of the crisis, which is that the existing framework has severe pitfalls. As with any stable ecosystem, what is needed is a space for heterogeneity – the space for unorthodoxy. As identified by the UN President's Commission[1], "strengthening the diversity of ideas" would be a key principle in addressing the issues underlying the crisis.

India has had the fortune of having a relatively stable financial system through the past few major crises affecting the world – the Asian crisis, the dotcom bubble and the recent financial crisis. I intend to divide my remarks today in two parts – I would like to start off with a discussion on the evolution of the financial sector regulation in India, particularly focusing on the elements of the policy framework which have contributed to the broader stability in the financial sector. In the second part, I would like to share my perspectives on some of the key issues in the current debate on future of financial sector regulation mainly dealt in detail in the Turner Review.

Indian financial system: the basic structure

Historically, the Indian financial system has been a bank dominated one and the gradual process of disintermediation through "public markets" has been of relatively recent origin. Banking institutions account for nearly 70 percent of the total assets of all financial institutions. The banking sector, as a whole, however has not grown disproportionately as a

[1] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System.

percentage of GDP and the challenge for us is to increase penetration of the banking system and ensure access of financial services to the large numbers excluded from the system.

The non-banking finance space comprises of heterogeneous entities separated across functional regulatory frameworks. Broadly speaking, the RBI regulates companies taking public deposits and non-deposit taking entities undertaking financial services involving asset financing, loan and investment companies. 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 regulators. There is also a separate framework for financial markets with equity markets completely under the securities regulator but the forex, interest rate and credit markets and the related derivatives being regulated by the central bank, i.e. RBI, which is also the banking regulator.

Evolution of regulatory framework

The philosophy and practice of financial sector regulation in India has largely evolved in response to the sui generis nature of contexts and imperatives over the years, which is also reflected in the division of regulatory responsibilities over different markets. The bank-based financial system, as a concept had come in for sharp criticism in the wake of the Asian crisis, and an "arm's-length, market-based, Anglo-Saxon system"[2] was propounded as a better model from a stability, accountability and governance perspective. The recent crisis has again brought the centrality of banks in a financial system into focus and underlined their role as ultimate risk repositories and ultimate liquidity providers, whatever be the form of the financial market model.

The gradual process to introducing structural reforms in the banking sector was a unique experiment undertaken with the key objective of strengthening the banking sector balance sheets and governance frameworks in a non-disruptive manner while managing the given political-economy considerations. The reforms were carefully sequenced in terms of instruments and objectives. Thus, prudential norms and supervisory strengthening were introduced early in the reform cycle, followed by interest rate deregulation and gradually lowering of statutory preemptions. The more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place. More recently, the regulatory framework has also focused on ensuring good governance through "fit and proper" owners, directors and senior managers of the banks. Broadly speaking, the evolution of regulatory framework for financial sector entities has been intrinsically derived from the objective of financial stability which has always been an objective for the RBI.

A unique feature of the reform of public sector banks, which dominated the Indian banking sector, was the process of financial restructuring. Banks were recapitalized by the government to meet prudential norms through recapitalization bonds (no cash payment was made). The mechanism of hiving off bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard. The overhang of non-performing loans had to be managed by the banks themselves. The subsequent divestment of equity and offer to private shareholders was undertaken through a public offer and not by sale to strategic investors. Consequently, all the public sector banks, which issued shares to private shareholders, have been listed on the exchanges and are subject to the same disclosure and market discipline standards as other listed entities. The cost of recapitalization to GDP has been low relative to experience in other countries. On a cumulative basis it worked out to about one percent of the GDP and the value of the equity

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[2] Rajan, Zingales, University of Chicago.

held by Government is much above the amount recapitalized. All these recapitalization bonds have since been converted to marketable securities.

The financial system has since expanded significantly across various segments and a number of cross-sector organisational forms combining banks, insurance companies and investment firms have emerged. In respect of certain identified conglomerates based on well defined criteria, there is an inter-regulatory mechanism for focused monitoring and supervision. However, in most cases, the non-banking functions are carried out in the form of bank-subsidiaries. While from a market perspective, such a model may tend to constrain growth, this model offers an interesting perspective in the “too-big-to-fail” debate. I will be touching on this aspect later but internally within India there is support from certain quarters for a “holding company” structure.

The other aspect of the “too-big-to-fail” debate, as succinctly dealt in the second FSA discussion paper on Turner Review relates to the core-banking versus trading activities of banks. We have a kind of hybrid model with banks being allowed to undertake proprietary trading as also sell insurance products. Insurance, all forms of asset management, merchant banking and broking have to be undertaken through separate subsidiaries. Issues with banks’ involvement with private pools of capital are being sought to be addressed through appropriate capital requirements for such exposures and the reputation risk.

As the financial system exists today, there are no major segments operating in an unregulated manner. The focus of regulation, though, is primarily on deposit taking institutions and systemically important non-deposit taking institutions. The model for regulation combines both direct entity regulation as well as overarching market regulation, where applicable. What such a framework enables is to provide a mechanism for containing market-based leverage, apart from a prudential oversight. 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. The problem, I realize, 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 with the unregulated entities can acquire systemic proportions. That is why it would be important to ensure that the markets too should not provide leverage capabilities to such entities beyond a limit.

Regulation of Non-Banking Finance Companies in India has gradually evolved from a focus on acceptance of deposits to acceptance of public funds in any form. 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. Banks exposure to these entities are subject to exposure norms and are separately monitored.

As regards the markets, there are two features that need to be noted: first, unlike many jurisdictions, there is a statutory responsibility on the central bank, the RBI, to explicitly regulate the forex, rate and credit markets and related derivatives; and second, since the dominant players in these markets are banks, there is also the added layer of entity regulation. The key aspects implicit in the regulation of organized financial trading in these markets relate to the product specifications, nature of participants, prudential safeguards, reporting requirements etc. OTC trades in such markets are legal only if one party to the counterparty is a RBI regulated entity. The operational aspects of trading and post-trade clearing and settlement in case of exchange traded instruments are regulated by the securities regulator i.e. the Securities and Exchange Board of India. The regulatory framework takes into account the macroeconomic situation as well as the huge costs of economic booms and busts brought on by financial instability – a cautious approach that has till now served us well. That we could consider putting in place a more conservative framework for securitization markets – incorporating those very elements which are now being included as part of Basel II framework – was possible only on account of the cautious approach.

Lot of emphasis has been placed on the development of market infrastructure. As early as in 2001, the Clearing Corporation of India was set up to settle interbank spot forex transactions and all outright and repo transactions in government securities whether negotiated or order driven systems. CCII has also introduced a collateralised money market instrument called CBLO which is also settled through the CCP. CCIL has also commenced non-guaranteed settlement of OTC trades in interest rate swaps in 2008. Once the risk management norms are determined they will be commencing guaranteed settlement of these trades. In the near future it will also act as central counterparty for forward contracts which will mitigate risks releasing counterparty exposure limits. The margins are in the form of cash and government bonds ensuring the quality and liquidity of the settlement guarantee fund.

One of the early lessons from our past experience that we incorporated in the policy framework was to be very careful about the vulnerabilities originating in the external sector. Perhaps not entirely in conformity with the then established policy axioms, we have dovetailed the capital account management framework with the prudential framework. Now, of course, when financial stability has come to be recognized as an overarching objective, the merits of such a harmonized approach are being appreciated. As part of a differential approach, the policy in respect of financial intermediaries, including banks, is distinct from that for individuals or corporates.

Prudential framework for banks – unorthodox measures

In respect of the prudential framework for banks, while there was a commitment to move towards the international prudential standards for banks, in many areas a more contextual approach was adopted keeping in view the idiosyncratic and systemic concerns.

- Counter cyclical measures were first taken on board in 2005 when risk weights and provisioning on certain segments were increased on account of rapid credit growth in these segments leading to concerns about potential impact of asset price bubbles and impact on credit quality. However, the important difference was that Indian approach entailed sector-specific prescriptions. To illustrate, the housing loans and commercial real estate are the sectors which experienced high credit growth during the high credit phase of 2002-03 to 2006-07. Accordingly, the risk weights on real estate lending and mortgage backed securities over the years were increased. The objective was not so much to lean against the wind of rising asset prices but as a cautionary measure to contain the exposure of the banking sector to sensitive asset classes where rapid credit expansion was observed.
- Banks are required to hold a minimum of 25 percent of their liabilities in the form of liquid domestic sovereign securities. This stipulation has worked both as a solvency as well as a liquidity buffer.
- The credit conversion factors (CCF) used for calculating the potential future credit exposure for off-balance sheet interest rate as well as exchange rate contracts were doubled across all maturities in 2008. This was done since it was felt that the CCFs as per the Basel norms did not fully capture the volatility in the interest rate and forex markets in the Indian context.

- Banks were encouraged to build floating provisions as a buffer for the possible stress on asset quality later. With the same objective, all banks have been advised recently to achieve a certain minimum provision cover. Very recently, provisions against commercial real estate standard loans have been increased from 0.4 percent to one percent.
- In regard to wholesale funding markets, prudential limits were placed on aggregate inter-bank liabilities for banks as a proportion of their net worth. The overnight un-collateralised funding market was gradually restricted only to banks and primary dealers and there are ceilings for both lending as well as borrowing by entities in these markets in order to reduce the systemic risk arising from interconnectedness. Other entities can participate in the overnight market but only on a collateralized basis. Repo markets are subject to a regulatory framework.
- To reduce systemic risk, investments by banks in subordinated debt of other banks is assigned 100% risk weight for capital adequacy purpose. Also, the bank's aggregate investment in Tier II bonds issued by other banks and financial institutions is limited to 10 percent of the investing bank's total capital.
- Securitisation guidelines issued in 2006 provided for a conservative treatment of securitisation exposures for capital adequacy purposes, especially in regard to the credit enhancement and liquidity facilities. A unique feature of these guidelines is that any profits on sale of assets to the SPV are not allowed to be recognised immediately on sale but over the life of the pass through certificates issued by the SPV. The policy enabled a liquidity facility by the originator or a third party, to help smoothen the timing differences faced by the SPV and was subject to certain conditions to ensure that the liquidity support was only temporary and got invoked to meet cash flow mismatches. Any commitment to provide such liquidity facility, is to be treated as an off-balance sheet item and attracts 100% credit conversion factor as well as 100% risk weight. The facility was specifically prohibited for the purposes of a) providing credit enhancement; b) covering losses of the SPV; c) serving as a permanent revolving funding; and d) covering any losses incurred in the underlying pool of exposures prior to a draw down.
- There are limits on the proportion of wholesale foreign currency liabilities intermediated through the banking system, other than for lending for exports. Retail foreign currency deposits from non-residents are subject to minimum maturity requirements and interest rate caps.
- The incremental credit-deposit ratio of banks is monitored as part of the macro-prudential framework since this ratio indicates the extent to which banks are funding credit with borrowings from wholesale markets.

Some thoughts on the key issues in the current debate

India as a key constituent of the international fora designing the blueprint for the reshaped financial system such as G20, FSB, BCBS has been committedly engaged in the discussions. The exercises in multilateral conformism have, understandably, tended to round off some of the sharper reactions witnessed in the immediate aftermath of the crisis. It would, however, be myopic to ignore so early some of the fundamental issues raised by the crisis. While the repair of the banking system, through a strengthened prudential framework, has seen progress, the much needed reform of the financial markets must be the next focus area for global oversight bodies, particularly the G20 and the FSB.

The financial industry has an excellent way with assuming a self-regulatory role whenever a crisis happens and coming out with a corrective framework. The experience shows that such self-framed codes of conduct have not really worked. More than the intent part, I would like to believe that an inside view, in the realm of financial policy which necessarily has to deal with systemic issues, will always be an incomplete perspective.

The most fundamental issue pertains to the role of the financial sector relative to the real sector. Before the crisis a view was gaining ground that while the need for "banking" will increase, there will be a seamless transition to a bank-less, market based financial system. Issues of competitive neutrality gained importance and the view that banks are "special" and therefore need to be effectively regulated perhaps assumed less attention. Now, with the kind of bank bailouts that the Governments have had to undertake, largely in view of the deep entrenchment of banks in the major markets, it is very clear that the amorphous existence of even the most deep and liquid financial markets also needed the sound institutional pillars of a banking system as the funding provider of the first and last resort.

There is an unequivocal consensus on some kind of control on the operations of banks, particularly the large financial institutions having cross border presence. Any discussion on systemically important financial institutions needs to put the institutions in the perspective of the surrounding market dynamics. The FSA discussion paper has given a comprehensive overview of all the major aspects concerning the issue viz. interpretation of failure, definition of systemic importance and alternative policy approaches. There is really little one can add but I would briefly like to comment on each of these.

Interpretation of failure

The paper makes an explicit distinction between failures where only common equity holders face losses and others where even creditors, providers of debt capital, are forced to share part of the losses. It would thus seem that the moral hazard issue is more relevant for creditors, since equity holders in all cases will have to face the losses. This point regarding the influence of creditors i.e. debt providers/debt holders of different classes of debt securities issued by banks comes out more starkly in banking systems in pre-dominantly market based economies.

On this issue we need to take into account a few other dimensions arising from the ex-ante treatment of uninsured creditors. One is whether this will induce unintended distortions in market practices. The other is a more fundamental issue. One of the less appreciated fallouts of the market-based financial system, which is that over the years there has been an increasing tendency in encumbrance of parts of banking assets either for issuance of various classes of debt/hybrid securities or to raise short term funds through money markets. Protection accorded to secured creditors as against unsecured creditors and depositors in case of banks, in a sense, goes against the basic model of banking which presupposes deposit mobilization by banks thereby requiring strict regulation. The classic dilemma, the likes of which the public policy needs to reflect upon is the case of covered bonds which has now gained centre place in few of its success in some countries. From the perspective of the bank and investors, this is an excellent instrument with sound collateral backing. It has been in operation for over a century and has facilitated fundraising by banks at lower rates and avoids pitfalls of securitization. However, by carving out a part of good assets of the bank backing the bonds, these create a risk to the deposit insurance system since these investors have priority over other creditors.

The above problem is further exacerbated by the exemption accorded to certain category of financial instruments from bankruptcy, an issue which has been widely commented upon in the post-Lehman phase. In all major well-developed securities markets, derivative securities and repurchase agreements (repos) enjoy special protections under insolvency resolution laws. Such transactions also enjoy netting and close-out benefits which are not always available to most other creditors. With these counterparties having first claim on available liquidity other creditors may have an incentive to push for bankruptcy impeding the use of other options for an orderly resolution. Though the primary argument for this was to contain systemic risk, in practice this dispensation has resulted in increasing systemic risk given the incentive structure for pushing the funding markets to more and shorter term. There is need to reflect on how to involve these creditors in burden sharing in the event of failure of an institution.

Defining systemic importance

Identification of systemically important banks is a very difficult and complex issue. As brought out in the FSA discussion paper the key variables to be taken into account are size and interconnectedness. Size, by itself, may not be very useful but it becomes important in respect of large conglomerates having presence across major segments as also for entities having dominance in the funding markets. Thus, size and interconnectedness need to be looked together as a matrix quadrant.

Both qualitative and quantitative criteria will be relevant; whether the bank is largely a domestic focused bank or multinational, complex or a constellation of subsidiaries and interconnectedness with the system. A large bank will also be dominant in financial markets and payment systems. On interconnectedness, an institution is clearly systemic if it is a dominant player in the inter-bank market or other funding and derivatives markets. The benchmark will no doubt be the guidelines that will emerge from the IMF/FSB paper. But emerging market countries would largely have to take into account the structure of their domestic financial system and its unique features. The definition of systemic importance has to be calibrated in a manner that it provides the right incentives for institutions which are large but not very interconnected or complex.

Policy responses

Broadly two kinds of policy responses are being debated: (i) reducing the probability and impact of failure of a systemically important institution and (ii) making the financial system better able to deal with such a failure. The single most important element in respect of both the above approaches would be containment of interconnectedness in the financial system.

The specific measures being discussed are: higher capital and liquidity requirements for systemically important firms; preparation of “self wills” by each of the systemically important firms and moving all OTC derivative markets onto a CCP model.

Although identifying an institution as systemic does present a moral hazard, in any event this element is present even today. Higher capital and liquidity requirement will be eminently sensible to make such larger firms internalize the costs of their externalities. The use of contingent capital can be explored once the details of this proposal are formulated. Apart from the quantitative parameters, the institution’s business model and its legal structure should also dictate the quantum of higher capital requirement. Less complex and less inter-connected firms may have to be provided a different leeway.

The “winding down plan” seems useful since it will force the Board to understand group structures and raises the credibility of the threat. It is however premised on two basic assumptions: one, the entity has been transparent enough in terms of the information content in drawing up its own demise plan – the adverse selection issue and two, the regulatory authorities would actually be able to enforce these plans in times of crisis. In unexpected scenarios, as our experience has shown, the regulatory actions would largely be a function of contextual assessments and any readymade plans may be dysfunctional. It would however be interesting to see how this plan is actually operationalised.

OTC markets: There is committed effort globally to move all OTC derivative transactions onto exchanges/electronic trading platforms which is a welcome move.. This is a more broad-brush approach but going forward, I am sure we will need to devise a more nuanced approach in this regard as there will be continued need for OTC products i.e. customized to the needs of the real sector. Furthermore, in regard to central counterparties, it is imperative to examine the incentive structures. To generate more income there is need for more volumes and that can come only from leverage. There is, therefore, need to closely regulate the risk management systems and mandate margin requirements in the form of high quality liquid assets. Given the nature of their functions and their systemic importance, it is worthwhile to consider central counterparties as "public utility" not-for profit entities. It would also become imperative for such systemic entities to be brought under systemic oversight and be regulated by the systemic regulator.

More than the above immediate measures, what is required is a debate on some of the fundamental issues. Now that the centrality of banks in the economic system has been established, a much stricter view needs to be taken regarding the activities that banks can undertake with depositors' money. Should large systemically critical banks be allowed to heavily leverage themselves with depositors' money? Should the banks facilitate the high-risk high-return leverage game to benefit private investors at the cost of depositor funds? In that sense, I appreciate the arguments for separation of traditional lending business of banks from investment business. However, the extreme view is not very practical. The "hybrid approach" indicated in the FSA paper seems to be the way out but I would suggest some form of quantitative limit – banks must have a substantial part of their assets in the form of traditional banking assets in order that they perform the role of supporting the real economy.

The exponential growth in the money and funding markets outside the formal banking system, primarily at the shorter end, was one of the critical drivers underlying the crisis. The crisis has demonstrated the vulnerabilities of firms whose business models depended heavily on uninterrupted access to secured financing markets. The entire market structure based on ample liquidity available against any kind of collateral –mainly illiquid and hard to value, with pro-cyclical haircut and margining regime hid severe underlying systemic risks The interplay of under-pricing and not recognizing both credit and liquidity risks through these collateralized markets, was an explosive amalgam exploited by many unregulated entities in the financial system, such as SIVs.

Going forward, there could be a multi-pronged, focused effort in the direction of: (i) removing the arbitrage incentives for creation of complex structures in the first place – tax, capital requirements, regulation etc. – to create simpler structures which are transparent and easy to regulate (ii) developing a prudential framework for funding markets, in terms of permissible leverage by any participating entity and nature of collaterals; (iii) explicit commitment to increase competitiveness in the financial sector to remove the perverse situation of few large institutions influencing the market and (iv) massively scaling up the supervisory monitoring framework for such entities.

There have been suggestions to have common cross border resolution mechanism or global fiscal burden sharing. However, these do not appear to be feasible and the most practical approach would be to incentivise organization of a group as a "constellation of separately subsidiarised national banks" in the case of systemic entities rather than as a globally integrated bank. There is inherent tension between the efficiency gains for individual institutions provided by centralized pooling of capital/liquidity and the objectives of host regulators/supervisors. Supervisors are accountable to the domestic depositors, creditors and policy holders and protecting the domestic financial system and therefore there may be justifiable reasons for requiring both capital and liquidity to be held locally, whether the presence is by way of a branch or subsidiary. In this regard, some of the short term efficiency gains may have to be compromised in the interest of broader financial system stability through containment of the contagion effects.

Conclusion

Much of the current debate on many issues centres on the epicenter of the crisis, the developed economies with relatively advanced financial systems. The emerging markets, though, can bring a different perspective from their own past experience. Many of the emerging countries, including India, are part of the global effort in search of a harmonized framework but certain key differences in perspectives in these two sets of economies need to be appreciated. The status of the financial sector of the emerging economies is different from that of the advanced economies with different set of imperatives having different implications for the trade off between financial stability on the one hand and financial development, financial inclusion and growth, on the other. For instance, with regard to identification and mitigations of sources of systemic risk, the emerging market concerns are heightened because of the fact that many sources of systemic risk lie outside their jurisdictions. There could also be the issue of negative externality of larger than warranted capital requirements without careful calibration which could adversely impact the flow of credit to productive sectors, particularly in bank funding based financial systems. Emerging economies are faced with the challenge of managing volatile capital flows which is not a source of systemic vulnerability for developed economies.

The financial system in India is admittedly not as advanced as in many other countries. Many of the issues I have touched upon in my remarks are based primarily on a secondary assessment and understanding of the experience of global markets. These are clearly not settled issues in our context and as we move forward to further liberalise our financial system, many other nuances may have to be addressed. However, what our experience till now has shown is that a more common-sensical approach, less driven by a doctrinaire mindset; clear prioritisation of objectives and studied caution while replicating models successful elsewhere will be reliable guideposts. We can certainly have the advantage of learning the right lessons from the crisis before progressing further and we support the various initiatives underway in the FSB and BCBS. However, we also realize that being responsible members of global policy making and policy influencing bodies, we are duty bound to bring required heterogeneity to the discussions. I hope that the reshaped financial system is different in a real sense.