Deepak Mohanty: Financial regulation – which way forward?

Speech by Mr Deepak Mohanty, Executive Director of the Reserve Bank of India, at the Economic Conclave on the theme "Indian Economy: Performance and Challenges", Gokhale Institute of Politics and Economics, Pune, 15 February 2014.

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I thank Prof. Rajas Parchure for inviting me to this Economic Conclave at the Gokhale Institute. The Conclave has brought together eminent scholars and policy practitioners to brainstorm on issues of contemporary relevance to the Indian economy. Such interchange of ideas is important not only in encouraging research but also in shaping the contours of policymaking.

While the recent global financial crisis taught us several lessons, one key message has been the weaknesses in financial regulation. Greater belief on market discipline led to light touch regulation of financial entities. Even this was found onerous by many entities which shifted their activities outside the regulatory perimeter. Coupled with inadequacies in the pricing and measurement of risks, this led to the build-up of substantial risk in the global financial system.

Against this backdrop, I examine the rationale for regulation in the context of the debate and initiatives in the post-crisis period. I then discuss the approach by the Reserve Bank to regulation and its interface with the new Basel standards and conclude by highlighting some related issues.

Rationale of banking regulation

Let me begin by asking the question: Why do we need to regulate the financial system, particularly banks? This is because banks have a critical role in modern market economies. First, banks channel money from the ultimate savers to the ultimate users of these funds. In this process, they determine which projects should get credit and closely monitor borrowers. These are tasks, which left to a single saver, would be difficult to execute. Second, banks are the backbone of the payments system. Hence, even if a few banks get into trouble, the resultant financial disruptions could be very high. Third, given the primarily short-term nature of banks' deposit contracts and illiquid nature of loans, banks are susceptible to "runs". Even a perceived threat of failure of a bank might induce customers to withdraw their funds from other healthy banks as well. This interconnectedness is much greater for banks than in other industries.

In view of the above risks, there is a justification for intervention by the State through regulation. However, there are opposing views. The *public interest view* which dates back to Pigou (1938) contends that, by addressing market failures, governments regulate banks to facilitate their efficient functioning.[1] Since banking crises impose significant social and economic costs, their prevention is often an explicit goal of public policy. The other view, often labelled the *private interest view*, accepts the presence of market failures, but conceives regulation as a product whose outcome is determined by the interplay between suppliers and demanders.[2] What this means is that different interest groups compete to

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[1] A Pigou (1938). *The Economics of Welfare,* 4th Ed (London: Macmillan).

[2] G. Stigler (1971). "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science* 2, 3–21.

influence policies towards banks in ways that favour their vested interests, even if those might be socially sub-optimal.

In this context, it is interesting to observe that the importance of regulation was not lost on Adam Smith, arguably the greatest proponent of *laissez faire*, when he observed that:[3]

> Such regulations may, no doubt, be considered as in some respect a violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments; of the most free, as well as or the most despotical. The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of the banking trade which are here proposed.

While there is evidence in support of both these views, the balance of argument is in favour of regulation which has been further reinforced by the recent global financial crisis.

Crisis and regulation

Before I delve into regulatory initiatives following the recent crisis, let me briefly touch upon the earlier initiatives following the Asian crisis in the mid-1990s. The Basel Core Principles for Effective Banking Supervision were expedited and initiatives such as the IMF-World Bank Financial Sector Assessment Program (FSAP) took shape. The Basel II regulatory framework also saw the light of day. These international efforts were complemented by national initiatives at strengthening the supervisory architecture.

The financial crisis that began in 2007 and morphed into a full-blown catastrophe with the collapse of Lehmann Brothers in 2008 served as a rude awakening as to how piecemeal those efforts towards revamping the regulatory architecture had been.[4] A microprudential approach to supervision coupled with information gaps and asymmetries limited the ability of supervisors to monitor risk exposures, risk transfers and threats to systemic stability. Indeed, a recent World Bank study on differences in regulatory and supervisory practices across 143 jurisdictions comprising both advanced and emerging economies highlights the fact that not only did crisis countries allow for less stringent definitions of capital but they also had less strict exposure limits.[5]

In addition, several "too-big-to-fail" institutions remained outside the regulatory perimeter. The comingling of rating and advisory services by credit rating agencies perhaps gave a false sense of comfort to the supervisors. Furthermore, misalignment in incentives between home and host supervisors impeded cross-border information sharing. Although institutions became international in scale and scope of their operations, regulation remained predominantly national in character, eroding the efficacy of the supervisory apparatus.

In response to these deficiencies, the leaders of the G-20 mandated the Financial Stability Board (FSB) with enhanced role and responsibilities to promote effective regulatory and supervisory policies. As part of this agenda, the Basel Committee has prepared new capital and liquidity requirements for banks. The Basel regulatory framework rests on three pillars: Pillar I: minimum capital requirements; Pillar II: supervisory review and evaluation process, and Pillar III: market discipline. First, the quality of capital that a bank holds has been

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[3] Adam Smith. *An Inquiry into the Nature and Causes of the Wealth of Nations* [E-book, 2009]. (Book II – Of the nature, accumulation and employment of stock; Chapter II: Of Money, considered as a particular branch of the general stock of the society, or of the expense of maintaining the national capital).

[4] R. G. Rajan (2010). *Fault Lines: How Hidden Fractures Still Threaten the World Economy.* Princeton NJ: Princeton University Press.

[5] World Bank (2012). *Global Financial Development Report* (Rethinking the role of the state in finance). The World Bank: Washington DC.

improved along with the inclusion of two buffers: a microprudential *capital conservation buffer* designed to cushion banks during periods of stress overlaid with a macroprudential *countercyclical buffer*, to be applied by national authorities to smooth cyclical swings. This has been supplemented with a backstop leverage ratio requiring banks to hold a minimum amount of equity as proportion of their total assets. Capital surcharges have been introduced for market and counterparty risk, including incentives for banks to use central counterparties for OTC derivatives, higher capital requirements for trading and derivative activities, securitisation and off-balance sheet exposures.

Second, in order to address imprudent maturity transformation, the Basel Committee has introduced two new liquidity ratios: the Liquidity Coverage Ratio (LCR) requiring banks to have adequate funds to meet severe liquidity stress over a period of 30 days and the Net Stable Funding Ratio (NSFR) requiring banks to hold an adequate amount of stable funds over a one-year horizon.

Third, the stipulations under Pillar II have also been substantially strengthened with improved requirements on corporate governance and stress testing. The disclosure standards under Pillar III have also been upgraded which include a detailed description of capital instruments and its components.

Fourth, the FSB has come up with a broad range of proposals, including those related to compensation practices, credit rating agencies and dealing with too-big-to-fail issues.

Fifth, the IMF has also raised the profile of financial stability assessments under the FSAP of 25 jurisdictions with systemically important financial sectors which includes India.

Let me now turn to key initiatives at the national level in major jurisdictions. Countries have reoriented their institutional arrangements with an overarching focus on financial stability. Three broad models of such arrangements are discernible. In the first case, the central bank has been assigned the role of systemic stability regulator. This approach is best exemplified by the Financial Policy Committee (FPC) of the UK. In the second case, a coordinated systemic stability regulatory council, typically headed by the chief of the Treasury and comprising of heads of national financial supervisors, has been advocated. The Financial Stability Oversight Council (FSOC) of the US is an example of such an approach. The third model is the European Systemic Risk Board (ESRB) arrangement. Its main focus is ensuring macroprudential oversight of the financial system within the European Union (EU) so as to mitigate systemic risks to financial stability in the EU.

The above jurisdictions are also contemplating regulations that impose restrictions on the scope of banking activity, or have already taken steps towards doing so. These include the Volcker rule in the US, the Vickers Commission in the UK and the European Commission's Likanen Report. Draft legislations in this regard are underway in Germany and France.[6]

The aftermath of the crisis has also pointed to a need for reforms in the shadow banking system[7]. In the US and elsewhere, policymakers are engaged in debates to ensure that the risks inherent in shadow banking are appropriately understood and managed. The FSB has recently published its *Global Shadow Banking Monitoring Report* examining the interconnectedness between banks and non-banks.

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6 L. Gambacorta and A van Rixtel (2013). Structural bank regulation initiatives: Approaches and implications. BIS Working Paper 412, BIS: Basel.

7 The definition of shadow banking, as adopted by the Financial Stability Board (FSB, 2011) is *credit intermediation involving entities and activities outside the regular banking system*.

While several initiatives have been taken, it is not clear how safe they would make the financial sector. There are views that the Basel capital standards have become too complex for their own good.[8] To quote from Admati and Hellwig (2013):[9]

> Today's banking system, even with proposed reforms, is as dangerous and fragile as the system that brought us the recent crisis. But this situation could change.

What is important to note is that the global financial crisis has triggered a healthy discussion on the best approach to regulation and supervision. This will inform the regulatory process going forward, leading to better future outcomes. Let me now turn to our experience with financial sector reforms and regulation in India.

The Indian approach

In India, the financial system till the early 1990s was essentially geared towards the needs of planned development, with an overarching role for the government. A large proportion of bank deposits was pre-empted in the form of reserves. Added to this was an administered regime of interest rates characterized by detailed prescriptions by size, purpose and activity. The penetration of technology was limited and the quality of customer service was low. Consequently, the banking system was characterised by low competition, insufficient capital, low productivity and high intermediation costs.

Financial sector reforms since the early 1990s was premised on the idea that the competitive efficiency in the real sector can only be fully exploited when accompanied by substantive improvements in the financial sector. Accordingly, the major focus of such reforms was to improve the allocative efficiency of resources. Concurrently, reforms have also focused on developing financial markets, removal of structural bottlenecks, introduction of new players and instruments, market-determined pricing of financial assets and improved clearing and settlement practices. In essence, the thrust has been to create depth and liquidity and promote efficient price discovery.

Indeed, the progress of financial development is evidenced from the various financial ratios at the macro level (Chart 1). Illustratively, the finance ratio – the ratio of total financial claims in the economy to national income – has risen from 0.17 during the early 1970s to 0.61 by 2011–12, indicating financial deepening. Similarly, the financial interrelations ratio – the ratio of total financial claims to net domestic capital formation – has increased from 1.38 to 2.0 during the corresponding period.

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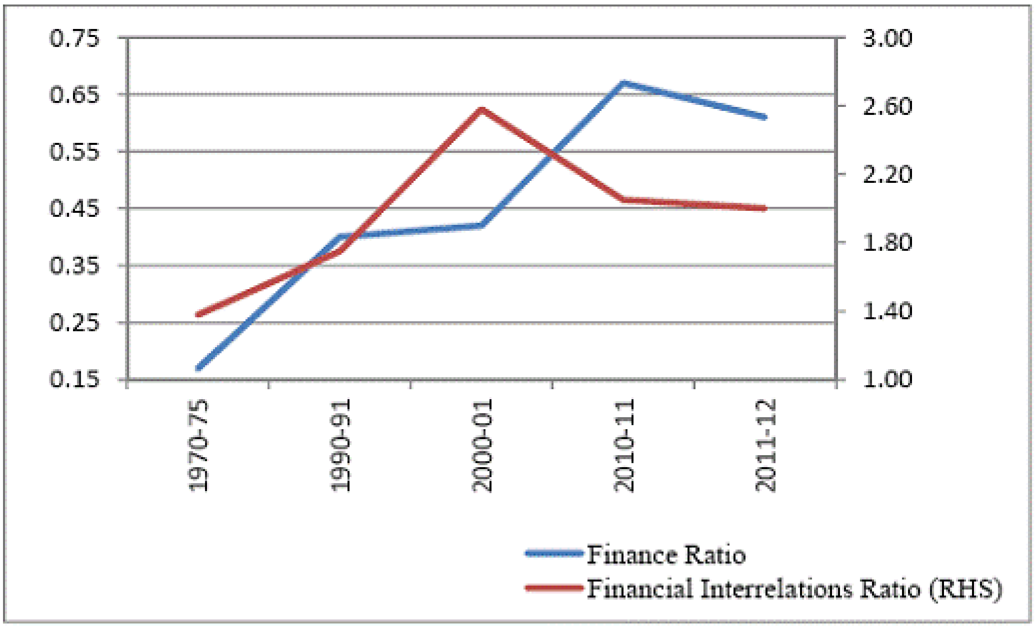
8 A Haldane and V. Madouros (2012). "The dog and the frisbee". Paper presented at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium, The Changing Policy Landscape, Jackson Hole, WY, USA.

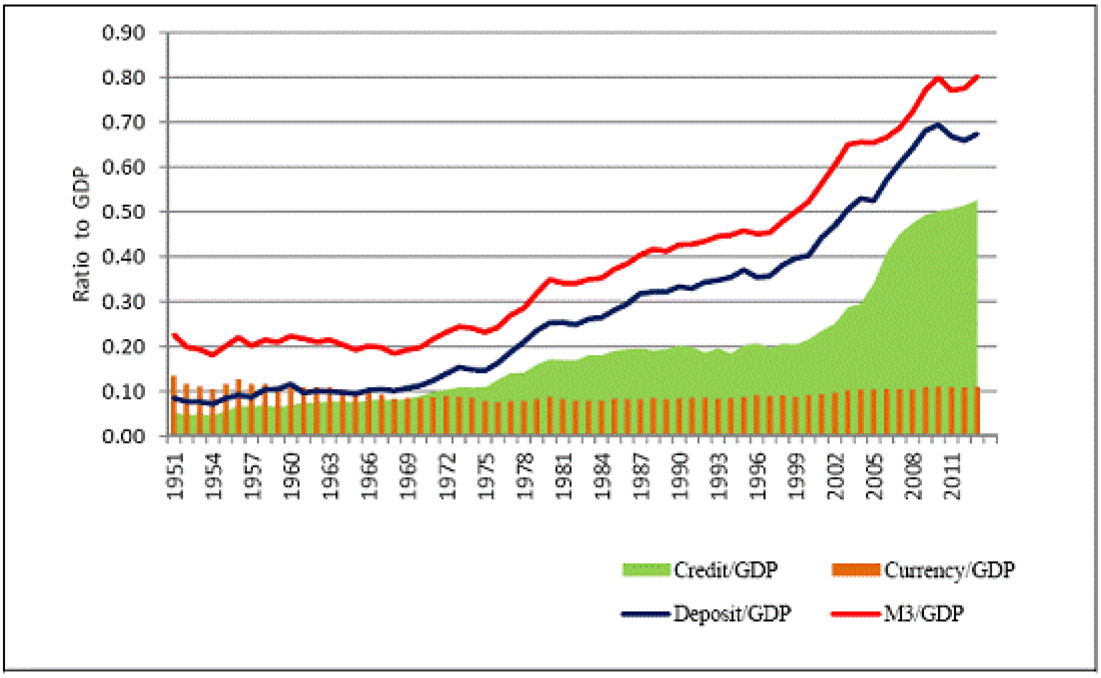
9 A. Admati and M. Hellwig (2013). *The Bankers' New Clothes*. Princeton University Press.

Chart 1: Flow-of-funds based indicators of financial development



The liquidity- and credit-based indicators also paint a similar picture. For example, the credit-to-GDP ratio and the broad money (M3)-to-GDP ratio have both increased substantially over the years (Chart 2). Interestingly, while currency-to-GDP ratio declined somewhat, it is the sharp increase in deposits-to-GDP ratio since the mid-1970s that pushed up the money supply, reflecting a greater role of the banking sector in economic development.

Chart 2: Liquidity and credit-based indicators of financial development



In terms of regulation, reforms have evolved to gradually bring the Indian norms at par with international best practices, while taking on board the country-specific considerations. Accordingly, prudential norms relating to capital adequacy income recognition, asset classification and provisioning (IRAC) were introduced early in the reforms process.

India was one of the earliest countries that employed macroprudential measures in 2004 by imposing higher risk weights on bank lending to selected sectors that seemed in danger of over-extension. While cross-national studies on the efficacy of macroprudential policies are not entirely conclusive[10], the balance of evidence in the Indian context appears to suggest that these measures were effective in moderating credit expansion.

The robust regulatory framework, well-managed banking system and timely and proactive action by the policymakers prevented any serious contagion of the global financial crisis that unravelled in 2008. However, the long-drawn global recessionary headwinds and several domestic policy uncertainties began to gradually seep their way through into the macro-economy, compounding the policy challenges.

The crisis fast-forwarded several of the reforms that were on the anvil. The time dimension of macroprudential policies were supplemented with measures that focused on the cross-section such as limits on cross-investments in capital instruments of banks and financial institutions, limits on aggregate uncollateralised inter-bank liabilities and limits on bank investments in mutual funds. Recognising that credit quality concerns could derail the stability of the financial system, a higher Provisioning Coverage Ratio was stipulated for banks. This is proposed to be replaced by a more robust dynamic provisioning practice, which is expected to be in place with improvements in the system.

In addition, guidelines have been issued for unhedged foreign currency exposures of corporates, measures announced for restructuring of advances by banks and financial institutions, guidelines issued on liquidity risk management and banks' exposures to group entities. The oversight of banks is strengthened with the introduced of Risk Based Supervision (RBS) process, beginning April 2013. The consultative process in supervision has also been buttressed with the establishment of supervisory colleges and the signing of MoU with several overseas financial sector regulators.

Even before the crisis, the institutional arrangement in the financial sector was already in place for inter-regulatory co-ordination to monitor financial stability in the economy. A High Level Co-ordination Committee on Financial Markets (HLCCFM) was set up in 1992 with the Governor of the Reserve Bank as Chairman, and the Chiefs of the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA), and the Finance Secretary to Government of India as members. However, post-crisis, the collegial approach to financial stability has been further strengthened by constituting the Financial Stability and Development Council (FSDC).

In addition, various committees of the Reserve Bank's Central Board monitor financial stability issues: the Board for Financial Supervision reviews the Reserve Bank's supervisory and regulatory initiatives and the Board for Payment and Settlement Systems oversees the overall functioning of the payment system.

Keeping in view the manifold requirements of finance for an ever-expanding economy, the Reserve Bank undertook a review of the existing banking structure in terms of its size, capacity, ability to meet divergent credit and banking services needs, access and inclusiveness. As part of this process, a Discussion Paper on Banking Structure was released, taking on board the observations made by earlier committees in this regard. Two

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10 S. Claessens, S.R. Ghosh and R. Mihet (2013). "Macroprudential policies to mitigate financial vulnerabilities." *Journal of International Money and Finance* 39, 153–185.

salient features of the Discussion Paper were advocating a multi-tiered banking structure to cater to various niches of the society supplemented by a process of continuous authorisation for new banks to enhance competition, enrich product diversity and promote newer ideas in the financial marketplace. I might also mention in this context that the recently released report of the RBI-appointed Committee tasked with the mandate of broadening access to finance chaired by Dr. Nachiket Mor has also advocated different categories of banks that can collectively meet the needs of the economy.

Going forward, as the financial sector grows in size and complexity, newer forms and dimensions of risk will emerge that will need to be carefully monitored. A beginning has already been made with issuance of guidelines on domestically systemically important banks (D-SIBs) and the creation of a central repository on large common exposures.

Conclusion

Let me conclude by highlighting some issues of relevance to the financial sector.

First, the quality of loan portfolio of financial institutions is directly dependent on the health of the non-financial enterprise sector. However, the current weaknesses in corporate balance sheets partly due to subdued economic environment have been feeding into banks' balance sheets. This trend, if left unchecked, could ultimately impinge on financial stability. In this context, the Reserve Bank has recently outlined a corrective action plan for tackling delinquent loans, including incentivising their early identification, timely revamp and prompt steps for their recovery or sale.

Second, there is a need to further beef up the levels of transparency and disclosures standards. Several countries have begun publishing financial stability reports (FSRs) to provide an objective assessment of the risks and vulnerabilities confronting their financial systems. However, publishing a FSR is not by itself sufficient to ensure financial stability.[11] FSRs for many countries are less than comprehensive owing to serious data gaps, which impede a holistic assessment of their financial sector, particularly the non-banking sector. While we have expanded the depth and analytical content of our FSRs, we are also looking into the data gaps in the financial sector that need to be addressed to improve our assessment.

Third, as we move along the path of stricter and more comprehensive regulation, it is important not to lose sight of the pricing mechanism, as determined by market forces. In India, we have, over time, moved away from an administered structure of interest rates, both on the lending and the deposit sides. These deregulations have given flexibility to banks to price their deposits and loans and have improved access to formal finance. Notwithstanding these advancements, distortions in pricing still persist which need to be addressed.

Fourth, in an underdeveloped financial system, lenders and borrowers may be two distinct categories. However, as the economy has gathered momentum and competition among banks has intensified, newer areas of lending, such as those for housing, education, automobiles – broadly categorised under the rubric of retail loans – has emerged, blurring the watertight distinction between lenders and borrowers. Hence, competitive and transparent pricing of both deposit and loan products has become important to enhance social welfare.

Fifth, the recent global crisis has highlighted the relevance of improving investor awareness, not only for ensuring orderly market conditions, but also for efficacy of regulation. However robust the regulatory framework might be, unless the small investor is adequately informed, it

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[11] M.Cihak, S.Munoz, S.T.Sharifuddin and K.Tintchev (2012). Financial stability reports: What are they good for? IMF Working Paper 1. IMF: Washington DC.

is possible for fly-by-night operators to exploit the regulatory arbitrage. In this context, the Reserve Bank is taking steps to improve awareness through the financial literacy campaign.

To sum up, the global financial crisis has given a greater macroprudential orientation to financial regulation and emphasised on better quality capital so as to safeguard financial stability. While there are differences in views on matters of details, there is broad acceptance of the new direction in regulation. India being a participant in global initiatives, with presence in various international bodies, our effort has been to adopt international best practices with necessary modifications to suit our local conditions. However refined the financial regulation might be, it cannot compensate for weaknesses in the real economy. Hence, macroeconomic stability characterised by fiscal prudence sustainable growth with low inflation is important to preserve the overall stability of the financial system.

Thank you.