

## Usha Thorat: Global agenda for regulatory and supervisory reforms – the stock taking and way forward

Opening remarks by Ms Usha Thorat, Deputy Governor of the Reserve Bank of India, at the Panel Session on “Strengthening financial regulation and supervision” of the FICCI – IBA Conference on “Global Banking: Paradigm Shift”, Mumbai, 8 September 2009.

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I thank the organisers of the FICCI – IBA Conference on *Global Banking: Paradigm Shift* for having invited me to chair the panel session this afternoon on *Strengthening Financial Regulation and Supervision*.

### Macro-economic scenario

The massive derailment of the financial sector in the advanced economies has had a knock on effect on the world economy. The world output is expected to contract by 1.4 per cent in 2009, GDP in the advanced economies is projected to decline by 3.8 per cent in 2009 before growing by a meagre 0.6 per cent in 2010. The GDP of US and the UK is forecast to witness a fall of 2.6 per cent and 4.2 per cent in 2009 before an anaemic recovery to 0.8 per cent and 0.2 in 2010, respectively. Euro area, on the other hand, is expected to shrink by 4.8 per cent and 0.3 per cent both in 2009 and 2010, respectively (WEO, 2009a). Unemployment in advanced countries is projected to scale higher from 5.8 per cent in 2008 to 8.1 per cent in 2009 and further to 9.2 per cent in 2010 (WEO, 2009). The unemployment in the US is expected to almost double from 5.8 per cent in 2008 to 10.1 per cent in 2010. Spain is forecast to suffer the highest unemployment within the euro area with 19.3 per cent unemployment in 2010. The fiscal stimuli that have been put together in these countries in response led to worsening fiscal positions. In the OECD countries, the fiscal position is set to deteriorate from -3.2 per cent in 2008 to -7.7 per cent in 2009 and further to -8.8 per cent in 2010. The fiscal deficit is poised to more than double in the US, Japan and the Euro area in 2009 and further deteriorate in 2010. By the end of 2010, the ratio of gross government debt to GDP is estimated to reach 98 per cent for the US, 87 per cent for Germany, 80 per cent for France and 73 per cent for UK. Financial stabilization in the world has come at a huge cost. Financial stabilization cost<sup>1</sup> is highest for the US at 12.7 per cent of GDP and lowest for Italy at 0.9 per cent of GDP. For the UK, it is 9.1 per cent, 4.4 per cent for Canada, 3.1 per cent for Germany, and 1.8 per cent for France (GFSR, 2009).

Collapsing growth in advanced economies led to a sharp contraction in economic activity in EMEs, due, *inter alia*, to an unprecedented drop in export demand that coincided, with a significant reversal in international bank lending and foreign portfolio investment. Emerging and developing economies are projected to post a much subdued growth of 1.5 per cent in 2009, notwithstanding an expected pick up in growth momentum during the second half of 2009. Emerging Asia is estimated to grow by 5.5 percent in 2009 and 7.0 percent in 2010, owing to improving prospects in China (7.5 per cent and 8.5 per cent) and India (5.4 per cent and 6.5 per cent). African countries are forecast to register much lower growth of 1.8 per cent in 2009 and recover to 4.1 per cent in 2010. On the contrary, Latin America is projected to contract by 2.6 per cent in 2009, before a recovery to 2.3 per cent in 2010. Badly affected by the reversal of capital flows and sharp contraction in commodity exports, countries in central and eastern Europe and in Commonwealth of Independent States are expected to suffer

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<sup>1</sup> Net cost, which is gross minus recovery over the next five years.

more severe shrinkage of 5.0 per cent and 5.8 per cent respectively in 2009 (WEO, 2009a). These countries are highly dependent on western European banks, which own the majority of banking systems in these countries. Cross-border bank funding has been disrupted as the banking crisis in western Europe intensified. This real sector weakness has been adversely affecting the banking sector in these countries through the negative feedback loop.

### **Global response by sovereigns and regulators**

It is not therefore surprising that there has been so much soul searching, especially in the advanced economies, of what went so seriously wrong with the international financial system leading to the worst crisis since the great depression. The various factors that led to and precipitated the crisis are now well known and documented and I do not want to go over these. What I would like to do, is to discuss the actions taken so far by Governments, central bankers and regulators over the last one year. Just last week, we have had two very important statements – one issued by the G20 Finance Ministers and Governors and the other by the Basel oversight body – the Group of Governors and Heads of supervision. These statements reflect the consensus arrived at, so far, for strengthening financial regulation and supervision and outline what remains to be done. It is therefore very timely that we are having this seminar today to debate and discuss the implications of the changing international framework for emerging countries like India.

Let me start with the Basel Committee. In July this year, the Committee issued a series of standards for higher capital for the trading book as it was recognised that the Basel II framework seriously underestimated the capital needs for the trading book. Therefore, the Basel Committee has introduced new trading book capital rules that substantially raise trading book capital requirements. It prescribes higher capital requirements for resecuritisations and exposures to off-balance sheet vehicles. It has evolved principles for stress testing and valuation of complex products, as also for supervision and management of funding liquidity risk. It has incorporated the FSB compensation standards into the Pillar 2 supervisory review process and has enhanced Pillar 3 disclosures focusing on trading activities, securitisations and exposures to off-balance sheet vehicles. Yesterday, i.e. on 7th Sep 2009, following a meeting of the Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision representing 27 important jurisdictions, issued a press release on a comprehensive set of measures to strengthen regulation, supervision and risk management of the banking sector. These measures include:

- Raising the quality, consistency and transparency of the Tier 1 capital base. The predominant form of Tier 1 capital must be common shares and retained earnings. Deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity.
- Introduction of a Leverage ratio which will be initially a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting.
- Introduction of a minimum global standard for funding liquidity that will include a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.
- Prescribe a framework for countercyclical capital buffers above the minimum requirement. The framework will include capital conservation measures such as constraints on capital distributions. An appropriate set of indicators, such as earnings and credit-based variables, will be used as a way to condition the build up and release of capital buffers.

- Provisioning requirements on a forward looking basis using the principle of expected losses.
- Recommendations to reduce the systemic risk associated with the resolution of cross-border banks.
- Assess the need for a capital surcharge to mitigate the risk of systemic banks.

In order to ensure transition to a higher level and quality of capital, supervisors will be encouraged to take actions to limit excessive dividend payments, share buybacks and compensation.

The G20 Finance Ministers and Central Bank Governors issued a statement on 5th September reaffirming their commitment to strengthen the financial system to prevent the build-up of excessive risk and future crises and support sustainable growth. The Group took note of the actions taken so far by FSB including introduction of CCPs to clear most credit default swaps, stronger oversight regimes for credit rating agencies, internationally agreed principles for the oversight of hedge funds, good practices for due diligence by asset managers when investing in structured finance products, and issuance of internationally agreed principles for regulation of short selling. More action has been called for by the Group in the following areas:

- Compensation practices.
- Stronger regulation and oversight for systemically important firms and strengthening the legal framework for crisis intervention and winding down firms.
- Delivering an effective programme of peer review, capacity building and countermeasures to tackle non-cooperative jurisdictions that fail to meet regulatory standards, AML/CFT and tax information exchange standards.
- Consistent and coordinated implementation of international standards, including Basel II, to prevent the emergence of new risks and regulatory arbitrage, particularly with regard to Central Counterparties for credit derivatives, oversight of credit ratings agencies and hedge funds, and quantitative retention requirements for securitisations.
- Convergence towards a single set of high-quality, global, independent accounting standards on financial instruments, loan-loss provisioning, off-balance sheet exposures and the impairment and valuation of financial assets.

### **The Indian position**

In India, strengthening and developing financial sector has been subservient to the needs of the real sector. Endeavour has always been to ensure harmonised development of all the sectors of the Indian economy. A number of measures based on the principles that are now accepted internationally were already brought into practice even before the crisis. These included restrictions on leverage for banking and non banking institutions, stringent liquidity requirements, counter cyclical prudential measures, not recognising in Tier I capital many items that are now sought to be deducted internationally, recognising profits from sale of securitised assets to SPVs over the life of the securities issued, not reckoning unrealised gains in earnings or in Tier I capital. The challenge for us is to facilitate the growth of the real sector through financial products and innovations subject to adequate safeguards and adoption of sound risk management policies. For further strengthening financial regulation and supervision, the following measures are under the consideration of RBI:

- Based on July 2009 final documents from BCBS on enhancements to Basel II framework, further guidelines relevant to standardized method are being issued.

- A draft circular detailing the modalities for adopting the integrated liquidity risk management system as also the guidance note on “Liquidity Risk Management” based on Basel Committee’s “Principles for sound liquidity risk management and supervision” brought out in September 2008 as well as other international best practices will be put up on the Reserve Bank website by October 31, 2009.
- As part of developing financial market infrastructure, recently, capital adequacy norms for CCPs have been laid down. CCIL’s role is being gradually extended to the OTC interest rate and forex derivatives segment, initially as a reporting platform and thereafter, covering the settlement aspect.
- Additional guidance on securitisation focusing on a minimum lock-in-period and minimum retention criteria for securitising the loans originated and purchased by banks is proposed to be issued shortly.
- Recently, regulatory and supervisory framework for financial conglomerates has been reviewed for enhancing the regime. The enhancements would be put in operation shortly.
- RBI would shortly be issuing a draft Discussion Paper on prudential issues in banks’ floating and managing private pools of capital in order to sensitize banks about risks inherent in such activities and limit such exposures commensurate with their risk management and available capital.
- As indicated in the Annual Policy Statement announced in April 2009, the Reserve Bank would recommend the implementation of the sound procedures/principles being developed by the FSB for financial institutions regarding the compensation packages.
- There has been significant progress in the area of convergence of accounting standards. The Indian accounting standards are expected to be fully convergent with IFRSs with effect from April 1, 2011. Reserve Bank of India is actively working with the Government, accounting standard bodies and banks for ensuring preparedness for smooth convergence by the banking system.

## Way forward

The agenda that is being developed for strengthening of financial sector regulation and supervision is ambitious. Contentious issues will arise both at national and at the international levels on regulatory cooperation. Whereas the principles underlying this regulatory overhaul are being increasingly accepted, many challenges will arise on their practicality and modes of implementation:

- Firstly, there is a need to ensure that regulators and supervisors remain firm in their resolve to ensure that there is no build-up of risk in the system and that the principles and framework articulated are adhered to in letter and spirit.
- Second, the interconnectedness of the institutions and markets requires central banks, banking and securities regulators to work in close coordination with full exchange of information and frequent interaction to assess the systemic risks at any point of time.
- Third, several of the countercyclical proposals are dependent on the assessment of economic and banking conditions in national jurisdictions which will determine the capital buffer requirements – these will obviously vary from one jurisdiction to another as cycles would also vary. With banks operating across the globe, this will imply that capital requirement could vary across jurisdiction – parking the transaction in a more favourable jurisdiction cannot be ruled out. Coupled with complex structures and differential tax regimes, minimising regulatory and tax arbitrage will continue to be a huge challenge.

- Fourth, cross border resolution issues will continue to be daunting especially as national regulators will seek to protect domestic depositors and stake holders.
- Fifth, convergence toward international accounting standards will be a huge challenge in terms of not only bringing in the changes in standards that are appropriate for the country but also for putting in place systems and capabilities to facilitate convergence. Issues such as putting in place prudential filters for not distributing unrealised gains would also arise.
- Sixth, while there are discernible signs of recovery in the global financial markets, the real test of the resilience of the financial system will be its performance through the exit process. For the emerging market economies such as ours, the challenge will be to manage the impact of this process of global stabilisation.
- Seventh, in emerging markets such as India, without sufficient historical data of credit and default cycles, there are difficulties in putting in place many of the advanced methodologies under the regulatory framework such as expected loss provisioning, additional capital buffers linked to PDs.
- Eighth, an additional challenge for the EMEs is that they are exposed to the volatile international capital flows necessitating suitable regulatory policies depending on the macro economic conditions for ensuring financial stability.
- Finally, for countries like India, the advantages of coming in late is that while introducing new products and instruments one can have the benefit of the global experience so that the pitfalls can be avoided while reaping the gains of innovation.

Thank you.

## **References**

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