

G Padmanabhan: Global convergence of banking regulations and its impact on the Indian banking system

Address by Mr G Padmanabhan, Executive Director of the Reserve Bank of India, at the Bankers Club, Raipur, 13 July 2012.

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I am very happy to be here to address the Bankers Club at Raipur. Chhattisgarh is a fast developing state and the banking system here has to play its role in ushering in economic growth of the state. The outreach programme in which I participated yesterday at Makaanpur was an eye opener for me regarding the active role played by the banks towards this direction.

Global financial crisis – A curtain raiser

As we are passing through difficult but challenging times as far as the financial sector is concerned, I thought of sharing with you some of the issues which are currently engaging the attention of the regulators around the world including the Reserve Bank of India for ensuring the stability and resilience of the financial sector. Though, it has been analyzed threadbare in different fora, it would not be out of place to start with a bird's eye view of the global financial crisis to put the recent developments in proper perspective.

The global financial crisis, though brewing for a while, started to show its severe effects from the latter part of 2007 and into 2008. Under its impact, world stock markets fell, large financial institutions collapsed or were bought out and Governments in most developed countries had to use public funds to formulate rescue packages to bail out their financial systems. There has been a broad consensus that regulatory failures are among the causes underlying the recent global financial crises. Some of the more salient weaknesses identified as drivers of the turmoil include lack of oversight of systemic risk, over-reliance on credit rating agencies, procyclical tendencies of regulatory frame work, shortcomings in risk management practices, laxity in oversight of shadow banking entities, financial innovation outpacing regulation and weaknesses in accounting and disclosures.

As a result, there has been an international endeavor to strengthen regulation of banks and financial institutions and bring about a greater element of convergence therein. Against this backdrop, firstly, I would outline the drivers for changing regulation of banks. Secondly, I would briefly present the global efforts aimed at formulating a regulatory reform agenda. Thirdly, I would analyze the likely impact of the evolving convergence in terms of implementing the said-agenda. Fourthly I will touch upon certain issues which are specific to Chhattisgarh before concluding my speech.

Regulatory reforms – A global endeavour

The magnitude of this crisis has clearly signaled the need for major overhaul of the global financial regulatory architecture. The G-20 leaders have mandated the international regulatory agencies and standard-setters, including Basel Committee on Banking Supervision (BCBS), Financial Stability Board (FSB), Committee for Payment and Settlement Systems (CPSS) and International Accounting Standards Board (IASB) to take active part in this process. The Washington Summit of G-20 in November 2008 was the first global initiative in this regard. Subsequently, various committees were set up to make relevant recommendations. Amongst the most influential reports on the subject are:

- i. Report of the High Level Group on Financial Supervision in the European Union (Chairman: Jacques de Larosiere)
- ii. The structure of Financial Supervision: Approaches and Challenges in a Global Market Place (Group of Thirty – Chairman: Paul Volcker)
- iii. The Fundamental Principles of Financial Regulation (The Geneva Report)
- iv. The Turner Review: A Regulatory Response to the Global Banking Crisis (Financial Services Authority of the UK)
- v. The Report of Working Group I of the G-20 on “Enhancing Sound Regulation and Strengthening Transparency (G-20)”; and finally
- vi. Principles for Financial Market Infrastructures (CPSS and IOSCO)

Responding to the unfolding situation, international regulatory agencies are working on strengthening the resilience of financial system, especially on bridging the gaps in the regulatory framework revealed by the current crisis. The broad contours of the international initiatives on regulatory reforms envisage strengthening the quality of capital, introducing minimum liquidity standards and leverage ratio, countercyclical measures in the form of capital buffers and forward looking provisioning, developing a framework for systemically important entities including cross-border resolution arrangements, extending the regulatory perimeter to unregulated pools of money, de-risking the OTC derivatives trading through central counterparties and new framework for regulating employee compensation within the financial sector.

This crisis has underscored the importance of effective contingency planning and open cross-border dialogue between authorities. Lack of information can quickly lead to uncoordinated measures to the detriment of all. Under the aegis of the FSB, central banks, supervisors and Governments are maintaining close dialogue and co-operation during this period of heightened uncertainty. The overarching objective of the recommendations of the above mentioned committees has been to reduce the probability of occurrence of the crisis in future and to enable the banking industry to withstand in case crises are to occur. Drawing from these recommendations, the major stands of the regulatory reforms underway are:

- i. BCBS has formulated what is called the Basel III framework aiming at increase the resilience of banks through prescription of a higher quality, quantity, consistency and better risk coverage of capital.
- ii. The set of reforms for Systemically Important Financial Institutions (SIFIs) are aimed at reducing the probability of failure of these large and complex financial institutions and at putting in place a robust resolution framework so that the institutions can be wound down in an orderly manner, should they fail.
- iii. Regulatory perimeter issues are being addressed by putting in place a regulatory framework for the shadow banking system.
- iv. Another set of reforms are aimed at strengthening financial market infrastructures by addressing issues in the OTC derivatives markets by ensuring that the transactions in these markets are reported, centrally cleared and, where possible, settled through a central counterparty.
- v. A macro-prudential overlay to the entire regulatory framework is being proposed to address issues related to procyclicality and the cross sectional dimensions of systemic risks. Most importantly, organized frameworks for pursuit of financial stability and crisis management, which promote inter agency co-operation, are being put in place both nationally and internationally.
- vi. The G-20 Leaders re-emphasized the importance of achieving a single set of high quality global accounting standards and called on the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to

complete their convergence project in areas where differences still persist (impairment, fair value/amortized cost approach for classifying and measuring financial instruments). Similarly, BCBS and IASB should coordinate for fine tuning countercyclical provisioning within modified accounting standards.

- vii. G-20 members, with their resolve to align compensation with prudent risk-taking, particularly at significant financial institutions, endorsed the FSB *Principles and Standards* on compensation. In May 2011, the BCBS has published the final report on “Range of Methodologies for Risk and Performance Alignment of Remuneration” and in July 2011, the BCBS in consultation with FSB has also published Pillar 3 disclosure requirements for remuneration.

Notwithstanding the fact that globally, these reforms are at different stages, the broader endeavour has been to achieve a greater degree of convergence in banking regulation across jurisdictions with a view to address the issue of regulatory arbitrage. A similar international effort is underway with regard to payment and settlement systems. As you are all aware, the one crucial segment of infrastructure which functioned effectively during the financial crisis was the payment and settlement system infrastructure. Payment Systems are the channels through which liquidity risks can get exacerbated and could very quickly turn into credit and systemic risks. In this sphere of payment systems, the measures taken by central banks the world-over in strengthening risk management in payment systems by introducing Real Time Gross Settlement Systems and encouraging the private sector to set up CLS Bank for PVP transactions for settling foreign exchange transactions is indeed laudable.

It was therefore found expedient in the wake of the financial crisis to revisit the existing three sets of standards which have guided the development of risk management standards in payment systems and securities settlement systems. Together the two international-standard setting bodies in this area the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) have published the “Principles for Financial Market Infrastructures” (PFMI) in April 2012. The PFMIs replace the three existing sets of international standards set out in the Core principles for Systemically Important Payment Systems (CPSS, 2001); the Recommendations for Securities Settlement Systems (CPSS-IOSCO, 2001); and the Recommendations for Central Counterparties (CPSS-IOSCO, 2004). The CPSS and IOSCO have strengthened and harmonized these three sets of standards by raising minimum requirements, broadening the scope of the standards to cover additional risk factors, and extending the scope to new types of FMIs such as Trade Repositories.

The 24 principles outlined in this report are categorized into nine broad categories: (a) general organization (b) credit and liquidity risk management (c) settlement (d) CSDs and exchange-of-value settlement systems (e) default management (f) general business and operational risk management (g) access (h) efficiency and (i) transparency.

Additionally CPSS-IOSCO has released the (i) the CPSS-IOSCO Assessment methodology for the principles for FMIs and the responsibilities for authorities and (ii) the CPSS-IOSCO Disclosure framework for FMIs for public consultation with a 60 days comment period. The public consultation period ended June 15, 2012. Based on the comments received the Assessment Methodology and Disclosure Framework will be updated and the final versions of both the documents will be released in end 2012. The PFMIs, along with the Assessment Methodology and the Disclosure Framework will form the bedrock for assessing whether a country’s Payment and Securities Settlement Infrastructure are compliant.

It would not be out of place to mention here that RBI as a member of the Steering Group which drafted the Principles made contributions to this endeavor. CPSS and IOSCO members are expected to strive towards adopting the new PFMI standards by the end of 2012. We in the Reserve Bank with the co-operation of our banking industry partners are fully geared to meet this challenge. Consistent with our international commitments to the

G-20 and the Financial Stability Board, on OTC Derivatives Market reforms, we are rapidly moving towards implementing a centralized clearing and settlement framework for IRS trades. The Clearing Corporation of India Limited (CCIL) would act as the CCP for IRS trades. Additionally, the industry is moving towards guaranteed settlement of forex forwards as well.

Simultaneously, the Reserve Bank has also authorized CCIL to act as a Trade Repository for all forex and interest rate derivatives. This is in addition to its existing function as a Trade Repository for Credit Default Swaps.

What I have provided is a broad-brush canvas of the myriad developments taking place in the international area on harmonization and development of better standards for risk management both in the area of supervision and regulation of banks and financial institutions and in payment and settlement systems.

Regulatory convergence and its impact on India

The direct effect of the global financial crisis on Indian banks/ financial sector was muted because of limited exposure of our banking industry to complex innovative products and other prudential policies put in place by the Reserve Bank of India. The relatively lower presence of foreign banks in the Indian banking sector also minimized the direct impact on the domestic economy. India is exposed to the spill-over effects of the regulatory policies adopted by the systemically important jurisdictions in the World. Volatile cross-border capital flows are one such manifestation. To the extent that these systemically important jurisdictions harmonize and converge to agreed international best practices, there could be positive externalities from the Indian stand point.

The need for convergence in banking regulation stems from the fact that while banking has become global, banking regulation is national. Therefore, addressing the issue of regulatory arbitrage is at the centre-stage of policy concern. The international standard setters have been attempting to achieve convergence by issuing broad principles that should inform national regulatory frameworks, which are peer reviewed under the aegis of the Financial Stability Board and the Basel Committee on Banking Supervision for ensuring cross-border harmonization. While formulating national regulatory policies, national authorities are expected to exercise *constrained discretion* on certain aspects.

As regards adoption of global regulatory reform agenda by India, it needs to be mentioned that a number of measures based on the principles that are now accepted internationally were already brought into practice even before the recent crisis. These included stringent liquidity requirements, countercyclical prudential measures, not recognizing in Tier I capital many items that are now sought to be deducted internationally, amortization of profits from sale of securitized assets to SPVs over the life of the securities issued, not reckoning unrealized gains in earnings or in Tier I capital, etc. The same applies to payment and settlement systems as well.

Notwithstanding the above, the adoption of new principles will no doubt pose challenges in certain areas. A concern which has been raised globally is that the adoption of Basel III capital requirements by banks would push down their RoE to an extent. This could have implications for investments into the banking sector. However, it is expected that by looking at the benefits of implementation of Basel III capital requirements by way of increasing resilience of the banking system, investors will get adjusted to the new reality. Though Indian banks have an undisputed advantage of a strong starting base in the form of a higher CRAR with a larger component of Core Equity Capital therein, going ahead raising additional capital would be a big challenge. This has to be overcome by carefully calibrated capital planning exercise by the management of banks and RBI and the Government of India being the owner of public sector banks will have to play a proactive role in this process.

The broader endeavour of global convergence in the banking or payment system regulations would, however, have to account for the country-specific idiosyncrasies to enable customized adoption of guidance of international standard setters as already recognized in many cases. For instance, the BCBS guidance on the conduct of the countercyclical capital buffer for India may require some adjustment/changes as the recommended metric of credit-to-GDP ratio could potentially adversely impact the structural drivers underlying credit growth in India. Thus, there may be a need for some adjustments to capital buffer guidance. Similarly the impact of new capital and margining rules for CCPs and OTC derivatives may require re-adjustments in India. Again the developments relating to Trade Repositories and Lead Entity Indicator approach to trades have implications for India. These aspects are being examined within RBI.

Issues specific to Chhattisgarh

Economy and banking scenario of the state

Chhattisgarh is one of the youngest States of the Indian Nation. Constituted on 1st November, 2000, Chhattisgarh is located in the heart of India, and shares its borders with six States. I was very happy to note that Chhattisgarh has featured among the top 5 states in GDP growth for the past three years, in which the States GDP growth has been in double digits. As on March 31, 2012, there were 36 Commercial Banks (Public Sector and Private Sector), 3 Regional Rural Banks, 6 District Central Co-operative Banks and 12 Urban Co-operative Banks, operating in Chhattisgarh in addition to the State Co-operative Bank and State Co-operative Agriculture and Rural Development Bank. The total number of bank branches in the State was 1912 as on the same date.

It is gratifying to note that 22 districts out of 27 have achieved 100% financial inclusion. Remaining districts viz. Rajnandgaon, Dantewada, Bijapur, Narainpur and Sukma suffer from Left Wing Extremism (LWE) and progress is relatively slower in these districts. There has been a consistent growth in the deposits and advances of banks over the last five years but the CD ratio remains below the expected level of 60%. Another significant factor is that Chhattisgarh has been one of the few States where the target for provision of banking services to villages having population above 2000 has been achieved. There were 1050 villages identified for provision of banking services by March 2012.

Opportunities in Chhattisgarh

The State has huge deposits of minerals. It is one of the few power surplus States in the country. The gender ratio is above the national level (991:1000). Literacy ratio is 71.04% (Male – 81.45%, Female – 60.59%) and it has improved considerably subsequent to the formation of the State. Steady GDP growth over the past few years has created a good investment climate in the State. Chhattisgarh with its immense natural beauty has got the potential to be one of the best tourism destinations in the country.

Challenges

The economy of the State is primarily agricultural but a major part of the agricultural land is mono-cropping in the absence of sufficient irrigation facilities. In order to bring more land under multi-cropping, minor irrigation schemes should be focused upon. KCCs need to be made available to all eligible farmers and we are quite far from that target. In cases where proper land records are not available or cases pertaining to “share croppers/oral lessees”, Joint Liability Groups (JLG) need to be formed so that crop loans are made available to these farmers. Farm mechanization is the need of the hour, as without modern techniques and implements productivity cannot be enhanced. Chhattisgarh has been an under performer as far as Agricultural Term Loans (ATLs). Banks need to bring in more region specific products

so that ATL off-take is increased and field level functionaries need to be sensitized that there is more to agricultural credit than just crop loans.

Besides agriculture, MSME is the second largest sector as far as employment is concerned. The Empowered Committee on MSME in Chhattisgarh has done a fairly good job and the State has witnessed a steady growth in loans to this sector. Subsequent to the recommendations of High Level Task Force by Prime Minister, there is an increased focus on Micro and Small Enterprises (MSE). They are present in the State but the spread of these industries is very limited and keeping in view the huge employment potential in these industries, growth of MSEs should be facilitated by banks and Government. Workshops, meetings and sensitization programmes elaborating various Government sponsored schemes, banks schemes and availability of collateral free loans should be organized in each block.

Education loans should be extended to all eligible students. Recently a news item mentioned that, more than a hundred students from tribal community residing in LWE areas got selected for engineering colleges. It is a great step forward and to ensure that such a process continues, the financial sector should provide all possible assistance.

Financial inclusion has been a key performance area for all of us since the last few years. Chhattisgarh has made good progress on this front as 22 out of 27 districts have achieved 100% financial inclusion and the remaining districts are expected to achieve this target soon. Bankers and Government agencies deserve appreciation for having achieved the target of provision of banking services to villages having population more than 2000. This is just the beginning, we need to go miles and there is no room for complacency. Opening at least one bank account in each family and providing banking services through business correspondent are the initial steps, we need to make sure that people develop a habit of banking. Their credit, remittance and insurance related needs are met and financial products delivered at their doorstep. Financial literacy and awareness plays a vital role in holistic financial inclusion. Bankers and Government agencies need to incorporate financial literacy as a part of their action plans at all levels. RBI has been organizing Outreach and similar programmes but they are just to show the way, it is for the banking industry to take it further to each and every village. A proper schedule for such programmes may be prepared and RBI would extend all possible assistance to such initiatives by banks. Financial Literacy and Credit Counseling centers are being set up at district levels, the functioning of these FLCCs should be monitored closely by controlling heads of banks and necessary guidance should be provided. FLCCs should not function only at their office but they need to step out at rural markets, gram sabhas and schools to educate people about financial products.

Looking at the banking statistics for the past five years it is observed that there is a gradual reduction in CD ratio. For a State featuring among the top in economic growth it is not comforting to note that the CD ratio is declining. It might be because of investments being made in the State resulting in greater growth of deposits. It has been mentioned that few large projects operating in the State have credit limits sanctioned from other States hence they cannot be included in advances for Chhattisgarh. Bankers need to address this issue, with CBS any customer can access his account from any branch, and this can be utilized by bankers in Chhattisgarh to sanction big ticket advances. Banks should have an area specific action plan for growth in advances keeping in view the huge potential available in the State. The State Government has signed MoUs with some major industries and they are likely to setup their project here, this opportunity should be grabbed by banks to boost up their advances. Business correspondents can also play a major part in increasing credit; banks can extend overdraft facility to MGNREGA workers. Keeping in view the huge number of such beneficiaries the resultant credit growth will be substantial.

Concluding observations

In view of the fact that regulatory failures are among the causes for the recent global financial crisis, globally, an endeavour has been underway to adopt regulatory reform agenda and thereby achieve a broad convergence of banking regulation across jurisdictions. The prospects of regulatory convergence could have positive implications for India as it could potentially address the negative spill-over effects of regulatory policies adopted by systemically important jurisdictions. However, the paradigm of regulatory convergence has to accommodate national imperatives of the individual jurisdictions to account, *inter alia*, for divergence in their stages of economic development, status of their financial markets and infrastructure. I would conclude by summing up the challenge in front of us by saying that *the need of the hour is to think globally but act locally*. In this backdrop it is important that all the regions of India are brought to the same level of economic growth and the banking sector has to play a catalytic role in this endeavour. I am sure that the banking system in Chhattisgarh will be able to meet this challenge and make this State a very prosperous and vibrant one in the coming days.