S S Mundra: Unintended consequences of new international supervisory framework – an emerging market perspective

Keynote address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the Bank of France-Reserve Bank of India Joint Conference, Paris, 20 July 2015.

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Bonjour!

1. Thank you Ms. Anne Le Lorier for your thoughts. It is my pleasure to deliver the key note address at this RBI-BdF joint Conference being hosted by Banque de France. Let me begin by thanking you and the BdF for your warmth, friendliness and cordiality. Banque de France is one of the oldest central banks in the world, set up in January 1800 by Napoléon Bonaparte with the objective of fostering renewed economic growth in the wake of the deep recession of the Revolutionary period. As we sit down to deliberate upon the consequences of new international supervisory framework today, the milieu is strikingly similar to what existed more than two centuries ago. Even today, the global economy continues its struggle out of retrenchment in output suffered during the financial crisis, proving right the adage "more the things change, more they remain the same". Even as the standard setting bodies (SSBs) have embarked upon various regulatory reforms to nurture the financial system out of quagmire that it had gone into before the outbreak of the crisis, we feel it is worthwhile to deliberate upon the unintended consequences of the new international regulatory/supervisory measures and chart out ways to counter the potential adverse fallouts. In my address today, I would like to present the views from the perspective of the emerging markets. I will begin by briefly tracing the genesis and context of the new supervisory framework and then, I will argue that there are limitations around how much can the regulatory regime be tightened, considering its cost on the economy. I would then close by offering my perspectives on the way ahead for limiting the unintended consequences of the new regulatory framework. But before I get to the subject proper, let me spend a couple of minutes in underlining the contrasting realties that the advanced and the emerging economies like India are faced with, in an otherwise "interconnected" world.

2. Let us face it – it's a multi-paced world. The ground realties in advanced economies (AEs) and in the emerging and developing market economies (EMDEs) are essentially different. While, many of the AEs, especially in Europe continue to grapple with the problem of deflation and stagnant or declining growth, most of the EMDEs are busy fighting inflation and are registering growth albeit, a bit moderate. The EMDEs like India continue to need big investment in the infrastructure sector with an underlying potential to earn real rate of return unlike in many other parts of the globe. Another feature that distinguishes India from the AEs is the dominance of the banking sector in the financial system. Notwithstanding the rapid developments in the Indian capital markets, the share of banking credit to firms and households taken together as a percentage to total credit at above 90% continues to remain high in comparison to that in advanced economies like France (around 50%) and USA (around 30%).[1] Bank finance for households has picked up significantly over the last decade, but household balance sheet still remain less leveraged compared to advanced economies. Banks also continue to be the most predominant source for funding the government deficits and their investment in government securities constitutes over half of the total market borrowing. Thus, given the bank-domination in India's financial system, an examination of the

[1] Economic Survey 2014–15: Credit, Structure and Double Financial Repression: A Diagnosis of the Banking Sector : http://indiabudget.nic.in/es2014–15/echapvol1-05.pdf.

unintended consequences of the reform measures that have been launched in wake of the Global Financial Crisis is of a vital importance in determining the ability of the banks to fund growth in a sustainable way.

Genesis of reforms

3. The New Framework was necessitated due to the chinks exposed by the global financial crisis in the then existing regulatory framework. It was generally recognised that the extant regulatory regime (i) did not consider the pitfalls of unrestrained financial innovations, (ii) could not handle pro-cyclicality of the financial system, (iii) paid scant attention to "too big to fail (TBTF)" syndrome, (iv) failed to restrain the rapid growth of shadow banking and (v) allowed build-up of asset prices and credit booms and busts.

4. Thus, a series of global initiatives followed supported by several multilateral frameworks that include the G-20, the Bank of International Settlements (BIS) and the Financial Stability Board (FSB). National legislative changes and regulatory reforms have simultaneously proceeded in several nations. The Dodd-Frank Act that incorporated the Volcker rule in the United States, Vickers proposals that have led to the Banking Reforms Act in the United Kingdom, the Liikanen Report that has helped shape the Banking Union in the European Union and France's initiative that culminated in ring fencing propriety trading activities through separation of lending activities and retail financial services have changed the face of international banking. The initiatives I just mentioned are aimed at building a global financial system that not only acts as a catalyst for growth but also stays crisis-resistant.

Consequences of regulatory stringency: some intended, some unintended

5. A safer financial system is an objective that hardly anyone will question. Sadly however, safety measures come with their own cost. There is a trade-off to be achieved and what is crucial to know is the point of that optimal trade-off. Unfortunately, we do not have clear guidance from theory that can be applied in practice.

Intended consequences of reforms

6. The major elements of the new regulatory and supervisory framework for banks are the Basel-III capital prescriptions, Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) to which we will soon be adding the Total Loss Absorbing Capacity (TLAC). Currently, work is also going on to improve the standardized, non-modeled approaches for calculating regulatory capital so that the problem of excessive variability in banks' regulatory capital ratios could be resolved. Discussions on countering the effects of shadow banking sector on the financial system and establishing a better resolution regime backed by a clear legal framework are at an advanced stage. There are other aspects of market regulation such as improving the risk management practices of CCPs and ensuring adequacy of their credit and liquidity resources and recovery procedures; regulation of OTC derivatives etc. The intended consequences of all these is to reduce liquidity and funding constraints that the banks might face in episodes of tight liquidity and low growth. These measures also reduce the dependence on taxpayers' money to bailout financial institutions in the event of stress.

7. Basel III is intended to not only improve the resilience of individual banking institutions during periods of stress but to also improve the banking sector's ability to absorb shocks arising from system wide risks as well as the procyclical amplification of these risks over time. The package aims at inter alia, improving banks' risk management, governance, transparency and disclosure standards thereby enabling depositors, investors and counterparties to take a more informed decision. The intended consequences of the regulatory reform measures are all too well known to need repetition before this knowledgeable audience.

Unintended consequences of reforms

8. It is obvious that the new regulatory and supervisory framework that we are putting in place now have some unintended consequences that are likely to entail additional economic costs. An underlying tension around the trade-off between financial stability and economic growth persists despite impact assessment studies showing results to the contrary. I would like to touch upon some of these issues with a particular focus on the impact on emerging markets.

i) Impact on GDP growth

Although, an ex-ante assessment of the economic impact of regulatory reforms is difficult; studies conducted by various international agencies indicate different magnitudes of impact. The BCBS (2010) estimated that the Basel III capital and liquidity charges would reduce the steady state level of economic activity by 0.6 per cent in total or 0.08 per cent annually if spread over the eight year transition period. MAG of BIS in 2010 covered 17 industrialized countries to conclude that the lending spread would increase by 15 bps by 2015 in response to a 1% increase in capital over 4 years. IIF which took a view (2010) of Europe, US & Japan concluded that a 2% increase by way of capital and liquidity would translate into increase in the lending spread by 132 basis points. Another study (2012–19) by IIF indicates a negative impact of 0.40%, 0.30% and 0.10% on the annual growth for Europe, Japan and the US respectively. While the differences in outcomes could be attributed to the differences in methodology, the direction of impact is nonetheless clear. The economies need to brace up to the fact that the new regulations would have an adverse impact on the economic growth.

The combination of (a) increased capital requirements, particularly in the common equity element of Tier 1 capital and capital buffers and (b) minimum liquidity requirements, are likely to reduce the return on equity for banks. It is unclear how different banks will address the situation but the options include: reduction of rates on retail deposits; reduced staff compensation; and increased margins on products. Reduction in retail deposits rates can have two consequences. First, it can result in increased disintermediation. Second, they can even affect the overall saving rate of the households in bank-dominated economies like India. At a time, when the rate of gross saving to gross national disposable income has already fallen to 30% in 2013–14 from around 34 % in 2009–10, this could have adverse impact on growth and current account gap. Also, the increased cost of lending or reduced quantum of lending resulting from more stringent capital requirements on banks would lead to deleterious impact on the economic growth.

ii) Impact on infrastructure financing

India has a growing population and has just crossed the tipping point when it can sustain high growth rate in the global economy, serving as one of engines for world growth. However, to facilitate this it needs to make massive infrastructure investments. As per the "report of the Confederation of Indian Industry (CII), 'Investment Requirements in India: 2014–15 to 2018–19" a total investment of Rs.64 trillion (US$ 1071 billion) at current market prices requirement is needed in the next 5 years in the infrastructure sector. Further, for achieving an average growth of 7 per cent per annum during the next five years , the investment requirements have been estimated at Rs.280 trillion (US$ 4667 billion) at current market prices. These are colossal numbers that cannot be realized if bank financing gets restricted in the quest for reinforcing buffers for the banks. So clearly there are limits to regulatory stringency, especially as emerging markets strive towards convergence in per capita incomes.

iii) Impact on finance to MSMEs

The Micro, Small and Medium Enterprises (MSME) sector plays a very important role in emerging markets and especially in India. The MSMEs contribute nearly 8 percent of the country's GDP, 45 percent of the manufacturing output and 40 percent of the exports.

Currently, there are approximately 47 mn enterprises in the MSME Sector providing employment opportunities to 106 mn people across the country. These small enterprises rely very heavily on the bank finance for their credit needs.

As the SMEs neither have sufficiently long credit history nor any external credit rating, they typically languish at the highest level of risk spectrum requiring banks to hold more capital against these exposures. In the event of banks being forced to conserve capital or to reduce their RWAs, the MSME borrowers are likely be the first to be jettisoned. This may be catastrophic for the MSME sector as they have virtually no access to the alternate formal sources of finance.

iv) Impact of liquidity prescriptions

A key learning from the crisis was that liquidity is also important as with dynamic equilibria, liquidity problems can soon turn into solvency problems. Therefore, SSBs have focused closely on improving the liquidity risk profile of the individual firms. But even these regulations have not been without their share of unintended consequences of varying degree across jurisdictions. On a broader level, in order to meet the LCR norms, the banks would need to hold more long terms liabilities and short term assets. Also, the NSFR norms would lead to curtailment of the market making abilities of the banks. Both of these would have adverse implications for the banks' margins.

In India, the banks are statutorily required to hold a certain percentage of their liabilities (SLR) in Government securities, State Government securities and other approved securities. The SLR securities meet all the characteristics of the Level 1 "High Quality Liquid Assets" (HQLAs) and hence, the current insistence on separately holding additional HQLA would mean a very high cost for the banks operating in India. Similarly, due recognition also needs to be given to high level of public deposits and a very low run-off rates for these deposits in the EMDE banks, including in India as compared to other jurisdictions. Thus, on the whole there is a strong case for according a fair extent of national discretion to the regulatory authorities for implementing the liquidity risk framework in their respective jurisdictions.

v) Impact of TLAC

The TLAC has added an additional dimension for emerging markets like India, even while the proposal essentially is aimed at G-SIBs that have acquired TBTF dimension in the advanced economies. Let me briefly describe the likely impact.

As I mentioned earlier, the characteristics of the banking system in the EMDEs is vastly different than in the AEs. These economies have potential to grow and hence supply of credit is needed to support growth. These economies play host to several G-SIBs and hence they compete with non- G-SIBs in the same market. There is potential for spillover impact and non- G-SIBs could be forced by market to hold higher level of capital on similar levels as the G-SIBs. There is also a likelihood of the G-SIBs present in the EMDEs, curtailing their operations. Either of these developments would impact the supply of credit and would be negative for the growth prospects in these economies.

On the demand side, there is hardly any market for TLAC compliant instruments. Our banks have experienced challenges in raising fund for the Basel III compliant capital instruments like Additional Tier1. If the banks venture abroad for raising such capital, the cost would be still higher due to comparatively lower sovereign rating and competing demands from G-SIBs.

Regulations in the making: risk weights on sovereign bonds

9. Regulatory reforms agenda set in motion following the GFC has not reached its culmination. Every now and then a new vulnerability appears and steps are initiated to mitigate the risks. Possibility of assigning a risk weight to sovereign bond holdings is one

such event. While it is difficult to defend such a proposition especially after the events of the immediate past, it needs to be acknowledged that the situation is not similar across the globe. Countries like India have been a pocket of stability and there is no reason to believe that the sovereign can default. Under the circumstances, assigning a risk weight to sovereign bond in countries like India would mean consumption of scarce capital with adverse impact on growth. Such possibilities only strengthen the case for a greater national discretion.

Case for national discretion

10. In my view, a very important facet that needs to be considered is the state of development of the financial markets in various economies. Banks in India have a relatively simple business model with plain vanilla product offerings. The regulatory capital regime in India has always been more stringent than the global standards. Not only is the CAR level set at a higher level even the risk weights assigned to several asset classes are higher. This is even while the Indian banks are still following the standardized approach. A "back of the envelop" calculation shows that the impact of higher risk weights on Indian banks when compared to BCBS prescriptions is of the order of 200 basis points.

Necessary macroprudential measures

11. While I have argued in favour of a differentiated, cautious and gradual approach while calibrating introducing regulatory reforms for the EMDEs like India, there are pressing challenges that the banking system faces. We are conscious of the need to bring in the right macro prudential regulations to overcome them. Early resolution of problem assets, lowering the levels of single/group borrower limits, strengthening of the asset qualification norms, improving corporate governance standards especially in public sector banks, ushering in a bankruptcy framework, deleveraging of corporate balance sheets and reducing the level of unhedged foreign exposure are some of the tasks at hand that need to be quickly completed.

Towards limiting the unintended consequences

12. Having seen the impact of new regulatory reform agenda, it is important to consider means to limit their unintended consequences without throwing away the baby with the bath water. The elements of this new framework are needed for the global banking system. If we have learnt our lessons from the global financial crisis and the feedback loops between banking and sovereign debt in the euro area, we cannot but move ahead in ushering the new regime. Yet, we have to be sensitive to the need to push growth and financial inclusion. We cannot chop the wings with which the banking can fly, but we need to clip its speed so that it does not crash and hurt itself. I would also like to mention here that lingering doubt still persist about the regulatory capture of the reforms process and efforts must also be made towards dispelling these doubts.

13. We need to prepare more fully for changes; and this applies to banks as well as regulators. For example, if bank's return on equity (RoE) falls, banks must engage more proactively on bringing in cost efficiencies and in restricting excessive bonuses for short-term risk behavior. If weaker banks can get crowded out, both the regulators and the banks should move to provide an enabling framework for mergers and acquisitions.

Conclusion

14. In conclusion, I would like to emphasize a three-pronged approach for the new international regulatory reform process.

a) Focus on closer supervision: Anatomy of the crisis revealed lack of effective supervision as a common theme across jurisdictions. More intense and effective supervision has to remain a central element of the supervisory and regulatory agenda. Closer supervision of institutions allows promotion of best practices and enables early identification of risks before they assume alarming proportions. Also, while regulation has to be specific to the jurisdiction, the supervisory tools can be universal. Supervisors need to continuously look at the banks' risk management architecture and the risk governance frameworks and conduct rigorous forward looking risk analysis to detect early weaknesses. They also need to have an ongoing engagement with the boards and senior management and closely supervise control functions such as compliance and internal audit together with the Corporate Governance practices.

b) Greater National Discretion: Although, we are conscious of the need for a universal regulatory framework for eliminating arbitrage, it is essential that greater national discretion is allowed to supervisory authorities. The FSB's November 2014 report on "Monitoring the effects of agreed regulatory reforms on EMDEs" mentioned inter alia that EMDEs would need to continue to make appropriate use of the flexibility available in international policy frameworks (e.g. using observation and phase-in periods, calibrating parameters, undertaking impact assessments, and applying national discretions and proportionality). However, the concept of national discretion as available under the international regulations is very narrow.

The international standards setting bodies need to recognize that the political mandates given to respective regulatory and supervisory bodies are sometimes not in alignment with the internationally agreed reform measures. A case in point is the European Commission's statement on the Basel Regulatory Consistency Assessment of Basel III implementation. The Commission stated that the diversity of banks in terms of size, complexity and legal form necessitates a degree of additional flexibility for supervisors to reflect local specificities. This was in response to findings of the BCBS as regards use of concessionary risk weights to the small and medium-sized enterprise (SME) exposures for customers located in both the EU and abroad.

Hence, as I have argued earlier, since each jurisdiction is at different stage of economic and political development, the supervisory authorities must be accorded a greater degree of freedom to fine-tune the regulations in keeping with the jurisdictional needs.

c) Calibration over a longer time horizon: Besides granting greater flexibility and discretion, in keeping with the requirements of the EMDEs, it is important that the implementation of the reform agenda is stretched out over a longer time horizon. This would allow the regulators to prepare the financial system and particularly the banking system for the stringent measures.

With above submissions, I would like to close my address and leave the field for a frank discussion amongst the regulators from two jurisdictions that have a great banking tradition.

I wish the conference all success.

Merci!