



Financial Stability : The Indian Experience

SAARCFINANCE Governors' Symposium

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FINANCIAL STABILITY AT THE CENTRE STAGE

- ❖ Financial stability
 - ❖ Came to the fore in the wake of the global crisis
 - ❖ Recognition of a need to pursue financial stability as an explicit policy objective
- ❖ International policy initiatives to ensure financial stability
 - ❖ G20, the Financial Stability Board, Basel Committee, IMF and other international institutions
 - ❖ Increasing the resilience of financial institutions and infrastructure
 - ❖ A macroprudential approach to regulation and supervision
 - ❖ International cooperation
- ❖ Institutional arrangements for financial stability
 - ❖ Councils for a collegial approach to preserving financial stability
 - ❖ Central banks being increasingly called upon to shoulder the greater burden of managing systemic risks

FINANCIAL STABILITY IN INDIA: EARLY BEGINNINGS

- ❖ Though not an explicitly defined mandate for the Reserve Bank, pursuance of financial stability has been the critical policy driver.
- ❖ The broader macro-policy context overarches the policy frameworks for:
 - ❖ Monetary management
 - ❖ Institutional regulation – banks as well as non-banks
 - ❖ External account
 - ❖ Market development and regulation
 - ❖ Financing of sovereign liabilities

THE INDIAN APPROACH TO FINANCIAL STABILITY

- ❖ Prudential framework for banks is comprehensive and addresses
 - ❖ Interconnectedness
 - prudential limits on aggregate inter-bank liabilities for banks as a proportion of their net worth.
 - The overnight un-collateralised funding market is restricted only to banks and primary dealers and there are ceilings for both lending as well as borrowing
 - Investment by banks in subordinated debt of other banks is assigned 100% risk weight for capital adequacy purpose.
 - Banks' aggregate investment in Tier II bonds issued by other banks and financial institutions is limited to 10 % of the investing bank's total capital.
 - Exposure of banks to any single NBFC is capped as a percentage of banks' capital funds

THE INDIAN APPROACH TO FINANCIAL STABILITY

- ❖ Prudential framework for banks addresses
 - ❖ Excessive dollarisation of bank balance sheets
 - Limits on the proportion of wholesale foreign currency liabilities intermediated through the banking system.
 - Retail foreign currency deposits from non-residents are subject to minimum maturity requirements and interest rate caps.
 - ❖ Countercyclical approach to regulation
 - Varying risk weights and provisioning norms – sectoral approach
 - Imposition of LTV ratios
 - Introduced requirement of investment fluctuation reserve (IFR) of a minimum 5 % of the investment portfolio as a buffer for interest rate risk during a low interest rate regime.

THE INDIAN APPROACH TO FINANCIAL STABILITY

- Capital Account Management Framework
 - Substantially large freedom to equity flows – both FDI as well as portfolio flows
 - Regulatory framework for External Debt flows with a combination of administrative, quantitative and price based measures.
- Management of sovereign borrowings
 - Banks permitted to hold stipulated 25 % investment in Government securities as ‘held to maturity’.
 - Limited dependence on foreign investors in respect of domestic currency debt
 - Strong domestic investor base, apart from banks, in the form of insurance and pension/provident funds, which has enabled India to elongate the maturity of its domestic debt.

THE INDIAN APPROACH TO FINANCIAL STABILITY

- NBFCs -Shadow banking
 - Regulatory perimeter extends to large NBFCs identified as systemically important engaged in credit intermediation. Subject to capital adequacy and other prudential norms.
 - SPVs exist but do not undertake significant liquidity and maturity transformation. Conservative securitisation guidelines.
 - Hedge funds and private equity not within regulatory perimeter. Currently not highly leveraged. The issue of regulation of such entities being addressed.
 - MMFs - liquidity transformation issues need to be addressed

THE INDIAN APPROACH TO FINANCIAL STABILITY

- Regulation of financial markets
 - Calibrated approach to liberalisation
 - Exotic derivatives have not been allowed
 - Regulatory framework for all OTC derivative markets, unlike most advanced countries
 - Repo markets, which were at the heart of the crisis, are well regulated.
 - Foreign participation in these markets is under a regulated framework – part of capital account management
 - Conservative prudential and accounting guidelines for banks – capital, liquidity, leverage
 - Shift towards CCPs much before the crisis

THE INDIAN APPROACH TO FINANCIAL STABILITY

- Monitoring large financial conglomerates
 - Consolidated regulation
 - Two-pronged structured process in the nature of off-site surveillance and the periodic interface with the conglomerates
 - Arrangement for supervisory information sharing amongst the regulators to address specific issues in the monitoring of the identified conglomerate
 - Steps underway to tighten the capital adequacy norms for these conglomerates.

PRE CRISIS INSTITUTIONAL ARRANGEMENTS

- ❖ A well defined regulatory framework for the Indian financial system
 - ❖ The Reserve Bank regulates the banking sector and the NBFCs
 - ❖ SEBI, IRDA and PFRDA are the other sectoral regulators
- ❖ A High Level Co-ordination Committee on Financial Markets
 - ❖ For inter-regulatory coordination
- ❖ Committees of Reserve Bank's Central Board – Board for Financial Supervision and Board for Payment and Settlement Systems
 - ❖ Focused regulation of financial institutions and infrastructure
- ❖ Deposit Insurance and Credit Guarantee Corporation
 - ❖ An effective safety net arrangement

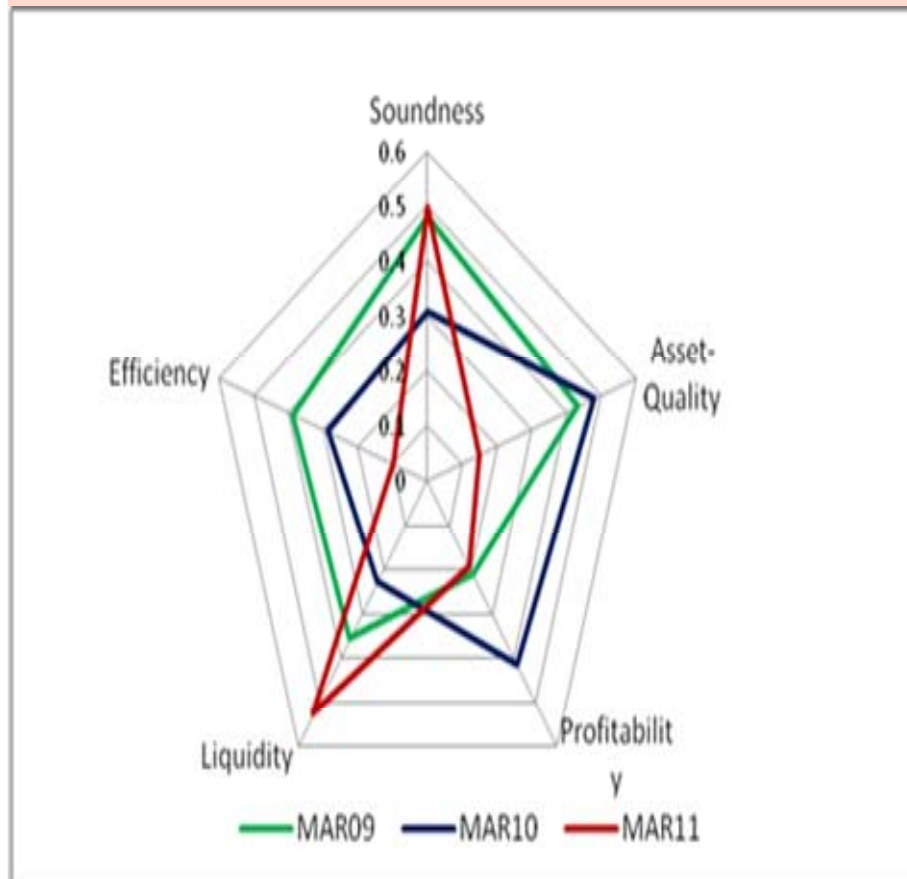
POST CRISIS INSTITUTIONAL ARRANGEMENTS

- ❖ Financial Stability and Development Council (FSDC) and its Sub-Committee – a collegial approach to financial stability
 - ❖ The FSDC – headed by the Union Finance Minister - providing broad oversight
 - ❖ The Sub-Committee – headed by the Governor, Reserve Bank – the operating arm for financial stability in peace times
- ❖ A multi-disciplinary department – the Financial Stability Unit within the Reserve Bank
 - ❖ Conducting ongoing macroprudential surveillance of the financial system
 - ❖ Bi-annual Financial Stability Reports
 - ❖ Initiatives to gauge stresses in the financial system

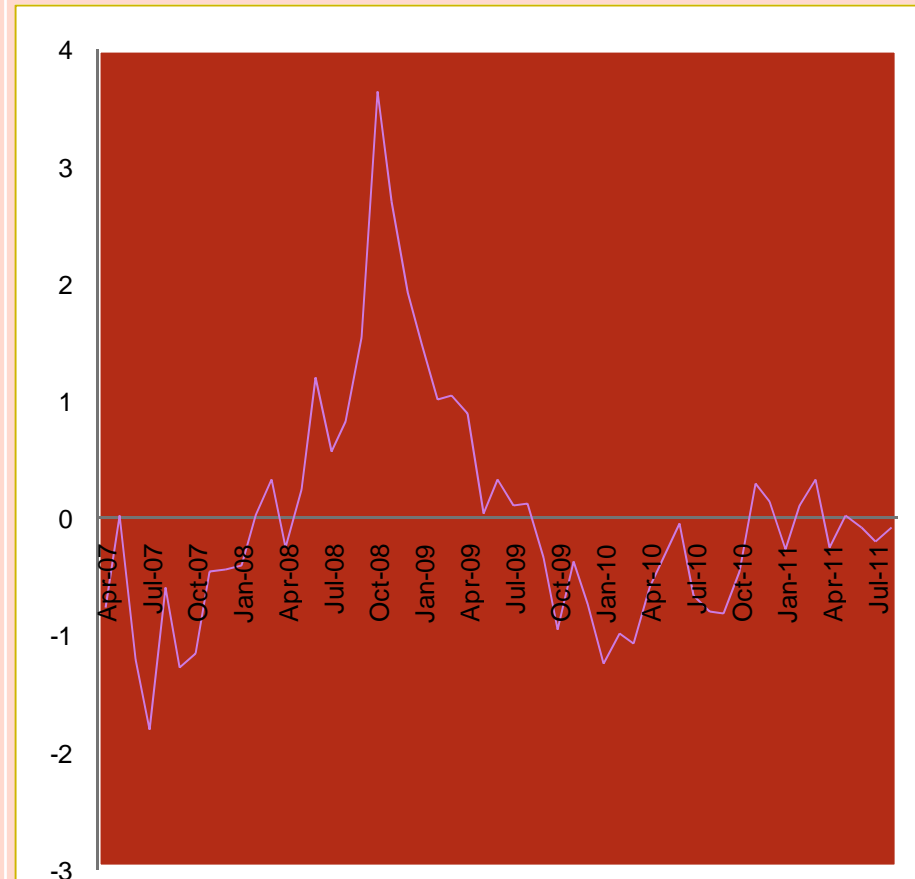
BANKING STABILITY INDEX AND FINANCIAL STRESS INDICATOR

- ❖ To gauge build up of excesses/vulnerabilities in the banking sector and in financial markets

Banking Stability Map



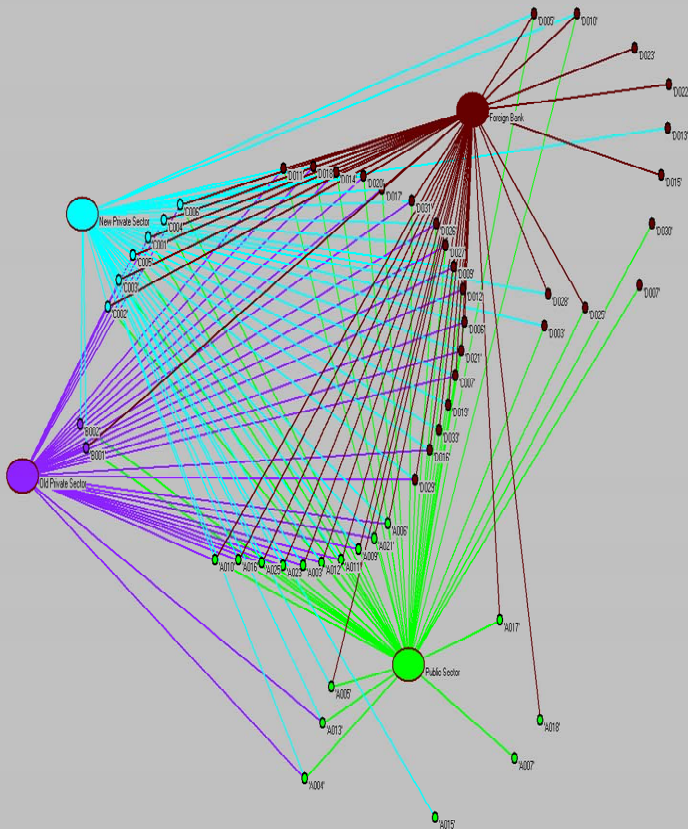
Financial Stress Indicator



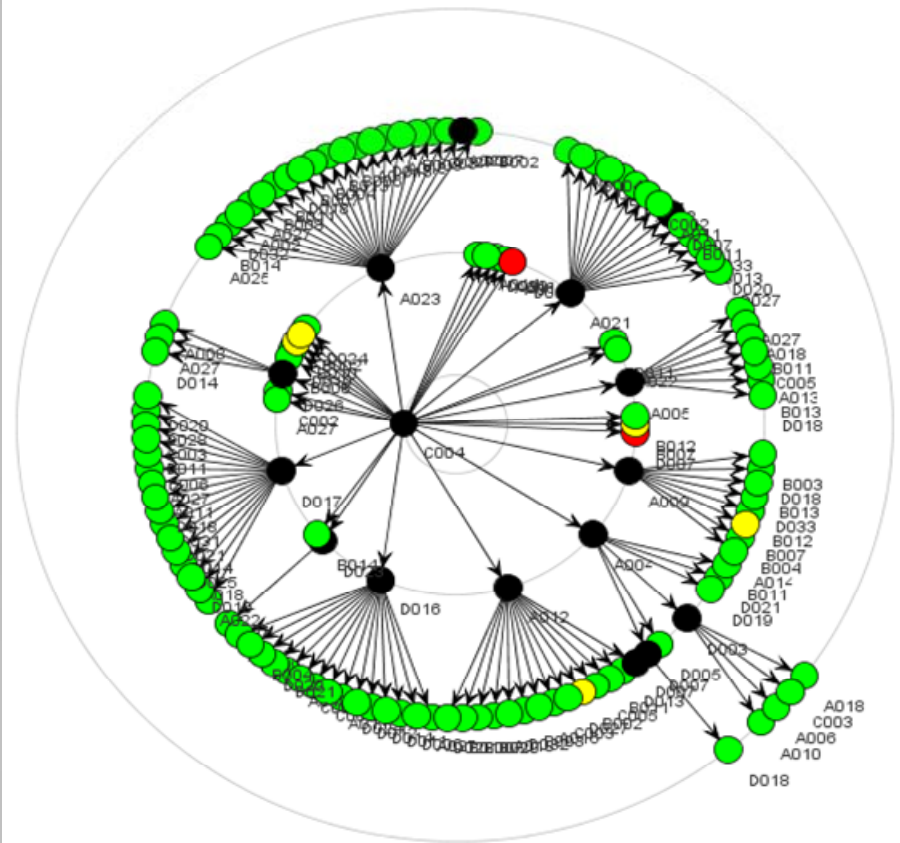
NETWORK ANALYSIS

- ❖ Analytical models which help identify, monitor and address systemic risks

The network of the Indian Banking Sector



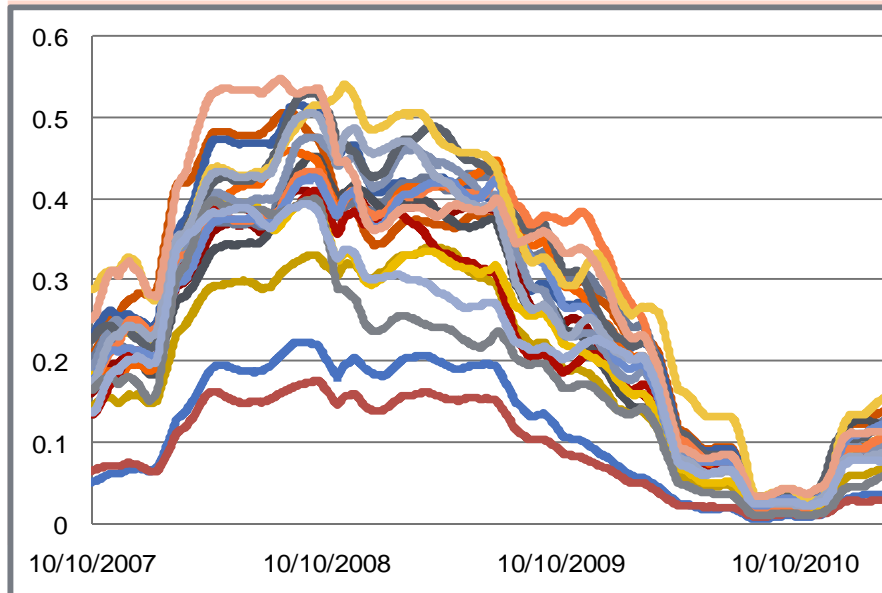
Contagion analysis of an idiosyncratic failure of an Indian



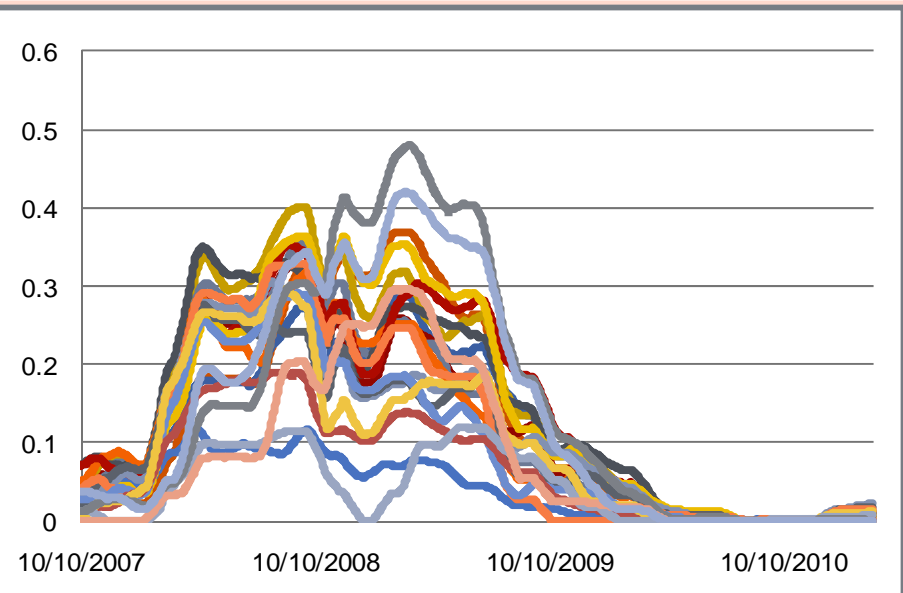
BANKING STABILITY MEASURES

- ❖ A set of stability measures which take into account the distress dependence amongst banks
 - ❖ Joint probability of default and Banking Stability Index (probability of all banks in the system experiencing large losses simultaneously and the expected number of banks under distress when at least one bank is distressed)
 - ❖ Toxicity and Vulnerability Index – the probability of a bank causing distress to another bank and of coming under distress if another bank in the system fails

The Toxicity Index



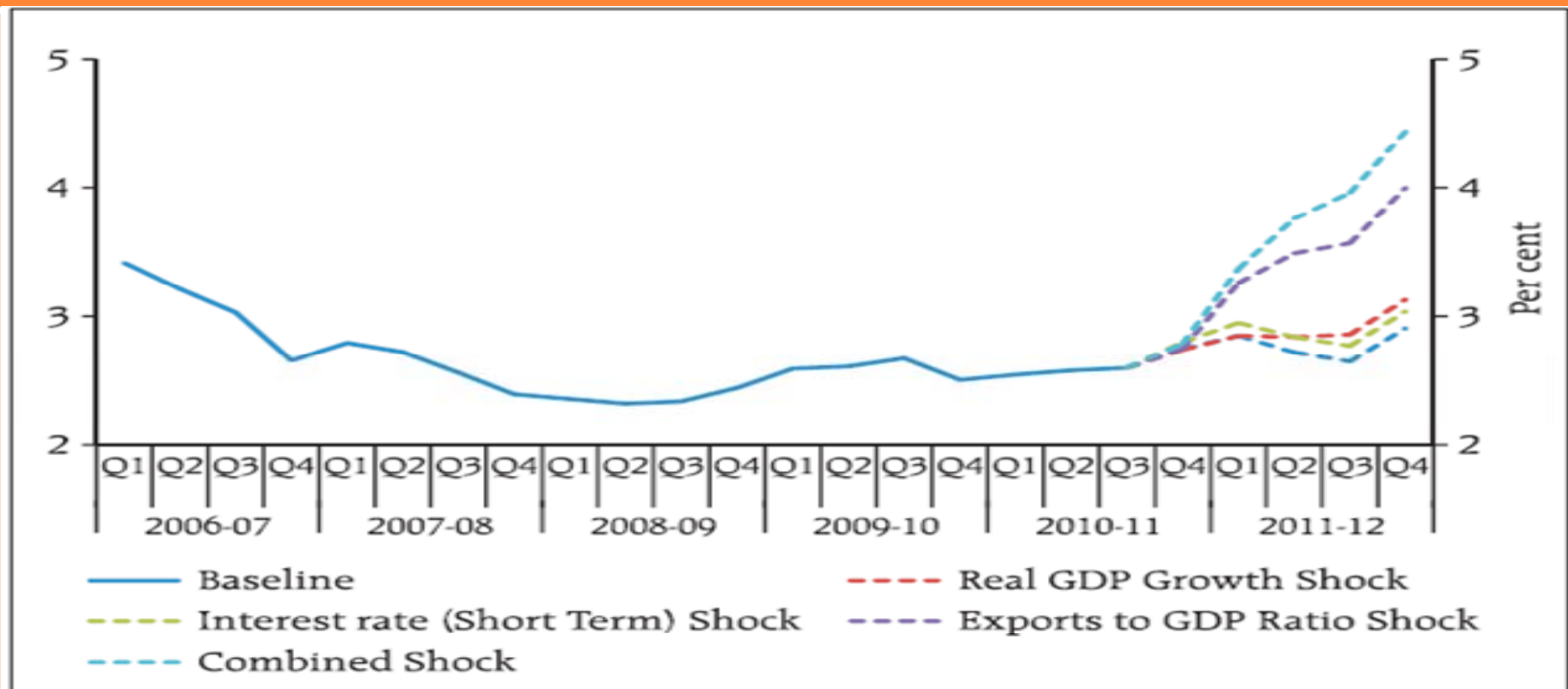
The Vulnerability Index



MACRO-FINANCIAL STRESS TESTING

- ❖ A model based methodology to assess the impact of macroeconomic variables on the performance of the financial system

Non-performing advances under stress scenarios



INITIATIVES FOR MAINTAINING FINANCIAL STABILITY

- ❖ The Indian approach to financial stability has stood the test of time
 - ❖ Contagion impact of global crises were managed with relative equanimity
 - ❖ Preventing crisis through ex ante actions has been our approach.
- ❖ Going forward, there are many challenges
 - ❖ Crisis prevention - each crisis will be different. Anticipating and taking timely action essential.
 - ❖ Growing complexities in the financial sector – domestically and internationally.
 - ❖ Addressing financial stability issues arising from operations of Indian banks overseas and globalisation of Indian corporates.

EMERGING CHALLENGES

- ❖ Gaps in the availability of data and its integrity
 - ❖ Absence of Data in respect of risks concentrations, interconnections in the financial sector
 - ❖ New techniques and analytical methods a sine quo non for financial stability assessment
- ❖ Communication of risks to financial stability
- ❖ Coordination with all agencies
 - ❖ With other functional arms within the Reserve Bank
 - ❖ With other regulators and with the government
- ❖ Developing skill sets

SOME PERSPECTIVES ON THE EMERGING CONTOURS

- There is still no coherent framework emerging for regulation of financial markets from a stability perspective.
 - In the area of reforming markets, the singular area of action has been to address counterparty risks and non-transparency in the OTC market by taking all such markets on to central clearing platforms.
 - Entity regulation - higher capital charge for trading and securitization transactions.
 - Role of banks and other entities in providing liquidity and leverage to financial market participants not addressed adequately
- In search of the holy grail of “level playing field” - counterproductive for financial stability

SOME PERSPECTIVES ON THE EMERGING CONTOURS

- Continuing disconnect between the financial sector and the real sector?
 - Post-crisis risk containment measures, in fact, pose the danger of perpetuating the dominance of trading activities in a bank – by making them uber-safe through CCPs, now considered a SIFI
 - It is the traditional lending activities that may be forced to shoulder much of the burden of increased capital

SOME PERSPECTIVES ON THE EMERGING CONTOURS

- An issue which will be of critical importance to the EMEs from a stability perspective is the nature of presence of foreign financial institutions - exposure of the domestic financial systems to the risk of proxy contamination with problems in global markets
- Effectiveness and intensity of supervisory process - the decision making framework and space for the regulators given that dynamic judgement is necessary to deal with system risk that is constantly changing.
- Rating agencies continue to rate SIFIs on the basis of implicit support from Government

SOME PERSPECTIVES ON THE EMERGING CONTOURS

- Macro-prudential regulation
 - Macroprudential regulation is an inexact science and needs to be used in conjunction with other policies to be effective.
 - Important to acknowledge what macroprudential regulation cannot do: It cannot manage economic cycles and or target asset prices. It can only provide instruments to respond to these developments to cushion the financial system from stresses
 - Mistaking Articulation for Action (MAFA) phenomenon

THANK YOU