*Regulation and Financial Stability**

N.S.Vishwanathan

Shri Hemant Bangur, President, Merchant Chamber of Commerce and Industry, Shri Pawan Bajaj, MD and CEO, United Bank of India, other dignitaries on the dais, friends from the print and electronic media, ladies and gentlemen. I am happy to be here in front of this august gathering to share my thoughts on ''Regulations and Financial Stability''.

The financial system and markets have to be subject to suitable regulation. Therefore, the macroeconomic policies and prudential regulation of the financial sector should provide for stability. There have been concerns in some quarters that the global standard setting bodies have introduced regulations which are too stringent. We must realise that financial crisis can have huge costs. You are all aware that the world is still feeling, in some parts, the effects of the crisis even after nearly a decade.

When it comes to financial stability, therefore, the usual adage of precaution is better than cure applies.

After the last global financial crisis, financial stability pitch-forked to the centre stage of economic policy and regulation. The crisis made it abundantly clear that financial strength of every financial institution does not add up to systemic stability. That was evident because when the crisis happened, almost every financial institution reported substantial capital adequacy. This made the policy makers realise that while micro prudential regulations would help determine the strength of a financial entity, they have to be complemented with adequate macro prudential regulations and anti-systemic risk measures; otherwise systemic stability could be at risk.

As Dr Subba Rao wrote in his book 'Who moved my Interest Rate', it is difficult to define financial stability but one can discern when there is financial instability. Financial stability can be impacted through several channels. It can be through the financial institutional channel, the markets, forex or even trade channels, particularly as the world economy is getting even more globalised and interconnected.

The change in the approach to regulation of financial system from mere micro prudential regulations to macro prudential regulations as well called for a forum that would bring all the sectoral regulators and economic policy makers together. This was necessary for ensuring that regulatory and economic policies pursued are calibrated to ensure not just resilience of the financial institutions but are holistic to address financial stability concerns. In the US, the Dodd Frank Act created Financial Sector Oversight Committee (FSOC) as the umbrella body. Recognising the various channels that could lead to financial instability and the fact that different segments of financial systems are regulated by different regulators, the Government of India set up the Financial Stability Development Council (FSDC) under the Chairmanship of the Finance Minister with other financial sector regulators, apart from senior government officials as members. FSDC sub-committee chaired by the Governor, RBI and comprising Chairman of other financial sector regulators and senior government officials meets more frequently and reports to the FSDC. The FSDC sub-committee and the FSDC review the developments in the economy and the financial system, the risk to financial stability from various channels and takes appropriate measures as may be required to deal with the situation. The FSDC sub-committee, the secretariat to which is provided by the RBI, publishes half yearly Financial Stability Report (FSR). The FSR analyses the current state of financial

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system, the extent of interconnectedness and possible sources of vulnerabilities that could impact financial stability.

Systemic risk assessment is crucial to understand vulnerabilities of the financial system. This meant that apart from ensuring the strength of financial institutions, it is necessary to assess the resilience of the system to various economic shocks. Globally, therefore, Central Banks embarked on system-wide stress tests under plausible but severe economic conditions. The RBI undertakes such stress tests and the results are published in the Financial Stability Report. The Reserve Bank also requires banks to conduct stress tests and use the results for their internal capital assessment.

I began by saying that a set of strong financial institutions may not necessarily lead to financial stability. While strong and resilient financial institutions may not be sufficient condition for financial stability, it is a necessary condition. It is, therefore, well recognised that a resilient financial system, more particularly banking system, would be critical for financial stability and to an extent acts as a bulwark against financial instability arising from other channels. As such, apart from various other efforts to prevent the financial crisis of the kind witnessed in 2007-08, the G20 mandated the Basel Committee for Banking Supervision (BCBS) to put in place appropriate regulatory framework that helps the banking system to be strong and resilient. The crisis called for changes in the global financial architecture as also the institutional architecture for making regulations. This resulted in the BCBS being expanded to cover the G20 countries which made India a member of the BCBS and the Financial Stability Board. No doubt, as Dr Subba Rao has mentioned in his famous book, India and other EME nations are generally perceived to have a vote but not a voice. But slowly these are changing and the EMEs' views are also being heard to an extent. The BCBS, in response to the mandate given by the G20 developed new regulations which are now commonly referred to as Basel III regulations.

To understand the basic foundations of the changes to the regulatory framework that the Basel III rules put in place, it would be useful to delineate the fundamental issues that characterised the financial system during the crisis in advanced economies.

(a) High leverage of the banking system was masked by high CRAR. The banks reported high CRAR by bundling low quality assets into highly rated securitised papers which enabled them to report a high CRAR while remaining over leveraged.

(b) Excessive dependence on market borrowings to fund and refinance their assets; supply of liquidity dried when mortgage backed securities were downgraded due to defaults in the underlying assets.

(c) Use of subsidiaries (in a way shadow banking entities) to undertake activities that might have been more regulated if carried out within the bank, thus creating regulatory arbitrage.

(d) The loss absorbing capacity of the capital was weak given that at least 50 per cent of the capital could be non-loss absorbing in nature (Tier II).

(e) Too big to fail banks required bailout with public funds. Therefore, there had to be a cost for an entity becoming too large and interconnected.

(f) The reliance on credit ratings resulted in potential under-capitalisation.

(g) Many banks had adopted internal rating based system (IRB) for determining their capital requirements for credit risk; the IRB essentially depended on models. Therefore the entire balance sheet was exposed to model risk.

In this background, let us look at the major changes that Basel III brought about:

1. It was found necessary that the quality and quantity of capital should be improved to enable the banks and the banking system to have higher loss absorbency and greater resilience to emerging risks. Therefore, the regulatory capital regime brought in three fundamental changes:

   (a) It was prescribed that out of 8 per cent CRAR, at least 4.5 per cent shall be common equity Tier-I with complete loss absorbency.

   (b) Two additional buffers in the form of capital conservation buffer of 2.5 per cent and counter cyclical capital buffer of another 2.5 per cent were prescribed. Capital conservation buffer could be run down in times of crisis with restriction on earnings distribution.

   (c) The banks were allowed to issue additional Tier I (AT1) bonds but with stronger loss absorbing features.

2. A framework to identify too big to fail banks globally and domestically was drawn up. The GSIBs (globally systemically important banks) and the DSIBs (domestically systemically important banks) were required to hold varying degrees of additional capital with a view to avoiding use of public funds for their revival, in case they fail and also to prevent excessive growth in their balance sheet. The GSIBs were also required to issue TLAC (total loss absorbing capacity) instruments which can be converted into equity in times of need.

3. As I mentioned earlier, one of the features of the banking system during the crisis was excessive dependence on market borrowings for funds. The first trigger of the crisis was inability of one of the banks to finance its liabilities because of the downgrading of the underlying assets. Strangely at that time, there were no liquidity standards globally except on the need to have an asset liability management system. The BCBS realised that lack of liquidity could singe a bank and hurtle it towards insolvency. Therefore, liquidity standards were prescribed as part of the Basel III reforms. These are - liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR ensures that the bank had adequate high quality liquid assets to meet demand on its liabilities in stressed conditions for a period of 30 days. The NSFR required that banks hold a minimum amount of stable funding based on the liquidity characteristics of their assets and their activities over one year horizon. This will reduce funding and roll over risk. Thanks to our SLR requirements, the Indian banks do not have any difficulty in meeting the LCR requirements.

4. The density of highly rated paper on the asset side enabled banks to mask their high leverage with high CRAR. With the quality of the assets getting downgraded, the inadequacy of capital came to the fore. With a view to obviating this possibility, the Basel Committee prescribed a leverage ratio. What it meant is that even if the entire assets of a bank were zero risk weighted, which under the sole CRAR regime would have enabled infinite leverage, there would be constraint now.

5. Several regulatory changes were brought on securitisation. The changes involved laying down a framework for simple, transparent and standardised (STS) securitisation. Higher

capital was prescribed for securitisation transaction that do not conform to STS framework with a view to prevent non-true sale being taken out of the banks' balance sheet and also for strengthening capital requirement for such deals.

6. The Basel Committee is also moving towards eliminating, as far as possible, use of internal model based approach to determine capital requirement. This is happening in three ways (a) Barring the use of IRB for several types of exposures; (b) strengthening the standardised approach and (c) prescribing the regulatory floor where IRB is used, so that the possibility of under capitalisation on account of risk from the use of models is minimised.

   Apart from these, there were other changes including on market risk, which I believe I need not elaborate here.

   Financial stability cannot be achieved through mere strong regulations. They need to be supplemented by effective supervision. In the pre-crisis days a light touch regulatory and supervisory approach was in vogue in many jurisdictions. As such, regulation were more 'comply or explain' and supervision less intense. These light touch regulatory and supervisory practices were also seen as a reason for weakness in the banking system. The global crisis changed all that and there is a move towards more hands-on regulation and intense supervision. In India, though, the Reserve Bank has been hands-on, both for regulation and supervision much before.

7. We have adopted Basle III regulations in India and in line with the global time-table, have required the banks to migrate to Basle III fully by March 31, 2019. Whenever we talk of banking regulation in India, there is a view expressed that we apply stricter norms than what global standards require. Among the issues raised to buttress this contention, is the oft repeated reference to the stipulation of 9 per cent CRAR as opposed to 8 per cent specified by the Basel rules. I must clarify here, as brought out in detail in one of the Working Papers[1], this is not really so. Fundamentally, among other factors, the one percentage point higher CRAR is also to calibrate the regulatory capital to the Indian conditions, having regard to the features of exposures assigned a particular credit rating being different from those of similarly rated exposures internationally. Let me point out here that the regulatory capital is essentially for meeting unexpected loss. Therefore, such a calibration is required. For those interested, I would suggest that you please read the paper I referred to. Incidentally, the higher CET-1 ratio of 5.5 per cent as opposed to 4.5 per cent, another oft referred 'deviation', is only a derivative of the 9 per cent CRAR.

8. Another area where our regulations are referred to as steeper than the standards is the need to maintain both SLR and LCR. As you would be aware, we have gradually reduced the SLR and also allowed 11 per cent of the SLR to count for LCR as well, thus softening the impact. Moreover, we have to do this in a calibrated manner particularly with a view to avoiding instability arising through upward movement in the Government securities' yield if SLR is lowered abruptly.

[1] RBI working paper series 2017 - Risk-weighting under Standardised Approach of Computation of Capital for Credit Risk in Basel Framework – An Analysis of Default Experience of Credit Rating Agencies in India.

9. We have required banks to implement the leverage ratio and have indicated that we would be monitoring them at a ratio of 4.5. This is more with a view to enabling banks to take corrective actions well before they get overleveraged even by the global standards as also to mandate banks not to exceed the present system wide average leverage ratio.

10. It is natural for business to move from the strongly regulated to the less regulated space. Therefore, as the banking system was more regulated, firms moved into the less regulated space. When financial intermediation happens in a less regulated or unregulated environment, even more particularly with banks using the subsidiary model to do so, they impact the financial system substantially. Shadow banking entities are defined as financial intermediaries involved in facilitating creation of credit without being subject to regulatory oversight. It can also refer to unregulated activities of regulated entities. Globally, therefore, the move to intensify the micro and macro prudential regulation for banks was complemented by an effort to get a better handle on the shadow banking system. The effort has been in the direction of mapping the shadow banking entities and containing regulatory arbitrage. The Reserve Bank also participates in this exercise undertaken by the Financial Stability Board and provides necessary information to it. The non-banking financial companies in the Indian context which provide financial intermediation services are regulated fairly strongly both in terms of minimum capital and the loan delinquency recognition.

11. It was also observed that during the crisis, the accounting framework, particularly for recognition of fair value of financial instruments resulted in the financial statements not reflecting true and fair picture of the financial institutions. Globally therefore, there is a move towards adopting international financial reporting standards (IFRS) as a basis for recording the balance sheet and profit and loss account. In India too, we are moving towards adoption of Ind-AS as the accounting framework for banks and we are in dialogue with the stakeholders on the way forward.

12. Of late, vulnerability of financial institutions to the threat of cyber risk has grown enormously. This has resulted from the use of technology by banks gaining momentum in the recent past. Susceptibility to cyber risk endangers not only a financial institution but can have system wide ramifications. Cyber risks take the form of theft of funds, data, corruption of the IT systems, which might prevent normal operations. Globally, therefore, inadequate cyber security is flagged as a serious threat to financial stability. Reserve Bank, realising the importance of putting in place a robust cyber risk management framework, has issued detailed regulations to banks in this regard. Reserve Bank has set up an IT subsidiary, Reserve Bank Information Technology Pvt. Ltd. to assist it to put in place appropriate cyber risk management regulations and assess the quality of the IT systems of the regulated entities as part of the supervisory exercise.

13. It has been found that in India the NPAs as a percentage of total exposure is higher in larger accounts. A highly leveraged corporate

sector will pose systemic risk. Globally there is a move to contain large exposure and we have aligned our large exposure norms with the global standards. Moreover, with a view to de-risking the banks' balance sheets and encouraging large borrowers to access the capital market, we have provided for higher risk weights for larger borrowers in certain circumstances.

14. I referred to the use of macro prudential tools for strengthening financial stability. RBI has used such tools even before it was fashionable. Prescribing higher standard assets provisioning and higher risk weights for exposure against assets susceptible to market bubbles is an example. We have, therefore, higher risk weights for capital market exposure and commercial real estate, additional capital for un-hedged foreign currency exposure, *etc.* Another macro prudential tool that is used is the loan to value ratio (LTV), particularly in mortgage loans.

15. The Reserve Bank has also taken a number of measures to address systemic risks arising out of interconnectedness in the financial system. These, *inter-alia* include -prudential limits on aggregate interbank liabilities and cross-holdings, restrictions on exposures to complex activities and products, monitoring of financial conglomerates, monitoring of common exposures (sensitive sectors), enhancing transparency and risk mitigation in OTC transactions through trade repositories and Central Counterparties (CCPs) and strengthening the regulatory and supervisory framework for non-banking financial entities.

16. When one speaks about the Indian banking system, the stressed assets issue comes to the fore. Undoubtedly, the problem of stressed assets in the banking system in India in general and the public sector banks in particular, is a matter of serious concern. The asset quality review undertaken in 2015-16 enabled a proper recognition of the stress in the banks' balance sheet and now we are in the process of providing for them adequately. As my colleague Dr Viral Acharya has pointed out in his recent lecture[2], there is strong evidence of high correlation between bank balance sheet strength and credit growth. The impact of the weak balance sheet of the PSBs is very evident in the form of considerably lower growth in credit as compared to private sector banks and foreign banks. We are examining various ways of strengthening the capital of PSBs so that they are able to increase their lending and thus, support economic growth. Apart from the correlation that Dr Acharya referred to, I believe that strong balance sheet also enables the bank to deal better with stressed assets. Capital constraints, apart from other factors, lead to delay in recognition of stress or sub-optimal re-structuring rather than initiating timely action that might provide better value to the banking system and economy in general. This is because, ever-greening, unviable re-structuring often postpones the right solution and attenuates the problem. In this context, provisioning system akin to global standards based on expected loss model, would be a way forward.

We do see a major push towards resolution of the large stressed assets through their reference under the Insolvency and Bankruptcy Code (IBC). As you are

[2] Speech delivered at the 8th R K Memorial Lecture organised by the Indian Institute of Banking and Finance at Mumbai on September 7, 2017

already aware, under the additional powers given to the RBI, through amendment to the BR Act, we have in June 2017, directed banks to refer 12 cases under IBC and a few more thereafter. The 12 cases are under various stages under the National Company Law Tribunal (NCLT) and we believe a strong insolvency and bankruptcy code will improve the credit quality and lower the loss given default of the credit portfolio of banks. This may take some time but I am sure that going forward it will enable the banking system to be placed on a firmer footing with regard to their resilience in general and their readiness to lend further in particular.

In this context again, it is commented that the provisioning norms stipulated by the RBI for stressed assets or for cases referred under IBC is stiffer than required. Let me explain the logic for the provisioning requirement for cases referred under IBC. Normally cases that are referred under IBC are likely to be those which could not be restructured outside the IBC. The S4A, which is a scheme for restructuring of stressed assets, envisages the minimum sustainable debt to be 50 per cent. It is therefore only logical that provision made for cases referred under IBC is atleast 50 per cent. This is not to say that the reference to IBC would result in recovery of 50 per cent or less. Provisioning is for expected loss and banks can write back in case the recoveries are higher than what the provision envisaged. Moreover, the provisioning for NPAs by the banks in India needs to be substantially higher to be comparable with global practices in this regard.

Before I close, let me respond to a couple of issues that were flagged by the earlier speakers and I have not yet covered. There was a reference to the high interest rate charged by the bank and a suggestion of regulating the same. We must all agree that the days of regulator's specified interest rates are well behind us and any move in that direction including in the form of 'spreads' will be market unfriendly. However, what we are aiming at, is transparency in interest rate determination and proper transmission of Monetary Policy decisions. The move from Base Rate to Marginal Cost of Funds based Lending Rate (MCLR) was to avoid the average masking the marginal changes in the cost of funds. However, as pointed out in the 'Report of the Internal Study Group to Review the Working of the MCLR System', external benchmark as the basis of determining customers' interest rate has been suggested. This will make interest rate determination more transparent. Competition is the only way to ensure that the 'spreads' are reasonable. On this, as you are aware, Reserve Bank recently licenced two new Universal Banks and 10 Small Finance Banks (SFBs). We have also put the Universal bank licencing 'on tap'.

The second issue was with reference to financing for MSMEs. Here again, I would like to point out that the Reserve Bank has put in place an ecosystem that facilitate flow of credit to MSME sector and address their financial needs. The licensing of 10 SFBs with a mandate to have 50 per cent of their loans to be of the ticket size of ₹25 lakhs and priority sector lending (PSL) target of 75 per cent. The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), the specific instructions for dealing with stressed assets of MSME sector, Trade Receivables Discounting System (TReDs), *etc.*, are all part of the 'MSME Finance' friendly ecosystem that I referred to.

Ladies and Gentlemen, I will close it here. As I began, financial stability is difficult to define. In an integrated economy, it is difficult to determine any one source of financial instability. After the global crisis, the standard setting bodies moved towards creating a strong financial system in general and banking system in particular. Since the financial system in India is dominated by banks, I have focussed on the global regulatory framework for banking system in general and how we have implemented it in India. A strong banking system will have the resilience to withstand financial instability arising from other channels. Moreover, the banks need to be strong so that they themselves are not the source of financial instability. The regulations provide the banking system with antigens to keep them strong and resilient so that they are not weak themselves and also are able to withstand financial instability arising from other parts of the economy. We, in the Reserve Bank, always work towards creating such a banking system through our regulatory and supervisory framework.

Thank you.