Financial Stability – Issues and Concerns :

Are We Barking up All Right Trees?

It's indeed a pleasure to inaugurate this Conference on 'Financial stability, credit distress and Economic Growth: The way forward' organized under the aegis of the Union Bank – Great Lakes Center for Excellence in Banking and Finance. I am happy to note that this is a collaborative effort by banking and academic and research institutions. As I will explain, the selected topic of the conference is not just on an apt and very contemporary issue, it also needs theoretical explanation, well researched solutions for practical use by banks. Hence, coming together of the three types of entities is very welcome.

2. Financial stability objective is, as widely recognised and by very nature, fraught with complexity and challenges in terms of precision in definition, measurement, tools and achievement. Though an often quoted and widely used phrase, financial stability has, in contrast to price stability, been difficult to define or measure. From a macroprudential perspective, financial stability could be defined as a situation in which the financial sector provides critical services to the real economy without any discontinuity. However, this cannot be quantified for measurement purposes.

Inaugural Speech delivered by Shri R. Gandhi, Deputy Governor at the 6th Annual Great Lakes – Union Bank Financial Conference on Feb 5, 2016 at Great Lakes Institute of Management, Chennai. Assistance provided by Shri R. Gurumurthy is gratefully acknowledged.

3. As regulators we are expected to indicate and also address the important systemic risk areas, preferably before they materialise, and in a world environment defined by an ever increasing degree of uncertainty, this task continues to get more arduous. While it is important to 'bark up' (or shout from the rooftops) about the systemic risks which, in the opinion of the regulators, are the most significant and more probable, at a given point in time, the regulators cannot afford to miss the woods for the trees. Effective regulation thus aims at understanding and guarding against the big risks, going beyond mere compliance with increasingly detailed and complex rules.

4. With this short introduction to the topic, let me set the tone for a post lecture brainstorming amongst you with a few broad themes that I think, underlie the ultimate purpose of my speech.

Financial Stability: A Dynamic Stability

5. The first one is to revisit the very purpose of the financial system amidst an existential angst (anxiety). The global financial crisis had brought in paradigm shifts in many areas viz., regulation, governance and mind-set, amongst others…all in pursuance of a sustainable financial system and a system that should be sub-serving the real sector rather than self-serving. I am not sure whether we are done with the post crisis learning curve or are still somewhere on it.

6. The second issue that comes to my mind is the need to bring a perspective to the concept of stability – stability which is dynamic and not static. One may wonder if 'dynamic stability' is an oxymoron, but a peep

into the heavens would tell us that it is not, as our own solar system and the planets are in a state of dynamic stability. On the other hand, the reason why I bring the concept of dynamic stability into the discussion is that we should not tend to view financial stability as an issue of importance only in post crisis periods; instead it should be imbibed as a discipline by itself. Besides, we can't ignore Minsky's famous words of wisdom – "stability creates its own instability". The best evidence for this comes from the days of great moderation, during which period, growth and inflation in the developed world became less volatile, interest rates were low resulting in search for yield and development of structured financial products starting with securitisation - without concern for financial stability; at least it appears so in hindsight.

Regulation vs innovation

7. The global financial crisis also brought into the fore the conflicts between regulation and innovation. The reason why we, the regulators, faced the flak for the crisis was that we were perceived to be too inadequate to understand and address the excesses committed by an industry in the name of innovation. While it is necessary to align the policy environment and innovation strategies with the available regulatory capacity, the latter needs to be upgraded to match the natural course of economic development. Sometimes necessary innovations won't even take off due to the policy making process getting influenced by paradoxes of innovative endeavours such as "success failure paradox" and/or "feedback rigidity paradox". Financial market innovations commensurate with the economic development and the needs of the real sector, if ignored, can push crucial markets outside the system and hence away from the reach of

domestic regulations. Innovation also will not take off in the absence of a supportive culture, understanding and adequate resources to carry it forward. While regulation can provide an enabling environment, it is for the market participants to exploit the opportunities provided, but they have to play the game as per the rules.

Bank Capital Regulations – The efficiency-redundancy paradigm

8. Let me now turn to some specifics. Being a banking regulator and also given the fact that our financial system is a bank dominated one, my focus will be largely on the banking sector, barring some generalisations panning the entire financial system. The evolving bank capital regulations have been more guided by the fact that financial institutions in the developed world ventured into risky innovations with the help of excessive leverage and an ex-ante insufficient capital. The process of re-regulation went through the global standards setting mechanisms, primarily under the Basel Committee and Financial Stability Board. The result is that we got into an 'efficiency-redundancy trade-off' debate which is all the more relevant to jurisdictions that are much less complex and are wanting financial inclusion and deepening. While it is important for the Emerging Markets and Developing Economies (EMDEs) to learn from the mistakes of others, we probably need much simpler regulatory approaches given our not so complex financial systems and also in view of the need to expand and extend the coverage and reach of financial services, given our much underpenetrated financial services industry.

9. Moving ahead to other pertinent issues in this regard, if we are dealing with a capital intensive industry that is overburdened with compliance, there is a danger of unwittingly setting strong entry barriers,

encouraging misallocation of resources and distorting incentive structures as well as pricing of financial products.

10. Closer on the heels of efficiency-redundancy trade-off, we have the safety-efficiency trade-off, the manifestation of which can be seen in the public-private sector bank paradigm in India. In terms of public perception, the public sector banks (PSBs) with the implicit government support, are considered to be relatively immune to destabilising impacts. However, the same sense of safety evades PSBs when it comes to their valuations. This has an efficiency imperative - when judged by their returns on asset or capital employed.

11. With the Indian government thinking of new performance based norms for capital infusion, this disconnect is sought to be addressed. There may be a notion, albeit incorrect and incomplete, that, with the government deciding on performance based parameters for deciding upon which bank deserves fiscal support. The move to link budgetary capital allocation with performance needs to be seen as a serious attempt to convey the right signals to all banks to introspect and, if necessary, redefine their business strategies. In other words, in the long run, the new norms will be value enhancing for the public sector banks. One caveat though…that the frictions that hinder the performance PSBs need to be completely eliminated and they should be allowed to work on commercial principles even as the costs of social banking have to be provided for separately. If that is through budgetary support the government may be more than compensated through increased revenues from and valuations of PSBs.

Semantics of shadow banking

12. The role of the 'shadow banking system', defined as 'credit intermediation involving entities and activities outside the regular banking system', as a source of systemic risk was an important learning outcome of the global financial crisis. Its importance stemmed not only from its direct role in supplying credit or liquidity to the economy but also due to its interconnectedness with the more closely regulated banking system.

13. The motivation for regulatory reforms in the shadow banking space in developed economies, especially in the US, emanated from certain dilemmas that, on the one hand, there was a need to de-risk the overgrown complex banking industry which inevitably needs the presence of shadow banking entities to absorb those risks and the concerns over the role of shadow banking entities in consummating the financial crisis, on the other. For developing markets like India these concerns may not be fully valid, given the low penetration of banking services, much less complex financial markets and level of regulatory oversight exercised over non-banking financial companies (NBFCs). The Indian shadow banking system is relatively small and less complex. Besides, the question is how intense the regulatory stance can get, so as to keep the costs of regulation commensurate with the systemic impact that these entities can cause and to ensure that certain financial market activities do not move out of the regulatory perimeter.

14. However, according to the FSB methodology and classification, the size of the shadow banking sector in India is estimated to be around USD 190 billion, which is the 15th largest in the world. Among the BRICS, India

has the third largest shadow banking sector. This may at once be discomforting but it must be understood that the shades of shadow banking in India's relatively underdeveloped financial markets are different, and unlike other major jurisdictions, the concerns in this regard mainly relate to a large pool of unregulated small entities with varying activity profiles. Thus for us, it is more of a consumer protection issue rather than a systemic stability issue and we have been tackling the same.

Asset quality in banks

15. Is the current emphasis on asset quality of banks a little overstretched undermining other concerns? Asset quality is one of the parameters, that define the strength and resilience of the sector; other factors are soundness (capital adequacy), liquidity (liquid assets to total assets), profitability and efficiency (cost to income).

16. While administering the regulatory medicine, we must be discerning in dealing with asset quality deterioration that is caused by economic / business cycles and for reasons beyond the control of borrowers / entrepreneurs to service their loans from those arising out of wilful delinquencies or over-leveraging. When we are not able to recognise this distinction, the sanctity of official / regulatory 'forbearance' is undermined by analysts and investors.

17. In our own case, such forbearance in the form of restructured standard advances was granted to ameliorate the impact of worsening economic conditions. What must be appreciated is the fact that restructured advances were disclosed transparently, though we later understood that

there is an uncertainty in the markets in reading through these numbers and arriving at what exactly is the quantum of 'bad apples' in the banking sector basket. It is to put an end to such speculation about the asset quality issues, good governance required us to take the 'asset quality review' on a priority basis so that all stakeholders can clearly see the strength of the banks' balance sheets.

18. Resolving asset quality issues in PSBs also has become little urgent ahead of plans for capital augmentation under the new dispensation, if we take into account the behavioural dimension, as both lenders and borrowers tend to be drawn towards taking extreme positions between 'total risk aversion' and 'the temptation to take bigger gambles' in the face of potentially weaker balance sheets.

Issues beyond Asset Quality

19. We need also to look at issues other than the quality of assets in banks, that include autonomy to take commercial decisions to governance structures, especially where the board level responsibilities should go beyond 'box-ticking' and that the so called 'grey' or 'independent' directors are truly 'independent'.

20. How to improve the liquidity of banks' assets – both loans and investments? For the securitisation markets to develop we need to improve the quality of loan origination, which solely depends upon 'ownership of decisions' relating to loan origination. Directed lending in whatever form and outsourcing the loan appraisal function dilutes the concept of owning up this crucial decision and hence impacts effective monitoring and asset

quality while those who have outsourced the loan appraisal have no commitment to the quality of the loan. Coming to investments, how do we convert a 'directed investment' portfolio of government securities into a liquid and desirable part of the asset portfolio aligning the same with the new Liquidity Coverage Ratio (LCR) norms while making way for an effective yield curve off which corporate bonds and loans can be priced out and also aiding better monetary policy transmission.

Debt Overhang

21. Let me turn to the issue of debt and financial leverage in general and in particular the corporate leverage in the post crisis context. Businesses all over the world were impacted in general due to demand slump. Indian companies too have been hit given the fact that they went ahead with their expansion plans before the crisis, unaware of what was unfolding. In the developed economies, the ultra-easy monetary policy measures, which also had a quasi-fiscal side to them, provided an outlet for the liquidity of the corporate bonds – either directly through purchase of corporate paper or through the massive purchases of government and agency bonds in turn providing liquidity to the corporate bonds thanks to 'search for yield' strategies. This was besides the corporate bailouts, like the auto industry in the US. Leverage in its extension can be debt overhang. Interesting though is the larger issue that jurisdictions where interest rates are negative or close to zero, the concept of "debt overhang" becomes meaningless, rendering high debt-to-GDP economies and their highly leveraged corporate solvent, which otherwise are not. We do however recognise the risks that reckless corporate leverage poses to the financial system and the

systemic stability, but the issue needs to be tackled with solutions and timelines that are non-disruptive.

Looking for the triggers

22. That brings us to the point that the triggers of financial instability can lie outside the financial system and our illustrative list of "macro prudential factors and tools" can still be insufficient. Working for financial stability is all about capturing "uncertainty". While financial models and stress testing methodologies are some of the tools that help us in dealing with the issue, they are based on observable market parameters. Oftentimes, the problem arises through the so called "illusion of knowledge" (Barber and Odean / 2001) – tendency to make stronger inference than warranted by the data. The difficulty comes when we have to overlay qualitative factors that have a bearing on financial stability. For instance we cannot always insist on empirical evidence to act upon an early warning. Even when early warning indicators are based on data, such indicators may be contradicting other financial indicators. If we can go back to the domino theory – We are dealing with a similar situation in financial markets. Triggers for the domino effect, latent in normal times become potentially destructive during crisis. The challenge is to search for the possible triggers which can initiate a damaging chain reaction.

Communication challenges and financial stability

23. The role of communication becomes even more challenging in the context of financial stability. There could be occasions, once in a while, when we may have to deal with certain non-events – non-events for the financial stability or otherwise. In our own case, even as we plan to move

over to the IFRS, there could be changes in the capital requirements to provisions, though nothing might have changed apparently on the ground. Announcing the results of stress tests of financial institutions, while desirable for the sake of greater degree of transparency, is fraught with the risks of wrong interpretation and inference. For example, a revision in methodology or shift to a revised series of GDP numbers or a shift in the policy stance to look at CPI instead of WPI, can throw up differences in the stress test results. The individual impacts of "announcement effects" may have separate ways of dealing with. Sometimes, it would become difficult to convince the public in general, having decided to place the stress test results in the public domain that they talk about extreme events and not something that is going to happen tomorrow or to comfort the public that stress test results are not meant to be predictive.

Concluding Remarks

24. Having spoken my own mind on certain issues and concern in the pursuit of financial stability, let me conclude on a cautious note. The best of the macro prudential policies may fall short when it comes to addressing a serious crisis. Future crisis may still evade all our efforts to foresee it. Future crises also may not replicate any of the past ones, hence history might not always be of help. Complacency may slowly set in even as our memories of the bad times are gradually fading away. But, the challenge is how do we establish an implementable framework to deal with the emerging systemic risks at their incipient stages? I hope at the end of this Conference you may come out with refined solutions to some of the challenges that lie ahead of us.

25. Thank you all for your patient attention.

&&&&&&&&&&&