

*Emerging Challenges to Financial Stability**

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It is indeed a matter of great pleasure for me to be here today amidst the business and financial sector leaders. My compliments go to the partners, namely, the Indian Banks' Association, Federation of Indian Chambers of Commerce and Industry (FICCI) and the Boston Consulting Group for spearheading this event. What really gives me the additional motivation to address you is the earnestness with which you have themed this year's conference, showing your appreciation of the need to prepare ourselves for a new paradigm in banking. The happenings of the past, especially the not so remote ones, have generated an attitude towards the financial sector that ranges from an existential angst to a more positive outlook that hinges on the opportunities beckoning at us. I would like to believe that solutions to a better future lie in unlearning from the practices which led to that angst and in relearning to benefit ourselves in the changing financial landscape. Prudent governance and emerging trends in the digital space have the potential to reshape the way we perceive finance. Against these broad underpinnings, let me present my thoughts highlighting emerging challenges to financial stability. This would be the theme of my address to this august gathering.

A consensus on the definition of the term financial stability remains elusive even today. Broadly speaking, the core principles governing financial stability can be thought of in terms of a financial system's ability to facilitate efficient allocation of economic resources; its effectiveness in assessing, pricing, and managing financial risks; and in maintaining its capability to perform these key

* Shaktikanta Das, Governor, Reserve Bank of India, at FIBAC 2019 – the Annual Global Banking Conference organised by Indian Banks' Association (IBA) and Federation of Indian Chambers of Commerce and Industry (FICCI) in Mumbai on August 19, 2019.

functions even when affected by external shocks. In other words, as one IMF research paper of 2004 puts it, *a financial system is in a range of stability whenever it is capable of facilitating the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events*¹.

The Global Context

The global approach to financial stability changed significantly after the financial crisis of 2008 which made it abundantly clear that financial strength of every financial institution does not add up to systemic stability. The policy makers realised that micro-prudential regulations have to be complemented with systemic risk measures; otherwise systemic stability could be at risk.

Ten years after the crisis, the major financial sector reforms, called for by the G20 and co-ordinated by the Bank for International Settlements (BIS) and Financial Stability Board (FSB), are now mostly in place. Large banks are better capitalised, less leveraged and more liquid. The banking system is, therefore, more resilient to economic shocks. Implementation of Too-Big-To-Fail (TBTF) reforms is advancing, including *via* the establishment of effective resolution regimes for banks. Over-the-counter (OTC) derivatives markets have been made simpler and more transparent. The use of central clearing has increased, and collateralisation is more widespread. Those aspects of non-bank financial intermediation that contributed to the financial crisis have declined. However, the implementation of reforms is not yet complete and remains uneven, especially in the non-banking space. It goes without saying that while dealing with all these issues, country specific situations have to be factored in.

Recent developments in the global economy should be seen in this perspective. A weaker than expected growth with signs of slowdown in major economies, as projected by multilateral institutions

¹ Garry, J. S. (2004). 'Defining Financial Stability'. *IMF Working Paper*, 2004: WP/04/187.

like the International Monetary Fund (IMF), is one of the key risks to global financial stability at this juncture. Looming trade-tensions, geo-political risks, and related uncertainties continue to exert pressure on the investment outlook. The latest Global Financial Stability Report (GFSR) by the IMF warns that because of these developments, vulnerabilities in the sovereign, corporate, and non-bank financial sectors are elevated by historical standards in several systemically important countries and regions. Under these circumstances, central banks and other regulators are required to follow the cardinal principle – the regulator never sleeps. Cutting the hyperbole out, what it means is that the regulators and other authorities need to be constantly vigilant and proactively take whatever steps that are necessary.

The current state of the global banking sector also presents a story of uncertainty. While bank capitalisation has increased significantly in the post-crisis period primarily due to Basel III reforms, bank profitability has been lacklustre. Both macroeconomic and bank-specific factors have contributed to this phenomenon. Importantly, banks are also facing increasing competition from non-traditional players, such as FinTech and BigTechs, which are taking advantage of digital innovation. These developments have implications for financial stability in Emerging Market Economies (EMEs) like India. It is indeed imperative that banks capitalise on these technological advances and the associated business models. Regulators on their part also need to provide enabling frameworks for these endeavours by banks as well as the non-traditional players.

The Indian Scenario

The pursuit of financial stability has always been a policy priority in India. The twin concerns of monetary and financial stability constitute the core objectives of the Reserve Bank. Similar to the global case, India also responded to the crisis by introducing changes in the existing institutional architecture to further the cause of financial stability. Recognising the various channels that could lead

to systemic instability and the fact that different segments of financial systems are regulated by different regulators, the institutional mechanisms of the Financial Stability Development Council (FSDC), under the Chairmanship of the Finance Minister, and the FSDC sub-committee, under the chairmanship of Governor, Reserve Bank, have been fully functional. The biannual Financial Stability Report (FSR), a report of FSDC sub-committee, analyses the current state of financial system, the extent of interconnectedness among its various segments and possible sources of vulnerabilities that could impact domestic financial stability.

The headwinds to financial stability could emanate from various sectors of the economy, namely, (i) the credit market; (ii) financial markets; (iii) external sector; and (iv) payment system. It may emanate from some other sources as well. But today, I will focus on these four aspects.

Headwinds from Banking Sector

In India, the credit market is dominated by the banking sector which plays a key role in financial intermediation in the economy. Soundness of the banking system may have a bearing on the financial stability through various channels - excessive credit growth; maturity mismatches and liquidity issues; high proportion of non-performing loans; and overleveraging, among others. Even if individual institutions are robust, the overall behaviour of the financial sector can pose a systemic risk. Hence, monitoring the health of the banking sector is crucial for financial stability.

In recent years, as a result of efforts by both the Reserve Bank and the Government, the overhang of stressed assets in the banking system has declined. Going forward, the macro-stress tests for credit risk conducted by the Reserve Bank indicate that under the baseline scenario, the GNPA ratio may decline further by March 2020². Other indicators like the provision coverage ratio (PCR), capital adequacy

² Financial Stability Report, June 2019, Reserve Bank of India.

and return on assets have also improved. I have earlier stressed that the real test of performance, efficiency, internal stability and governance improvement in public sector banks (PSBs) would be their ability to access capital markets rather than looking at the Government as a recapitaliser of first and last resort.

Despite certain teething problems, the Insolvency and Bankruptcy Code (IBC) is proving to be a game changer. New norms for resolution of stressed assets framed in June 2019 by the Reserve Bank provide incentives for early resolution, with discretion to lenders on resolution processes. The objective is to ring-fence future build-ups of Non-performing Asset (NPA) stress and protect the banking sector. The recent amendments to the IBC should also be able to facilitate faster resolution of stressed assets.

As we have seen in the recent past, the build-up of risks among regulated entities due to interconnectedness, exposure concentrations, non-transparent market practices, governance deficiencies, and their contagion effects have repercussions for financial stability. In this regard, the Reserve Bank is keeping a close watch on the interconnectedness of banks and non-banks. The Working Group on Core Investment Companies (CICs) has already started its deliberations and based on its recommendations, the Reserve Bank proposes to carry out necessary changes in the regulatory architecture for CICs. We are also in the process of building a specialised regulatory and supervisory cadre for regulation and supervision of banks and non-banks.

Another important issue in this context is the immediate need to strengthen corporate governance structure in banks, which I have elaborated earlier as well. This would include efficient functioning of their boards and board sub-committees, especially audit and risk management committees; robust system for monitoring of performance of MDs/CEOs; and, an effective performance evaluation system to improve the financial and operating parameters

of banks. We have already sent our suggestions to the Government for governance reforms in Public Sector Banks (PSBs). Overall, it is important that risk management systems, compliance functions, and internal control mechanisms are strengthened and made more dynamic.

Non-Banking Sector

Coming to the Non Banking Financial Company (NBFC) sector, we all know that this sector complements the banking sector and aspires to act as the bridge to provide last mile connectivity. Further, niche NBFCs fulfil the unmet and exclusive credit needs of infrastructure, factoring, leasing and other such activities. Non-traditional and digital players are now entering this space to deliver financial services by way of innovative methods involving digital platform. There is a web of inter-linkages of the NBFC sector with the banking sector, capital market and other financial sector entities. The Reserve Bank keeps a close watch on these inter-linkages to ensure financial stability. With a view to strengthen the sector, maintain stability and avoid regulatory arbitrage, the Reserve Bank and the Government have been proactively taking necessary regulatory and supervisory steps. It is our endeavour to have an optimal level of regulation and supervision so that the NBFC sector is financially resilient and robust. We will not hesitate to take whatever steps are required to maintain financial stability in the short, medium and the long-term.

Our objective is to harmonise the liquidity norms between banks and NBFCs, taking into account their unique business models. We are also looking at governance and risk management structures in NBFCs. Recently in May 2019, NBFCs with a size of more than ₹5,000 crores have been advised to appoint a functionally independent Chief Risk Officer (CRO) with clearly specified role and responsibilities. This is expected to bring in professional risk management to the working of large NBFCs.

The move to bring Housing Finance Companies (HFCs) under the regulatory ambit of the Reserve

Bank is significant, given their asset-liability profiles. Including HFCs, the size of the NBFC sector constitutes about 25 per cent of combined balance sheet of scheduled commercial banks. The Reserve Bank will take necessary measures to deal with these challenges.

Headwinds from Financial Markets

Apart from banks and non-banks, headwinds to financial stability can also originate from financial markets. The increasing frequency and severity of currency and debt crises globally and their ability to cause output loss calls for careful regulation and surveillance of financial markets. Globalisation of finance, by amplifying the risk of contagion, and thereby constraining the policy space for effective regulation, has added to the difficulty of this task. As a regulator of various market segments such as money markets, government securities, forex and interest rate derivatives, the Reserve Bank has followed calibrated, sequenced and careful approach to develop and integrate these markets. The broad objective has been to keep pace with the requirements of fast-growing Indian economy, while being vigilant of potential risks to financial stability. This is done through freeing up market forces by moving away from prescriptive to principle-based regulation, whose core features are simplification of processes, encouraging product innovation, removing regulatory differentiation across participant categories and ensuring protection for retail market participants.

Let me give one example. Recently, we have permitted the creation of an electronic platform on which one can buy or sell foreign currency at market rates. This platform is accessible over the Internet and the customers can get the best market price without having to approach any individual bank/broker. This is how FinTech can be used to inject greater efficiency to financial markets.

As financial markets are opening up, stability concerns are addressed through capital flow control measures (e.g., the overall cap on foreign investment in the debt market) or macro-prudential measures

(e.g., cap on total external borrowing as a percentage of Gross Domestic Product).

Adoption of global best practices to improve market integrity is another important aspect of regulation. In the last couple of years, the Legal Entity Identifier (LEI) system has been implemented in a phased manner in all financial markets, including derivative markets regulated by the Reserve Bank, as well as for bank loans. We believe transparency of financial markets will greatly improve once the LEI system is used widely. The recent regulations to control market abuse, upgrade the benchmark setting process are all consistent with global standards.

A key feature of regulation of derivative markets has been the differential treatment of professional and non-expert clients. Moreover, differential access to derivative markets is being gradually removed. Anyone - resident or non-resident - can now access these markets for hedging on similar terms. In fact, alignment of incentives for non-residents to gradually move to the domestic market is an important regulatory aim. As you would be aware, the Task Force on Offshore Rupee Markets with Mrs. Usha Thorat, former Deputy Governor as chairperson, has made important recommendations that are likely to improve participation of non-residents in the onshore market. Our aim is to make the onshore market more accessible and attract higher transaction volumes.

External Headwinds and Domestic Financial Stability

With increased trade and financial linkages with rest of the world, India has become more susceptible to the vagaries of heightened global economic uncertainties. While trade channels take some time to show a tangible impact of global shocks, it is the financial and confidence channels that quickly transmit the global shocks as was evident in the case of India during the taper tantrum period in mid-2013. In fact with negative and low interest rates in major economies, net private capital flows to EMEs in the form of direct and portfolio investments have nearly doubled in the post-crisis period. However,

with high monetary policy uncertainties in advanced economies, these flows have proved to be fluid and therefore posed considerable risk to EMEs. Just a year back, EMEs like India faced financial market turbulence due to a faster-than-expected tightening in monetary policies in advanced economies. Many EMEs including India witnessed portfolio capital outflows, exerting downward pressure on domestic currencies.

In recent years, India's external sector has benefited from a sustainable level of current account deficit, largely financed by robust foreign direct investment inflows and flexible exchange rate policy. Improvement in other vulnerability indicators during 2018-19 such as fall in external debt to GDP ratio (from 20.1 per cent at end-March 2018 to 19.7 per cent at end-March 2019) and debt service ratio (from 7.5 per cent at end-March 2018 to 6.4 per cent at end-March 2019) also augur well for mitigating the spill over of external headwinds on the domestic financial markets. Notwithstanding strong macroeconomic parameters, constantly changing dynamics of external headwinds warrant policy preparedness in order to minimise spill overs of global shocks and preserve financial stability. As a supplementary safeguard, the Reserve Bank has signed a bilateral currency swap agreement with the Bank of Japan for US\$ 75 billion with the objective of bringing greater stability in foreign exchange and capital markets in the country.

Payment System and Financial Stability

A number of innovations have taken place in retail payments which have reshaped payment processes and changed the retail payments landscape. India's payment systems are considered to be efficient, safe and secure. While acknowledging this and without trying to be complacent, the Reserve Bank has made an attempt to benchmark domestic payment systems and practices with those prevalent in prominent countries worldwide. The assessment of various indicators including regulation and oversight suggests that India has a strong and robust regulatory structure.

However, new entrants into the financial services space, including FinTech and BigTech firms are altering the universe of financial service providers. A range of new lending platforms, including P2P and marketplace lenders, have appeared in jurisdictions around the world. Highlighting some of the related challenges and opportunities, the recent Annual Economic Report of the Bank for International Settlements (BIS) states that such firms can collect large amount of data at nearly zero costs, which can be used to better assess the riskiness of borrowers and could reduce the need for collateral to assure repayment. These new players have also made inroads in the provision of payment services, remittance services and cross-border payments. Moreover, they have the potential to grow very quickly and become large and systemically important financial institutions, raising concerns over financial stability and consumer protection.

Faced with such profound changes, the policy makers' dilemma is more than walking the middle path between innovation and regulation. The public policy approach here needs to be more comprehensive and holistic, taking into account issues such as financial regulation, competition policy and data privacy regulation. Coordination among various authorities – such as financial regulators, competition authorities and data protection supervisors – becomes critical at this juncture.

The Reserve Bank's Vision-2021 for Payment and Settlement Systems in India visualises empowering every Indian with access to a bouquet of e-payment options that is safe, secure, convenient, quick and affordable. The Committee on Deepening of Digital Payments under the chairmanship of Shri Nandan Nilekani has suggested to increase the volume of digital payments by 10 times in the next three years which can be facilitated by initiatives such as removing transaction charges on digital payments, simplifying Know Your Customer (KYC) processes, and reducing KYC costs for banks. The Reserve Bank is taking necessary action based on the committee's recommendations.

Concluding Observations

At the end, I would like to highlight the significance of consumer protection which is not only important from the point of view of access but also from a broader context of stakeholders' trust. The trust of the consumers that the services are fairly priced, the trust of the investors that the stakeholders are acting in their best collective interest, the trust of the regulators that the audited financial statements do represent a fair and reasonable assessment of the activities of a firm – all have intangible but substantial contribution to national savings and financial stability. Post Lehman developments in the US financial markets are a prime and sobering

example of what happens when investor trust evaporates. In fact, consumer protection should be seen as a key pivot around which all regulatory and supervisory initiatives are required to evolve.

Let me conclude by saying that much progress has been made in maintaining a stable financial system. However, as we have seen, the financial landscape is continuously changing, and new challenges are emerging. The Reserve Bank is continuously harnessing the regulatory and supervisory framework to better adapt to the evolving scenario. The IBA, its members and other stakeholders should, therefore, be active partners in ensuring that such a process evolves successfully.