*Financial Regulatory Reforms: Not far enough or Overkill?**

Anand Sinha

A very good afternoon to you all. It is my privilege to chair the panel on '*Financial Regulatory Reforms: Not far enough or Overkill?*' Let me welcome the four very eminent panelists, Mr. Jae-ha Park, Deputy Dean ADBI; Mr. Stephen Pickford, Associate Fellow, Chatham House; Mr. Paul Bernd Spahn, Professor Emeritus of Goethe University, Frankfurt am Main, Germany and Ms. Susan Thomas, Assistant Professor, Indira Gandhi Institute of Development Research.

2. The topic of the panel discussion is a subject of heated debate around the globe and I hope our discussions today would help set a balanced perspective on the issue involved.

3. Let me first try and flag the major issues and present both sides of the argument, without expressing my views at this stage.

4. Regulatory reforms undertaken as a policy response to the crisis have generated as serious a debate as the crisis itself. The crisis is still continuing and is unprecedented in terms of its coverage, impact and longevity. The policy response to the crisis, too, has been quite extensive and as some would say, onerous. Going by the Newton's third law of motion (*every action has an equal and opposite reaction*), it is fair to expect that reaction (policy response to the crisis) matches action (the crisis), in magnitude. Many, however, hold the view that this law has been violated inasmuch as the policy reaction is a case of overkill.

5. The crisis has highlighted many gaps in the conceptual framework. Some of the gaps are: the notion that macroeconomic stability ensures financial stability; light touch regulation and supervision are adequate because financial markets are sophisticated and efficient, which can distribute risks to those who can handle these risks; risk models measure risk accurately and all financial innovations are useful, *etc.* Serious gaps have also emerged in macroeconomic modelling and, above all, in the understanding or lack of understanding of systemic risk and how to deal with it. The crisis has challenged the intellectual foundations of macroeconomic and financial policy making. New theories have been written debunking the old ones and new regulatory framework is being put in place to make the financial system more resilient. The redesigned regulatory framework encompasses measures such as enhancing the quality and quantity of capital to be maintained by banks, reducing leverage, enhancing risk coverage, stipulating liquidity ratios, maintenance of countercyclical capital buffers *etc.* More importantly, the recognition of the role of systemic risk and the importance of financial stability are the major lessons learnt from the crisis.

6. The new regulatory framework, inasmuch as it requires higher quantum of higher quality capital and liquidity buffers leading to reduced leverage, has raised intense debate over the impact they could have on the economic growth and the profitability of banks. It is argued that the increased capital requirements would impinge on the profitability of banks, forcing them to either increase their lending rates to maintain their margins or cut down on lending to preserve their capital base, both of which may have a large negative impact on economic growth. The proposed restrictions on activities permitted to be undertaken by banks and the ring fencing of certain banking activities have also led to concerns in some quarters. The prohibition under the Dodd Frank Act on proprietary trading by US banks, bank holding companies and their affiliates, despite certain carve outs has, particularly, caused discomfort from the perspective of its negative impact on market liquidity and its cross border implications.

7. On the other hand, many feel that these regulations are necessary to preserve systemic stability

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and to ensure long term growth. The crisis has wreaked havoc on the global economy with significant economic and social costs. To strengthen the financial system and enhance the systemic stability with a view to minimising the incidence of such crises in future, it is argued that stronger regulation is necessary. The proponents of stronger regulation argue that the benefits of financial stability would outweigh the costs of regulation and, therefore, there is a good reason for revamping the regulatory framework. The debate is still inconclusive and the judgement on whether these regulations are a necessity or a case of overkill is broadly dependent on which side of the fence you are on *i.e.,* whether you are a regulator or associated with a regulated financial sector entity. There are, of course, many others not in either of the two categories who hold strong views. While even the critics broadly agree on the idea that regulations need a revamp, the critical question remains, how much regulation is adequate? At what point the regulations start having diminishing returns – regulatory costs outweighing benefits? And whether the regulation which is global in scope caters to the local needs of specific jurisdictions?

8. Let me, in addition to some of the concerns mentioned earlier, highlight a few other issues:

i. The redesigning of regulations, distilling the lessons taught by crisis, has been an enormous task for the policy makers. While a significant amount of work is already done, work relating to some critical areas is still in progress, such as – framework for forward looking provisioning, management of liquidity risk, cross border resolution mechanism and oversight and surveillance of the shadow banking system, *etc.*

ii. Some parts of the new regulations, despite having recently designed framework, need more clarity. For example, there are currently no readily available and widely accepted metrics of systemic risk to help calibrate instruments or gauge policy performance, even ex post, with much precision[1]. The transmission mechanism of macroprudential policies need to be better understood and modelled. Similarly, interaction between liquidity coverage ratio (LCR) and monetary policy is an area which is still being examined. The likely asymmetrical effect of macroprudential policies during the upturn and downturn phases of the economy, and fine tuning of communication by central banks or designated macroprudential regulators on macroprudential issues and policies are other areas requiring focussed attention. The possible role of monetary policy in leaning against the credit cycles is being researched and debated and it may be a while before a clear direction emerges.

iii. As regards implementation of new regulations, many questions linger– Is it the right time to implement, especially when the global economy is slowing, as the new regulations require higher quantum of capital which would not only be difficult to raise but may also have an adverse impact over global growth due to deleveraging and higher lending costs? Are all Basel Committee members in adequate state of preparedness to implement the Basel III framework in time and in full compliance with the framework?

iv. Another concern voiced by many is the possible impact the new regulations may have on Emerging and Developing Economies (EDEs) which, did not contribute to the crisis. EDEs require growth and the new regulations, in their pursuit of stability over growth, may impinge upon their growth at least in the short term. The opinion often expressed, therefore, is that these regulations are an unnecessary burden on EDEs.

9. Today's panel discussion on '*Financial Regulatory Reforms: Not far enough, or overkill*' is quite apt in scope and timing. I am sure we are going to have an enlightening discussion on the adequacy and impact of the regulatory reforms. The eminent panelists would present their views on the subject followed by Q & A.

Now, over to the panelists…

[1] Caruana, Jaime, (Sept 2012), *'Dealing with financial systemic risk: the contribution of macroprudential policies'*.