

Systemic Risk

FSLRC Research Team

Financial Sector Legislative Reforms Commission

July 22, 2013

Introduction - what is systemic risk?

Using the BIS - IMF - FSB definition:

“Systemic risk is a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.”

- The essence of systemic risk oversight is to see *the woods and not the trees*.
- It is not about looking at one firm at a time or one sector at a time: it is about seeing the *entire* financial system.

Some examples of systemic crises

Vulnerability of core exchange infrastructure BSE, CSE crises, rooted in ownership/governance of exchanges.

A SIFI that's too big to resolve A domino effect can kick off when it fails.

Failures of key markets London money market: rooted in counterparty exposure through OTC contracting.

Gujarat and cooperative banks Households are unconfident in all cooperative banks when one large cooperative bank goes bust, and these cooperative banks all have money deposited with each other.

Possible terrorist attack on NSE/NSDL

The 2008 financial crisis Lehman failure, London money market choked, led to trouble in India with some banks and with many mutual fund schemes, likely role of Indian MNCs.

Framework of systemic risk oversight

Since systemic risk oversight requires monitoring of the entire financial system, the agency charged with this responsibility must:

- Foster the stability and resilience of the financial system by identifying, monitoring and mitigating systemic risk
- Improve co-ordination between multiple regulatory agencies
- identify and reduce regulatory uncertainty (including regulatory arbitrage)
- Assist in the resolution of any crises

FSDC as the agency for systemic risk oversight

- The FSDC already has the mandate for maintaining financial stability
- A council of regulators, such as the FSDC is best placed to address systemic risk in the financial system
- The FSDC must be a statutory body
- It will have operational and financial autonomy
- It will be headquartered in Mumbai

Composition of the FSDC

- The chairperson of its board will be the Minister of Finance, Central Government
- Other members of the board will be the heads of the regulatory agencies, the chief executive of the resolution corporation and the chief executive of the FSDC
- There will be an administrative law member to fulfill the requirements of regulatory governance
- The FSDC will be served by an executive committee chaired by the regulator for banking and payments.
- There will also be a secretariat which will assist the board and the executive committee

Functions of systemic risk oversight

Systemic risk regulation is envisioned as a five-element process. The first four would be performed by the FSDC exclusively and the fifth would be carried out under the supervision of the Ministry of Finance, Central Government:

- Data, research and analysis
- Identification and designation of SIFIs, including conglomerates
- Formulation and implementation of system-wide measures for mitigation of systemic risk
- Inter-regulatory agency co-ordination
- Crisis management

Principles guiding the FSDC

- Performs actions proportionate to the benefits expected from those actions
- Ensures that its actions seek to reduce the potential for regulatory inconsistency
- Does not cause a significant adverse effect on the competitiveness or growth of the financial sector
- Acts in a transparent manner
- Be subject to the “Duty to explain” principle: Whenever there is a conflict between principles, the agency must explain the rationale for acting in contravention of a principle, subject to the caveat that the agency’s actions must always further its overall objective under the IFC

The Financial Data Management Centre

- The FDMC will work within the FSDC as the sole electronic system for the collection of data from financial entities for regulatory reporting and supervision
- All decisions on the nature of information to be collected will be entirely within the domain of individual regulatory agencies
- The FDMC staff will merely aggregate the data and provide access to the regulators.
- All vetting and review of such data will continue to be done by the individual regulators
- The FSDC would be empowered to enter into memoranda of understanding for increasing the ambit of a centralised data function

Function: Data analysis and research

- In performing this function, the FSDC must
 - Conduct analysis and research to develop indicators and instruments to monitor and mitigate systemic risk
 - Each policy initiative in the field of systemic risk should be associated with datacapture and post-mortem analysis
 - This research must achieve state of the art capability by world standards.
- Regular progress reports on the data analysis, and results of the research programme, should be disseminated to the public.

Function: SIFI Designation

- SIFIs are Systemically Important Financial Institutions
- The FSDC will agree on the methodology for identifying SIFIs, which will embrace global standards to the extent possible for the Indian financial system
- Using this methodology, the FSDC will identify SIFIs. The list of such institutions will be released into the public domain annually
- SIFIs will have the choice of appealing their designation
- This designation will be used by to exercise a higher standard of regulation and supervision on the SIFIs

Function: System-wide measures

- System-wide measures are applied to the entire financial system to address concerns such as systemic cyclicalities and leverage or lending levels in the financial system
- One such measure, the counter-cyclical capital buffer has been proposed for implementation by the FSDC
- This measure aims to target and address counter-cyclical capital variation
- The FSDC is tasked with doing research to identify other suitable system-wide measures for the Indian financial system

Function: Inter-regulatory co-ordination

- The FSDC will promote formal co-ordination mechanisms amongst regulatory agencies
- In doing so, it will also co-ordinate the conduct of systemic-risk monitoring functions
- The FSDC will facilitate the adoption of common standards and practices in rule-making and enforcement
- Further, the FSDC will co-ordinate with international organisations and multilateral bodies in conjunction with the Ministry of Finance
- The FSDC will also help resolve inter-regulatory agency disputes

Function: Crisis Management

- Despite the best efforts at avoiding systemic crises, there is a possibility that some crises may occur.
- Crisis management requires extraordinary co-operation between the various regulatory agencies
- During a crisis, the FSDC will:
 - Provide and conduct data analysis and research to seek to understand and resolve the crisis
 - Assist the regulators and members of the FSDC in their efforts to resolve the crisis
 - Discuss and assist in the implementation of extraordinary methods of resolution for certain entities, such as SIFIs, if required
 - Initiate an audit of all actions leading up to, and taken during, a crisis

Thank you