Shri Urjit Patel discussed various issues in the role of financial regulation in averting the next crisis. The issues include globalization and adherence to global rules/standards, financial regulation and suddenness of crisis incidence, backward-looking versus forward-looking risk-based supervision, too-big-to-fail (TBTF) and moral hazard, and adequacy of global financial safety nets (GFSNs) in the context of the size and speed of crises. Although, emerging market economies (EMEs) have benefited from globalisation, they are exposed to more vulnerabilities than before. With increase in globalization, it is important for financial systems to embrace global norms, especially on capital, risk recognition and accounting standards; monetary policy based on some rule relating to a nominal anchor such as inflation; fiscal policy based on a budget or expenditure rule; and market-based exchange rate regimes, complemented by strong and effective financial sector regulation and supervision, corporate governance and enforcement rules, and bankruptcy and resolution architecture.

This entails discipline and various widely accepted rules, specifically, monetary, fiscal and accounting. First, fiscal rules are institutionalized or legally binding rules that credibly commit authorities to fiscal discipline. Second is a transparent and predictable monetary policy framework. Third, while regulation is imposed from outside, corporate governance is internal to firms and is more in the nature of self-regulation with safeguards that principles and rules laid down by the regulations are followed conscientiously. Fourth, with globalization, operations of large firms have become transnational, and massive cross-border movement of capital requires adoption of uniform accounting standards, such as the International Financial Reporting Standards (IFRS).

In the context of financial stability, acceptable regulation ought to be predictable, should aim to shoehorn internal governance mechanisms of the regulated entities in an incentive compatible way, and should aim to address information asymmetry between the key stakeholders. Forward-looking regulations are required to tackle unforeseen risks as threats to financial stability may come from quarters that regulators are completely unaware of. On account of the advent of big data analytics, cloud computing and artificial intelligence, data can be used to model future events with certain confidence intervals, and regulations can be structured to deal with such events. The recent thrust is on two areas - cybersecurity and FinTech, also identified as major risks to the financial system.

The last financial crisis prompted doubts that the internal ratings based (IRB) approach may have been used opportunistically to minimize capital requirements, thus helping banks to disguise credit bubbles by keeping their risk weighted assets (RWAs) artificially low. The BCBS’s work on the implementation of the Basel capital framework has gathered evidence that significant variations in capital outcomes generated by internal models for portfolios with similar risk profiles may be unwarranted. Thus, there is a need to improve transparency and comparability across internal models to ensure that internal ratings are built and validated on the basis of a set of common standards. A reasonable degree of transparency and disclosure

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will help establish the credibility of the risk assessment models used currently by many large global banks.

There are concerns related to the implicit government guarantee for TBTF institutions. The TBTF status gives large banks a competitive edge and incentives to take on additional risks, and this in turn could drive smaller banks competing with them to take on further risks, exacerbating the riskiness of the entire financial system. Although, regulatory labelling of systemically important financial institutions/banks (SIFIs/SIBs) may convey the promise of implicit taxpayer-sponsored bailouts for uninsured deposits in case of insolvency, the possibility of SIFIs/SIBs taking additional risks to earn the additional returns on capital and thereby negating the role of additional capital can never be ruled out. Hence, the nature of supervisory oversight of SIFIs/SIBs ought to be a lot more intrusive relative to other financial institutions.

The quest for a robust, equitable and quickly deployable GFSN has remained elusive. As a consequence, EMEs have been buffering themselves by maintaining reserves and managing financial volatility through a combination of policy instruments, including a macro-prudential/capital flow management toolkit. Further, EMEs have resorted to building foreign exchange reserves to calm volatility in financial markets and to provide adequate liquidity buffers for sudden stop and reversals. Also, regional financial safety nets have emerged to complement the agenda of financial stability. However, in the post global financial crisis era, the GFSN has grown significantly with increased accumulation of reserves by countries, and increase in various bilateral and multilateral swap arrangements. Bilateral swap lines between central banks which expanded considerably during the crisis have further increased since then. Other regional financing arrangements (RFAs) that have emerged are Eurasian Fund for Stabilization and Development (EFSD), Arab Monetary Fund (AMF) and the Latin American Reserve Fund (FLAR).

There exists a threat to the modest defences that EMEs have been able to muster due to the stark asymmetry prevailing in the provision of swap lines by systemic central banks. The situation may be described as a virtual apartheid by which systemic central banks protect themselves and their self-interest, as a result EMEs that are at the receiving end of global financial turbulence are systematically denied access. Thus it is imperative to establish a broader swap network to enable EMEs to manage risks better and prevent them from assuming systemic proportions, thereby threatening global financial stability.

There has been considerable focus on macro-prudential measures (MPMs) in the recent period with well-established legitimacy. However, the same legitimacy for capital flow measures (CFMs) has not been universally accepted despite an explicit endorsement by the IMF for selective use of CFMs. Thus, soft capital account management becomes a necessity, thereby keeping external debt within practicable limits, and prudence regarding the external sector to strengthen financial and macroeconomic stability.

In conclusion, Shri Urjit R. Patel said that the challenge is to identify the next threats. Any regulation of the financial system should take a preemptive approach, and consider the potential fragility of banks alongside all other elements of the financial system. This would prevent regulatory arbitrage and help to ex-ante determine the supervisory guide rails/rules of the game for the system.

Source: www.rbi.org.in