

FINANCIAL REGULATORY REFORM

A mid-term reality check

The G20 financial reform agenda is no doubt ambitious. But, six years on, the outcome is mixed—work in progress at best, and a tale of progressive dilution at worst, on account of the putative incestuous relationship between the Treasury & Wall Street



ALOK SHEEL & MEETA GANGULY

LAX financial regulation and supervision took the major blame for the global financial crisis (GFC). This initiated the most far-reaching reform in advanced economies since the Great Depression under the watchful eyes of the G20, supplemented by national initiatives in major jurisdictions.

The G20 approach was comprehensive, logical and progressive, based on four pillars: agreeing new regulations, supervising their implementation across major jurisdictions to avoid regulatory arbitrage, formulating resolution mechanisms to avoid taxpayer bailouts in case systemically important financial institutions (SIFIs) failed, and periodically stress testing the new structure for robustness.

There is notable progress on the first pillar through the Basel III capital and liquidity standards for commercial banks focused on strengthening both the quantity and quality of capital, introducing new leverage and liquidity ratios, and improving risk management, governance, transparency and disclosure norms to insulate them from the activities of shadow banking that triggered the GFC.

To address the third pillar, the Financial Stability Board (FSB) released guidelines and a list of global SIFIs whom national regulators could subject to greater regulatory oversight. The Dodd-Frank Act (DFA) in the US put in place a framework to regulate any financial institution (FI) determined to be a SIFI and also for their orderly resolution, as required. On the fourth pillar, the FSB has moved to strengthen the Financial System Assessment Programme of the IMF and stress tests are now routinely used by national regulators. The progress on the second pillar is, however, patchy.

Basel III

The quick international consensus on the new Basel III norms is remarkable,

notwithstanding criticism from both sides of the ideological spectrum. Intense lobbying to dilute Basel III stringency is backed by the argument that since the economy is struggling to get back to its feet, the aggressive regulatory push would only damage the recovery through accelerated deleveraging. The quick rebound of shadow banking to pre-crisis levels is also linked to the stringency of Basel III.

Critics of Basel III have emphasised on some additional concerns. First, it is ironic that although the source of the GFC lay in shadow banking, it is commercial banking that has been fixed while regulation of shadow banking remains work in progress.

Second, Basel III continues to aid pro-cyclicality through the principle of mark-to-market (MTM), notwithstanding an element of counter-cyclicality introduced through revised ratios.

Third, although financial risk, asset inflation, bubbles and leverage are all correlated, Basel III does little to prevent build-up of leverage in the financial system. It does endeavour to disincentivise commercial banks from taking risky debt through higher risk weights and also to rein in leverage through a new leverage ratio. The attempt to prevent overall build-up of leverage is, however, feeble as high levels of leverage underlie the financialisation of advanced economies through rapid expansion of claims and reclaims of the same underlying asset between FIs rather than through expansion of claims on real assets that expand production frontier. Basel III fails to distinguish between good and bad forms of leverage or to contain total leverage in the system, which includes sovereign debt and shadow banking at levels commensurate with economic growth. Fiscal policies that encourage debt over equity through tax asymmetric treatment are also unlikely to change any time soon.

Shadow banking and the Volcker Rule

Recognising that sources of systemic instability in the financial system may remain outside commercial banking, the FSB is developing a framework for reining in shadow banking. It has released policy documents for strengthening oversight and regulation of shadow banks that may be finalised at the ninth G20 Summit in Brisbane, in November



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In the eurozone, with its flawed monetary union, several banks are too big to be bailed out by their sovereigns, and no financial institution seems small enough to be allowed to fail because of interrelatedness of the financial system. An unreformed monetary policy framework also continues to put financial stability at risk

2014. The G20 initiative on shadow banking, however, remains work in progress.

New components of shadow banks like less leveraged real estate investment trusts, finance companies, business development companies, sovereign funds and private equity have emerged; while old instruments like ABCPs, SIVs and CDSs are now becoming extinct. Whether shadow banking in the post-crisis period is less destabilising than what it was prior to the crisis is, however, arguable. Be it as it may, given the experience with shadow banking during the recent crisis, and because it does not have the liquidity buffers of commercial banking to prevent runs and panics, regulators have agreed on the need for tighter control of shadow banks. Apart from DFA facilitating regulation of non-bank SIFIs, there are ma-

major national initiatives in the US (Volcker), UK (Vickers) and the eurozone (Likanen) that ring-fence the 'shadowy' proprietary trading from the commercial banking arms of FIs.

Too big to fail (TBTF) and resolution

SIFIs have assumed a special role by virtue of their size, complexity of operations and the volume of transactions handled across a wide range of products, services and markets. They play a critical 'public utility' role in the smooth functioning of financial markets and are, therefore, considered TBTF as problems within a single SIFI can trigger system-wide crisis. The near collapse of the American financial system between 2007 and 2008 following the decision by the US Fed and Treasury to

not bail out Lehman Brothers underscored this systemic fragility.

National regulators are now inclined to impose greater oversight and higher capital requirements for SIFIs. The FSB has stepped in with a list of global SIFIs and to prepare a roadmap for recovery and resolution planning of global SIFIs through the formation of crisis management groups. The US has a concrete roadmap vide orderly liquidation authority (OLA) under the DFA. The OLA holds shareholders and creditors responsible for the losses of FIs so that taxpayers' funds are not used for liquidation purpose. This implies that bank survives through bail-in by creditors rather than bail-out by taxpayers.

In order to facilitate orderly liquidation under DFA, all FIs classified as SIFIs are required to submit resolution plans (living wills) to regulators. The living will lays down the roadmap for its orderly resolution, during liquidation. Several of the US's largest banks have released their blueprints on how they could be dismantled after its collapse.

The robustness of OLA can only be tested in an actual financial crisis. There are several imponderables like probable knee-jerk market reaction to the news, absence of cross-border resolution framework, failure of living wills when faced with market-wide crisis and inherent difficulty in capturing all possible risks. Although these resolution mechanisms might minimise the likelihood of taxpayer bail-out, they also result in an implicit subsidy for SIFIs, lowering their borrowing costs relative to smaller banks. There are, therefore, fears that the implicit government guarantee enjoyed by SIFIs may result in riskier behaviour.

The SIFI problem is particularly acute in the EU with several individual bank assets exceeding the size of their respective sovereign GDP, making the SIFIs too big to be bailed out as their central banks do not have the power to print euros. This vicious loop between weak banks and weak sovereigns is impelling the EU towards a politically challenging single supervisor, single resolution and a harmonised deposit insurance system, and also lies behind the European Commission's backing for a Franco-German initiative to levy Financial Transaction Tax to strengthen the fiscal hand of eurozone governments. These issues call for a stronger fiscal union.

The overall focus of regulatory re-

form has been on strengthening capital buffers and resolution mechanisms to avoid taxpayer bail-outs. These buffers may be effective in business downturns, but may never be enough to deal with systemic risks of a financial crisis, when assets are marked down and markets are dysfunctional that taxpayers may still have to step in. The payments system is so closely integrated with the financial system that together they can be considered a public utility underwritten by the taxpayer. It is arguable whether the financial system is now safer despite the new regulations, as the underlying source of heightened instability, namely financialisation of the economy to the extent that there is little correlation with economic growth, remains unaddressed. A new source of instability emanating from a monetary policy framework unresponsive to asset price inflation has accentuated the disconnect between the real economy (economic growth) and financial markets (asset prices).

To summarise, the G20 financial reform agenda is undoubtedly ambitious. But will this time be different? Six years on, the outcome is mixed—work in progress at best, and a tale of progressive dilution at worst on account of the putative incestuous relationship between the Treasury and Wall Street. The overwhelming concern is that as normalcy returns, business would be as usual. Basel III might be diluted. The moral hazards inherent in the banking emolument and credit rating systems remain unaddressed. Cross-border harmonisation and cooperation to obviate regulatory arbitrage remains weak. Shadow banking is back on its feet even as commercial banks struggle with new regulation. The issues of pro-cyclicality and over-leverage continue to haunt regulators. Banks today are bigger than what they were before the crisis due to M&A. In the eurozone, with its flawed monetary union, several banks are too big to be bailed out by their sovereigns, and no FI seems small enough to be allowed to fail because of interrelatedness of the financial system. An unreformed monetary policy framework also continues to put financial stability at risk.

(This is the first of a two-part series)

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It's raining umbrellas

Thanks to the 3,000 mm rainfall that Kerala receives every year, many umbrella manufacturing firms are afloat in the Thrissur-Kochi belt alone

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GUJARAT, which has given the country its new Prime Minister, has been sweating it out to shield the southern state of Kerala from the just arrived monsoon too.

In Kerala's ₹250-crore umbrella industry, a good many of the 84-lakh-odd umbrellas ready for the seasonal market have their vital parts—ribs, shafts and handles—sourced from Gujarat.

Earlier, it was from China that the southern state sourced the ribs and chrome-plated shafts for its umbrella industry spread over Thrissur and Alappuzha. At one point, many umbrella SMEs even had tiny umbrella assembling facilities in China. As the import barriers grew, the Chinese sourcing became cumbersome and uneconomic. It is now the turn of the cottage industry in Umbergaon in Gujarat to feed the umbrella units in Kerala, reveals a close look at the supply chain of the assembling units.

"We still get the monsoon-resistant umbrella cloth from Taiwan," says KN Marsook, chairman, Colombo group of umbrellas. "There is a current trend of using fibreglass ribs, as they are lighter and do not rust. But then bulk sales are in two-folds and three-folds, that have sturdy metallic ribs and shaft. Many firms buy them from Gujarat," he adds.

Talking about the new west-to-south sourcing in the umbrella ribs, there seems to be some strange connection between West Bengal and Kerala that goes beyond their waning Left politics commonality. According to 80-year-old Sadananda Shenoy, who spend his prime years marketing umbrellas brands from Kerala in east and south India, it should be Tamil Nadu, Andhra Pradesh or Rajasthan with the mer-

cury flaring up in the summer season that should be the umbrella markets. "I know plenty of outdoors people in households from hot Ramagundam, Chennai, who do not even consider buying an umbrella. On the contrary, in Kerala and West Bengal, there is an almost cultural passion for umbrellas," observes Shenoy.

While West Bengal cherished traditional umbrella brands like Citizen, Garden and Hindustan, in Kerala, at one point, there were about 40-odd umbrella making units. However, even though close to 1 crore umbrellas are sold every year, the business has little ambition to scale-up and become rain-gear suppliers to the nation. One reason could be skilled labour scarcity.



Colombo Umbrella Mart in Kochi was the first to introduce the folding umbrella, followed by three-fold umbrellas and four- or five-fold umbrellas. Although Colombo Mart still offers about 100 varieties, the firm has diversified to other sectors like furniture.

Thanks to the 3,000 mm rainfall that Kerala receives every year, currently about 10 umbrella manufacturing firms are afloat in the state. These are mainly in the Thrissur-Kochi belt. However, it was left to an Alappuzha-based entrepreneur to transform the tall, shadowy rain-gear in the corner of the room from a mere commodity to a value-added and branded product.

At present, 70% of the business pie is happily split between the two grand-

children of the pioneer umbrella industrialist, the late Thayyil Abraham Varghese, fondly nicknamed 'Kuda Vavachan'. It was he who brought the umbrella industry from north of Kochi to the historic Iron Bridge Junction in the tourism-propelled Alappuzha town, adding to its tourism charm.

Often, the season's varieties are launched by competitive cousins Davis of Popy Umbrella Mart and Dr Abraham Thayyil of Johns Umbrella Mart. The marketing thrust is always on innovation, both in functionality and fashion, but the ads unerringly grabbed the news of the moment, grabbing the customer's attention. For instance, when Tata made a market splash with the Nano car, Davis was

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quick to get his Popy Umbrella to launch Nano umbrella—Nano claims to be the smallest umbrella. Dr Abraham, a surgeon and the business brain of Johns Umbrella Mart, responded with a corresponding Atom umbrella.

Although umbrellas are growing as a pet co-branding product among paint firms and automobile manufacturers, the scaling up of the units in Kerala is not seen feasible. Umbrella-assembling is largely labour-intensive. Manpower-addition, according to most company managements, could cause unionisation and labour unrest. A good many of these firms take refuge in outsourcing part of the production, to keep the stock flow smooth.

"Nevertheless, we do export to Gulf

countries and Maldives, utilising the trade connections of Kerala diaspora in these countries," says Premananda Prabhu, partner, Hindustan Umbrella Mart. In fact, Hindustan Umbrella Mart, Stag Umbrella Mart and Sun Umbrella Mart used to be the leading umbrella makers once. Most of these family concerns have now taken to retail trading of umbrellas, rather than manufacturing.

Contrary to earlier days, when people preserved a much-repaired umbrella as a family hand-me-down, there is a growing appetite for contemporary styles and technologies in umbrellas. The current season's toasts are the 16-rib umbrella, the ladies umbrella with ribs covered with petal-cuts that make it look like a flower, says Marsook, who's also vice-president, Umbrella Manufacturers Association.

UV-ray resistant umbrellas are almost a must now in college campus, forcing families to cough up ₹250-350 in their monsoon budgets. The umbrella ad campaigns have packed in so much health-consciousness among youngsters that, in a middle-class household, a ₹150 per piece Chinese imported umbrella available in Mumbai and Delhi markets would not be accepted.

Come school season and innovation-loving children are the best salesmen. When Popy came out with an umbrella with a torch, compass, whistle, and thermometer, Johns Umbrella retorted with one that gets the umbrella go shake-dry after a wet spell. An umbrella with ribs, resisting the winds, is the toast of the season. And the ribs of the most umbrellas made in Kerala, this season, come from Gujarat.

Kerala is yet to be part of the Modi Cabinet, after shying away from sending any BJP member to the 16th Lok Sabha. All the same, as the South-West Monsoon storms into Indian peninsula through its usual Kerala gateway in June, it would be the strange onus of the umbrella-ribs from the Prime Minister's homestate to touch the Malayali lives on a rainy day or two.

What if the Fed has created a bubble?

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Investors might be surprised to learn that they have a lot riding on something that they pay very little attention to: macro-prudential regulation, or what central banks and other government agencies do to reduce the risk of systemic financial disasters.

The aim of such regulation is to lower both the probability and potential costs of financial accidents. It does so by enhancing the resilience of the system, establishing circuit breakers to prevent problems in one area from contaminating others and, at the extreme, containing the detrimental impact on the broader economy when failures occur.

Macro-prudential regulation has been significantly enhanced in the aftermath of the global financial crisis. Authorities around the world have imposed higher and more intelligent capital requirements, required financial institutions to value their assets more conservatively and to hold more easy-to-sell assets, placed constraints on allowable risk-taking, insisted on more stable funding, and demanded greater provisions against bad loans.

The impact of the revamped regulation has gone far beyond the targeted banks and other financial companies. It has allowed central banks to be bolder in maintaining and evolving exceptional monetary and credit stimulus, which in turn has significantly bolstered the prices of stocks, bonds and other assets as a means of stimulating the economy.

The more confident central bankers are in their macro-prudential approach, the greater their willingness to persist with stimulus policies today that could involve a bigger risk of financial instability down the road—a trade-off that has been noted by Minneapolis Fed President Narayana Kocherlakota,

Boston Fed President Eric Rosengren and former Fed Governor Jeremy Stein.

Essentially, the Fed has been pushing stock and bond prices up to "bubblish" levels, in the expectation that they will inspire the kind of consumer spending, physical investments and hiring required to justify them. The hope is that the convergence will occur in the context of full employment and inflation near the Fed's target of 2%. So far, though, the wedge between asset prices and economic reality remains large, as last week's juxtaposition of new stock-market highs and still-anaemic wage-inflation data demonstrated.

The danger is that the economic recovery will ultimately fail to validate artificially high asset prices, leading to significant financial instability and adverse "spillover" for the economy. The more comfortable the authorities are in their ability to counter—and, if necessary, contain—such potential instability, the greater their appetite for maintaining the stimulus that markets love.

The key question is whether the recent strengthening in macro-prudential regulation is sufficient to warrant the risks that the Fed is taking with respect to future financial instability.

Given the number of moving pieces in the global economy, I suspect that few are in a position to answer this question with precision and conviction. After all, the regulatory framework is still evolving, bank behaviour has yet to adapt fully, some institutions remain too large to fail and manage, and some activities are migrating outside the direct purview of supervisors and regulators.

Macro-prudential progress, while notable, has fallen short of what national authorities initially envisaged, and international coordination has fallen short of what is needed to make it all work globally. Investors would be well advised to take this into consideration in making their Fed-driven trades, especially if they involve positions that will be difficult to sell or unwind in more volatile markets.