Financial Stability and Regulatory Architecture

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Revitalizing Global Economic Growth: Views from G20 Countries
ICRIER, August 9-10, 2016

Three Big Worries

1. The Cyber Threat to Financial Stability
2. Finance $\Rightarrow$ Shadow Finance $\Rightarrow$ Dark Finance
3. Resolution Capability

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Cyber Threats are Escalating

	Past	Present
Target	Small Stuff: ATMs, individual accounts, credit cards	Big Stuff: SWIFT
Scale	A few million dollars	Close to a billion dollars
Nature	Casual, opportunistic	Advanced Persistent Threat (APT)

From bad to ugly

- The criminals are better organized and the “free market” or “dark market” works very well. The financial world and their regulators are relatively naive and under-prepared.
- But the biggest threat are the attackers with non pecuniary motives especially nation states.
- These attackers would be less interested in stealing money than in causing lasting damage.
- Whom should you fear more?
  1. The attacker who wants to steal $1 billion; or
  2. The attacker who wants to erase the entire data or maliciously alter it
- This is particularly serious for countries like India which face unfriendly neighbours with proven cyber warfare capabilities.
- Regulators need to consider backing up critical financial data on highly robust, distributed and tamper resistant databases like the blockchain.

Three Big Worries

1. *The Cyber Threat to Financial Stability*
2. ***Finance $\Rightarrow$ Shadow Finance $\Rightarrow$ Dark Finance***
3. *Resolution Capability*

Financial regulations increasingly pursue extraneous objectives

- It is easier to monitor financial flows than physical activities.
- Financial regulation is therefore an attractive weapon for governments seeking to achieve objectives totally unrelated to the core functions of financial regulation.
- A few examples of this "mission creep":
  - Governments around the world have for long used financial sector regulations not to promote prudential requirements or market integrity but to improve tax compliance – AML/CFT regime.
  - India uses financial market regulations to bolster its capital controls.
  - The United States uses financial regulation to achieve its foreign policy objectives (for example, sanctions) leading to the progressive weaponization of the banking system.
- Lucas critique: as people change their behaviour, regulations would become less effective.

Regulators driving finance into the dark alleys?

- The financial system is gradually being repurposed from being an instrument of financial intermediation into an instrument of state policy. Regulatory enforcement rewards and punishes banks more on the latter than on the former.
- In response to these incentives, banks and other financial institutions are becoming customer unfriendly:
  - Poor people in India who have never travelled outside their native town are being asked to sign a bunch of US FATCA forms which nobody understands. These forms are not actually required, but why would a bank officer take chances with compliance?
- All this could push consumers away into alternative channels.
- As a result, finance is at risk of being pushed not just into the shadows but into the dark alleys.
- Financial regulators would then be powerless to monitor financial stability.

A few examples

- Correspondent banking
  - Many banks are terminating their correspondent banking relationships because of the costs of KYCC compliance.
  - Some countries like Belize have been completely cutoff because all of their banks have lost their correspondent banking relationships.
  - The most feasible method for people in these countries to carry out cross border payments or business is bitcoin or *havala*.
- Offshoring of finance
  - Brexit day saw massive trading in Indian rupee futures in Dubai.
  - More than half of the trading in the rupee is outside India.
  - The Indian corporate bond market was already largely outside India and *masala* bonds are exacerbating this.

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1. *The Cyber Threat to Financial Stability*

2. *Finance ⇒ Shadow Finance ⇒ Dark Finance*

3. *Resolution Capability*

Do we have workable resolution regimes?

- Probably not.
- Countries like India never had real resolution capability except for a partial and unsatisfactory capability in banking resolution.
- Post Dodd-Frank, resolution in the US will probably not work in a crisis.
- European resolution regime is already failing the test in Italy.
- In this respect, we are probably worse off than in 2008.