DEVELOPMENTAL DIMENSION TO FINANCIAL SECTOR

by

Dr. Y. V. Reddy

FORUM
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"Free Enterprise was born with man and shall survive as long as man survives".

- A. D. **Shroff**
Founder-President
Forum of Free Enterprise

Introduction

The FORUM is greatly pleased to publish the speech delivered by Dr. Y. V. Reddy, the former Governor of the Reserve Bank of India, on the occasion of his receiving the Sixth M. R. Pai Memorial Award. The theme of Dr. Reddy speech is "Developmental Dimension to Financial Sector".

Doubtless, this subject is not only of topical interest, but is of great significance in the context of the recent global financial crisis (2008-09) and its aftermath. Across the world in all international forums be it of international institutions like IMF, World Bank and the UN or central banks of various countries of the world or powerful formations of major globally influencing countries like G7, G20, etc., one of the most critical on-going issues of debate and discourse is about restoring to the global community the enduring financial stability and steering the path of requisite new resilient, responsive and responsible global financial architecture.

In his speech, Dr. Reddy is completely at ease on reflecting on the role of the financial sector in economic management as well as on various new dimensions and complexities of reforms of the financial sector. All this has been made possible thanks to the fact that as a central banker, he has had one of the longest composite tenures – both as the Deputy Governor (1996-03) and the Governor of the RBI (2003-08). This entire span permeated well over half of the India's momentous era of economic reforms ushering in liberalisation, deregulation and globalisation. Among other major global events during this period, he was also a very close witness to the Asian melt-down of 1997, and its serious economic consequences thereafter.

Based on his deep understanding of our socio-economic ethos and his global learning, Dr. Reddy truly showed the courage of his conviction in wading through the middle path of financial liberalisation in our country. He did not resist, but restrained and regulated astutely the pressures for faster pace of financial reforms. He articulated the core objective of financial stability by bringing this to the forefront, along with growth and price stability, while shaping substance and stance of monetary policy for the Indian economy. If India could successfully ride through the adversity of global financial turmoil with the least damage, and unveil remarkable economic resilience in the recent past, this has been almost entirely made possible thanks to this key plank of financial stability, calibrated banking reforms and judicious capital account management – all of which Dr. Reddy so assiduously strived for.

While providing historical perspectives on the changing role and transformation of the financial sector as an instrument of public policy and economic development, he clearly highlights the enormous pitfalls of the erstwhile days of financial repression and its adverse consequences suffered by many countries, including, of course, India. At the same time, the process of deregulation that took place since 1980 in various countries at varying degrees of scope and speed, while bringing about significant gains, especially in terms of enhancing efficiency in several dimensions, has also been fraught with some serious dangers.

Dr. Reddy, thus, points out that "many countries, both developing economies and industrialised countries, had experienced banking and currency crisis attributable largely to the excesses of the financial sector consequent upon deregulation". He further elaborates on subtleties and distinguishing features of the extent of deregulation that has taken place among different countries. While acknowledging the benefits of deregulation, he comes to the conclusion that "it is possible to generalise that excessive liberalisation of financial sector, thus, constituted a conduit for contagion of stress and crisis from economies with soft regulation to others during the recent crisis, though it contributed to good contagion of efficiency and good practices, during the pre-crisis period".

Based on his intense experience and rigorous analysis of the recent policy debates, Dr. Reddy very wisely advises that we need to avoid "a danger of extremes, namely, of over-regulation and of under regulation", and advocates instead the cause of moving towards "rebalancing" of the financial sector. He concludes the entire debate of conflicting views on forces for regulation versus deregulation by stating that "it is very difficult to state at this stage how these opposing forces in favour of and against significant changes will operate and where exactly the rebalanced regulation would fan out".

In the context of India too, he suggests that "while the domestic factors will have to dominate the reform of the regulatory regimes, India will have to keep watch on the developments in the global bodies and other countries, so that the lessons from global experience can also be taken into account ...."

While reflecting on "rebalancing and depositors' interest" in the concluding part of his speech, he rightly stresses that "banking itself is treated as a public utility" and that "the evolving new balance in regulatory framework should take into account both stability and developmental issues recognising that there are no banks if there are no depositors".

We greatly appreciate the manner in which Dr. Reddy has woven his deep concerns on the next generation of financial sector reforms from the perspectives of such diverse viewpoints of global community, Indian financial sector and not least important the retail depositors. Such balanced treatment and approach of such complex subject could only be possible from a person who can legitimately proclaim dispassionate way of analysing the complexities of the subject and who has his roots firmly in ground. We are confident this booklet will be avidly read both in India and abroad by all the stakeholders of the financial sector and generate healthy debate eventually leading to sound, healthy and sustainable financial sector.

Sunil S. Bhandare
Editor

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Dr. Y. V. Reddy *

I am grateful to the organisers for honouring me with The Sixth M.R. Pai Memorial Award. I believe, the Award is basically a recognition of the initiatives taken in the recent past by the Reserve Bank of India (RBI) to increase the sensitivity of the banking system to the common person in his/her dealings with the banking system. The initiatives taken were wide ranging and encompassed financial inclusion, financial literacy, financial advice, and consumer services. It happened that several initiatives were undertaken by the RBI while I happened to be the Governor. Hence, I would consider this award to be an Award to the work of Reserve Bank of India in the area of depositors' interests.

I had the good fortune of knowing Mr. M.R. Pai personally, though briefly, when I was the Deputy Governor. Mr. Pai's simplicity was appealing; his dedication was transparent;

*The author was Governor of the Reserve Bank of India during 2003-2008. The text is based on the speech delivered while receiving the Sixth M.R.Pai Memorial Award, instituted by the Punjab and Maharashtra Co-operative Bank Ltd (PMC), at a function organized by the All-India Bank Depositors' Association (Mumbai), in Mumbai on 6th May 2010. The text is reproduced with kind permission of PMC for wide and free distribution.

his knowledge was outstanding and his achievements impressive. Above all, he made any person who met him, to be totally comfortable with him. I am honoured to pay my respects to a great champion of the consumer. In my new retired capacity, as a full time consumer and not an income earner, I have reason to greatly appreciate Mr. Pai's commitment to the interests of the consumer.

Let me now turn to the theme of my talk. The Global Financial Crisis has resulted in a dramatic review of the role of financial sector in economic management. One of the most significant developments in this regard is a review of the policy of deregulation, with emphasis on maintaining financial stability. In the process, while the desirability of using regulatory policies for stability has been accepted, there is a conspicuous silence on the use of regulatory policies for achieving developmental objectives. This presentation argues that a rebalanced regulatory regime currently under consideration globally, should address issues of stability as well as development.

Financial Repression and Benefits of Deregulation

In the post colonial era, financial sector was used as an instrument of public policy and, in particular, for economic development. In some countries the banks were nationalized. The policy framework governing the financial sector was oriented toward promoting economic development in developing countries. In advanced economies, use of financinl sector for reconstruction was

not uncommon. In India, banks were nationalized in 1969 to ensure that they achieve development and welfare objectives. However, there was a convincing body of literature which argued that these measures amounted to financial repression, and that such repression of market mechanisms has resulted in serious inefficiency in the allocation of resources, thus retarding the growth in the real economy.

In substance, it was felt that the financial repression, which includes the policy framework within which the financial sector operates and the excessive regulation of the financial sector, does not aid development, but often undermines it. Hence, it was argued that the thrust of the financial sector reform should be to remove such financial repression and allow the market forces to determine the allocation of financial resources through deregulated financial markets. The movement against financial repression coincided with several other theories and practise extolling the inefficiencies of the state or governmental intervention, and emphasizing the benefits of allowing the market forces to allocate resources. This philosophy as applied to financial sector held that the development finance as it was being practised, was tantamount to financial repression. This approach was also popularised in the developing world, and became a staple element of financial sector reform. In brief, deregulation of financial sector by itself became the instrument of development.

The process of deregulation of financial sector was undertaken by many countries, and had several dimensions. First, the overall policy constraints on banks' ability to perform their core functions were removed. Second, the universal banking was encouraged in a sense that the banks were increasingly permitted to undertake activities other than core banking functions of accepting deposits and extending loans to households and the enterprises. Thirdly, entities other than banks were also encouraged to undertake financial intermediation so that the different risk appetites of savers and investors are matched. Such diversified financial intermediaries were expected to lend stability to the financial system in addition to adding to overall efficiency. Fourth, the role of financial markets in allocating resources was emphasized and these included equity, debt and forex markets. Fifth, it was considered necessary and useful to integrate the various financial markets within the country sometimes described as bond - currency - derivatives nexus. Finally, there was increasing globalization of finance which reinforced the integration of different financial markets within the countries.

It is essential to note that the process of deregulation took place over three decades since 1980, although with different countries commencing the process at varying points of time. The process was rapid in some cases while it was gradual in others. However,

deregulation did not mean absence of regulation but, a marked preference to minimize regulation. Market efficiency was assumed and the case for regulation had to be proven; thus putting the onus of proof of market failures on the regulator. The twin objectives of the financial regulation in this policy framework of trust in market-efficiency were (a) consumer and depositors' protection and (a) solvency of individual financial institutions.

Perceptible benefits did accrue in terms of accelerated development as a result of deregulation. No doubt, there were several banking and currency crisis in many developing countries and in some advanced economies also, after the process of deregulation of financial sector. The overall impact of the persistent and continuing deregulation was assessed to be undeniably positive, till the global financial crisis erupted in 2008.

Excessive Deregulation and Consequences

The process of deregulation, undoubtedly, resulted in eliminating costly distortions or tardiness and enhancing efficiency in several dimensions. But at the same time, many countries both developing economies and industrialized countries, had experienced banking and currency crisis attributable largely to the excesses of the financial sector consequent upon deregulation. However, the extent of deregulation varied significantly as between different countries, and some broad generalizations in regard to softness of regulation and its consequences may be in order. The countries which desired to develop as international financial centers, in particular, USA and UK, had adopted relatively soft regulation. There are larger economies in Latin America, and other economies of Eastern Europe and CIS countries, like Russia, which had considerably deregulated their financial sector. Most of these economies have been severely affected during the financial crisis. On the other hand, there were other countries, particularly in Asia, where there was relatively lesser deregulation and most of them have been less affected by the financial crisis. It is also interesting to note that in those economies which were less affected, traditional banks continued to play a dominant role and there was less extensive use of financial innovations such as credit derivatives.

There are, of course, some countries such as Canada and Australia, where the financial sector has not been severely affected, though there has been considerable degree of deregulation. Among the large economies whose real economy has performed well, but the degree of deregulation in the financial sector has been modest, are China and India. It may, therefore, be possible to make a preliminary generalization that deregulation in those economies where there has been financial repression, has been desirable, and added to efficiency, but if such deregulation are persistent beyond a point, it could be treated as excessive deregulation with a potential for causing more harm than good.

In assessing the benefits of deregulation, it is also necessary to distinguish between the benefits that accrued by (a) wide-spread use of technology at about the same time as process of deregulation was underway and (b) enhanced competition that was made possible, due to deregulation. In this regard, it may be possible to make a distinction between deregulation of the domestic financial sector and liberalization in terms of cross border exposures of the financial sector. It is possible to generalize that excessive liberalization of financial sector, thus, constituted a conduit for contagion of stress and crisis from economies with soft regulation to others during the recent crisis though it contributed to good contagion of efficiency and good practices, during the pre-crisis period.

On the basis of experience with the crisis, it is possible to list several consequences of excessive deregulation. There is a considerable body of opinion that the process of deregulation has enabled development of large institutions which were too big to fail. These large institutions had incentives to take excessive risks, and were also capable of influencing the political economy of the regulators. Irresponsible lending, in particular housing finance in USA, is considered to be yet another consequence of excessive deregulation. In some countries, micro-finance was developed since banks and the banking system was concentrating more on activities relating to financial markets, thus neglecting the credit needs of the large sections of the population. The micro-finance institutions also tended to indulge in predatory lending. In many developing economies, foreign banks tended to concentrate on participation in equity, debt and forex markets, rather than traditional lending and borrowing. Overall, a highly deregulated atmosphere lead to excessive leverage, recourse to high risk activities, concentration on fee-based income, and experimentation with innovations whose social or economic benefits were suspect, cumulatively resulting in the crisis. As a result of the crisis and a broad appreciation of the consequences of deregulation, there is now a general global consensus towards revisiting the totality of the regulatory framework.

It is possible to locate some illustrations of consequences of a highly deregulated atmosphere in India also. Urban Cooperative Banks, for several years, were subjected to softer regulation relative to the commercial banks. Many of them rapidly deteriorated. Some of the private sector banks, which were recently licensed, took advantage of the deregulated atmosphere resulting in a majority of the newly licensed private sector banks not surviving as they were subjected to mergers or acquisitions. While it is not possible to quantify, several scams have taken place, and some of them are attributable to inadequate regulation. There is considerable evidence of the hollowing of traditional bank lending, particularly to agriculture and SMEs. A large

expansion of consumer and real estate lending is also consistent with the deregulated atmosphere, though some timely correctives were taken by the regulators. Finally, there has been expanding use of banks resources in risky activities such as private equity funds and venture capital funds. However, almost all these problems have not lead to any serious systemic instability in India, but they do provide some lessons for a more effective regulation. while drawing upon the current experience of other countries also.

Towards a Rebalanced Regulatign and Unlevel Playing Field

Globally, there is a recognition now that some rebalancing is required in favour of undoing some of the measures of excessive deregulation already undertaken. Two sets of measures towards rebalanced regulation are being considered: (a) those that relate to the regulatory structures, boundaries and jurisdictions in the financial sector, which are mostly determined by legal frameworks; and (b) those measures that relate to the regulatory skills, standards and measures to be adopted by the regulators.

In this regard, the relative emphasis between principle-based and rule-based, is also being reviewed. The rebalancing of regulation is addressing simultaneouslv several constituencies, namely regulatory institutions, regulatory entities, functioning of markets, financial instruments, and infrastructure such as clearing and settlement mechanisms, in addition to credit rating agencies.

While rebalancing of regulation is being attempted in several areas in different countries, there is a simultaneous effort to bring about globally acceptable standards of regulation. For this purpose, a Financial Stability Board (FSB) has been constituted, in which both developed and developing countries are represented. Almost all the deliberations of FSB so far are focused on achieving financial stability in the functioning of the financial sector without sacrificing the benefits of market mechanisms, including financial innovations to serve the goal of allocative efficiency. The most important measures suggested include adoption of counter-cyclical regulation, emphasis of macro-prudential regulation, treating banks or banking activities as special, ensuring the safety of the financial products, expanding the scope of regulation to the shadow banking system, modifying incentives to excessive risk-taking and intensifying the regulation of infrastructure agencies, such as, credit rating and clearing systems.

It is necessary to recognize that there is a fundamental change now in the philosophy underlying regulation. The assumption that the financial sector will have self-correcting mechanisms to bring about stability has been questioned and diluted. The public policy has to go beyond consumer protection and solvency of individual institutions and intervene in the market for averting

financial instability. The regulator has also to take a view on the price of assets in order to adopt counter-cyclical policies. There is distinction between highly risky and less risky activities which has to be made by the regulator. This would include both the nature of the sector and the appropriate financial activity. There is also a differentiation to be made in the extent of regulation on the basis of the size of a financial institution. Those who are considered large, or systemically important, may be subjected to a different regulatory regime through measures such as higher capital prescriptions. In other words, the rebalanced regulation increases the overall magnitudes of regulation and introduces or creates unlevel playing field as between of financial institutions, financial products and the end use of funds. In brief, the main instrument of the rebalanced regulation under consideration is creation of unlevel playing field which raises another fundamental issue,i.e.,whether such unlevel playing field, should be entirely rule-based or discretionary. The current consensus is in favour of a predominantly rule-based approach, though the details remain unresolved.

Rebalanced Regulation and case for Development Finance

The measures currently under consideration for a iebalanced regulation are addressing only stability issues, but the basic implication of the suggested approach of injecting unlevel playing field is significant.

The unlevel playing field could be the basis for introducing developmental objectives in regulation, as explained below.

Firstly, it is agreed the proposed rebalanced regulatory regime should avoid pro-cyclical tendencies and should prefer counter-cyclical measures. However, it is very difficult to distinguish ex-ante the cyclical elements and structural elements in the economy. This is particularly true in developing economies where significant and rapid structural transformations are taking place. Further, if the financial system requires to be regulated in order to avoid cyclical fluctuations, there is no particular reason to oppose the use of the public policy to strengthen financing of structural changes in the economy.

Secondly, the proposed regulatory framework is expected to moderate the generation of large asset bubbles. If the regulation is expected to moderate asset bubbles, then it is possible to argue that the regulation should legitimately promote financing of productive assets.

Thirdly, if sector specific capital provision or loan to value ratios is considered to be legitimate instruments for directing credit to avoid instability, the use of similar instruments in favour of productive investments or longer term goals such as financial inclusion cannot be ruled out.

Fourth, to the extent systemically important institutions could be subjected to high capital requirements, there is

no reason why systemically less important, institutions which operate primarily within the country or smaller jurisdictions should not be subjected to a softer type of regulatory framework.

Finally, if intervention is required in the normal functioning of the financial sector in order to achieve stability, it is very difficult to insist that achievement of developmental objectives should be left to the market forces, while the achievement of the stability objectives should be subjected to public policy.

Rebalancing: Need to avoid Extremes in New Balance

The current debates and proposals in regard to rebalancing of financial sector are essentially focused on correcting the risks that arise due to excessive deregulation. However, it may be simplistic to assume that the correction of excessive deregulation will be a simple reregulation or simply reverting to an era where there was significant regulation. In other words, rebalanced regulation will have to be different from the excessive deregulation and also from excessive regulation that have been experienced in the past years. The rebalancing should, therefore, strive for what may be described as a new balance. The new balance should be able to moderate excessive deregulation; and in the process should not be dogmatic, but should be pragmatic. A new balance will have to take into account

(a) the technological developments that have already taken place; and (b) the globalization of trade, which requires a noticeable element of globalization of finance to the extent the international trade has to be funded.

On the basis of current discussions on the regulatory reforms warranted by the experience of the crisis, there is a danger of extremes, viz., of over-regulation and of under-regulation. The danger of over-regulation arises due to several reasons. Firstly in the intellectual debates there is a huge reaction to the costs of market failures in the financial sector, seeking significantly larger role for public policy. Secondly, there is strong political pressure from the citizens in seriously affected countries due to the economic distress and, particularly, because of high unemployment. Increase in public debt, particularly due to bail out of the financial sector, is indicative of the burden on the tax-payers in the future, and this fear is causing resentment. At the same time the insistence on payment of huge bonuses by the financial sector during this critical period has invited the fury of large sections of the populations. In some countries, where IMF programmes had to be put in place, the austerity required is generating social tensions. Hence, the legislative framework for rebalancing the regulation may yield to the population pressure. Thirdly, there could be a temptation for the governments to extend their reach and control over the financial sector.

There are several countervailing forces which are operating against large-scale changes in the current deregulated financial sector, and if they prevail, there is a danger of under-regulation rather than over-regulation. First, it is evident that the financial sector enjoys enormous influence over the decision-making processes in many countries. Many parts of financial markets and the institutions are resentful of significant changes. They advocate that the regulators should improve their operational skills and argue against significant change in the overall regulatory framework. Second, tightening of the regulatory framework may expose several existing weaknesses of both governments and regulators and may add to the loss of confidence in the total financial system. Therefore, both the government and the financial sector may consider it to be in the larger public interest not to disturb the status-quo beyond at this point. Third, the free market ideology is still dominating several economic policies and the financial crisis is considered to be only an aberration or a part of cycle, and thus does not warrant any expanded role for public institutions. Fourth, the financial sector is dominated by the international financial centres of New York and London, both of which have believed in soft regulation. There is a strong incentive to keep this advantage of soft regulation so that the economic and financial activity continues to be dominated by these centres. Finally, the developing countries may find it difficult not to follow the globally coordinated views on these issues.

In brief, it is very difficult to state at this stage how these opposing forces in favour of and against significant changes will operate and where exactly the rebalanced regulation would fan-out. This has important policy implications for developing economies. In view of the huge uncertainties, it is better for developing countries to avoid extreme solutions. It is also necessary to wait and see the global developments before undertaking any reform based on the unsustainable regulatory framework of the past or a yet to be clear regulatory framework for the future.

India: Need for Domestic Orientation

India has experienced in 1970's and1980's the adverse consequences of financial repression. Considerable progress has since been made in terms of dismantling financial repression. During this period the role of the public policy in utilizing the financial system for developmental purposes has not been up to the expectations. Hence, the lesson for India is clear, viz., that it will not be appropriate to increase or expand the regulatory regime, though there can be considerable scope for enhancing the effectiveness of regulation. At the same time, India had significant benefits due to deregulation since the reforms of early 1990s. The efficiency, quality, resilience and diversity of financial intermediation have been evident in India after the commencement of the deregulation. The savings rate, as a percentage of GDP, has increased substantially.

At the same time, there have been instances where a price was paid by the economic system due to pre-mature or excessive deregulation. Thus, Urban Cooperative Banks which had spread softer regulatory regime had developed weaknesses, and number of banks went into bankruptcy. More than half of the new private sector banks disappeared due to mergers and acquisitions. Some banks have also paid a price for their excessive participation in equity. Some financial scams also accrued during the period of reform. In brief, therefore, while there has not been systemic instability, the adverse consequences of pre-mature or excessive deregulation have been faced by India.

In regard to the liberalisation and opening up of India's financial sector, the benefits of gradual liberalization of capital account have been recognized globally. In brief, India has experience of both, successful deregulation and cautious liberalization with some lessons which are particularly relevant due to the global financial crisis.

India, therefore, must concentrate on rebalancing of regulatory framework drawing lessons from its own experience with the regulatory framework and liberalization. While the domestic factors will have to dominate the reform of the regulatory regimes, India will have to keep a careful watch on the developments in the global bodies and other countries, so that the lessons from global experience can also be taken into account, as some clarity emerges on new balance in global regulatory standards. It is important for India to recognize that some assertions associated with benefits of deregulated financial sector have proved to be no longer valid and there is as yet no clear emergence of a new balanced regulation or a new balanced deregulation

Rebalancing and Depositors' Interest

During the days of financial repression, the depositors had comfort of safety, but the service was poor and the options available for the depositors were limited. Deregulation has helped promote genuine competition. Several new financial products were developed. However, the benefits that accrued to the retail depositors were far less than those that accrued to the whole depositors.

Excessive deregulation resulted in a situation where the focus on all institutions, including banks, was on financial markets. Banks themselves were emphasizing income from fees, thus underminifig the traditional banking activities. Banks also started taking recourse to non transparent practices. Traditional banking was almost neglected. While credit cards became a large source of income, a number of institutions took recourse to injection of complexity in financial products to confuse the depositors. Finally, efficiency gains due to technology, innovation and competition in financial sector were appropriated almost wholly by the management, and to

some extent, by the equity holders, thus ensuring that there has been little or no percolation of the gains to the depositors.

During the crisis, the importance of depositors became evident from the fact that in some countries the blanket guarantee on the safety of depositors was extended. Many of the reform proposals under consideration globally are oriented towards ensuring the safety of deposits in the banks by insisting on the Volcker rule. The Volcker rule emphasizes that the banks should concentrate on traditional banking activities and should be subjected to more intensive regulation, and that they should not be exposed to risky activities. Proposals also include appropriate regulation for all deposit taking institutions, and not merely to the banks narrow defined. There is also a focus on ensuring the safety of the financial products and making them as simple as possible, which should also be helpful to the depositors also.

In brief, the interests of the depositors, particularly retail depositors, are gaining attention, and hence banking itself is being treated as a public utility. However, this is happening more as incidental to the goals of financial stability rather than a heightened consciousness about the interests of the depositors. Similarly, if a developmental dimension given to financial sector is accorded, it is possible that depositor's interests are protected but, as the experience of not so distant past shows, it may not necessarily be so. Hence, the evolving new balance in regulatory framework should take account of both stability and developmental issues recognizing that there are no banks if there are no depositors.

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

\- **Eugene Black**
Former President,
World Bank

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