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FINANCIAL CRISIS AND FINANCIAL INTERMEDIATION – ASKING DIFFERENT QUESTIONS

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The financial sector, which was hailed as driver of growth, has brought about a crisis globally, not only in finance but in the real economy. There is recognition that reforms are needed, and perhaps they are needed not only in financial sector, but also in how we should think about financial sector in the overall context of the objectives of economic and social well-being.

After the crisis, if the same questions as before are posed, it is quite possible that the answers will be the same or at least within the fundamental beliefs that existed before. Asking a different set of questions or the same questions put differently has the advantage that it could give new insights. This search for new questions in the presentation, by way of illustrations, is to a large extent based on the Indian experience with the regulation of financial sector, recognising that it may not have universal validity.

There is currently a broad agreement on the need for reform that minimizes the chances of future catastrophes, while maintaining as much as possible of the social benefits of the financial sector. Is it better to reformulate the statement on agreement for reform so that it reflects longer-term global concerns rather than merely as a reaction to the present financial crisis? For example, a statement addressing the same issue differently by clarifying that the social benefits are goals, would read as: there is need for reform in financial sector that maximizes social benefits of the financial sector while minimizing chances of future catastrophes.

Is there merit in considering, more seriously than is the case now, the diversity of experience with the crisis? The financial crisis originated in some countries with great intensity, and it had its impact on other countries. However, the intensity of the crisis in the financial sector varied among countries. In other words, is it appropriate to universalize the causes of crisis on the basis of the most affected countries like the U.S.A., or would it be better to analyse the variations in the intensity of financial crisis in different countries, say Canada, Australia, China or India, to learn lessons? The Economist, in November 2007, identified India, Hungary and Turkey, as the most vulnerable economies among the Emerging Market Economies (EMEs), but in two of the three countries it proved to be wrong. Were we wrong in the framework for assessment of vulnerability? Similarly, inflation targeting helped in obtaining credibility for policies and thus price stability. But in many countries price stability was maintained without inflation targeting. The question is, whether those countries which achieved credibility through inflation targeting can now give up the instrumentality of inflation targeting while retaining a focus on price stability in order to acquire operational flexibility to maintain some output and financial stability also.

How should the reform agenda of financial sector be linked to other policies? For example, precautionary steps may be taken in the regulation of the financial sector to reduce the risks that may emanate from other policies. For example, the regulatory framework for the financial sector in India consciously built precautionary approaches to mitigate the ill-effects of high fiscal deficits and large government borrowing programs. These measures were not exactly countercyclical, but in some ways macro-prudential.

While globally agreed standards of financial regulation would ensure coordination among national regulations as needed in a globalised world of finance, should there be emphasis on allowing for diversity in financial regulations among different countries? For example, if we had a globally binding model of best practices over the previous decade, it would have been the model practiced in London or New York, since that was believed to be the ideal. In that case, we would not have China and India or much of Asia leading the recovery. After all, no one can be sure of a monopoly of universal wisdom on financial regulation. So, how do we ensure diversity in financial regulations among the countries in future?

Whose fault? Markets or the government?

There has been considerable discussion about the market failures and the government failures. We assumed that the failures of one, say markets, can be made up by the strengths of the other, say regulation, but it need not necessarily be so. Experience with the crisis has shown that the market failures and the regulatory failures reinforced each other. In the interactions between the market and government, governments can make up for market failures, or they can interact with their strengths to positively synergise for the overall benefit, or they can reinforce each other's failure. The appropriate question may be: how to ensure that markets and the regulation interface each other in order to maximize social benefits, and not collude or allow one to be "captured" or "dominated" by the other.

Institutions like Fannie Mae and Freddie Mac in the U.S., as instruments of public policy, conducted their business no differently from their private sector counterparts in terms of lobbying and tinkering with accounting standards. At the same time, public sector banks in some other countries have been prudent and risk averse.

What accounts for differences in the economic behaviour of instruments of public policy in different countries? Is there relevance for public governance being different from private sector in regard to values, checks and balances, incentives, security of employment etc.? Should those factors influence the relative roles of government and market?

The social value of the financial sector?

The social value of the financial sector can be assessed in terms of its direct relevance as a service to the average person in providing financial services and its indirect relevance through its resource-mobilization and allocation, including managing risks and rewards.

The provision of financial services should be treated as public utility services and subject to regulation accordingly. A distinction in actual operations between provisions of financial services and intermediation is difficult, but it is necessary for a good design of public policy. The well-known Volcker Rule attempts this.

Broadly, financial services may be defined as those that a common person would want from the financial sector, and more generally are of direct social value. For example, safe custody of cash and access to cash when needed is important (withdrawal of cash from ATM ensures equity in the quality of service). Second, every citizen would like to have one extremely safe instrument in which his savings can be kept for a rainy day. Third, the payment system should enable transfers of money between people in different locations with minimum inconvenience as well as cost. Fourth, it should be possible to provide resources to smooth consumption when incomes are uneven over a period, while the bulk of consumption may be more stable. This requires access to some credit facilities, but finance for the common person is often equated with personal credit to them. Finally, a common person indulges in financial transactions as incidental to their normal lives. The default option indicated by public policy should take account of these needs, and not leave it to financial markets and regimes of contracts (between financial intermediary and common person) which are often among unequals. Has there been any assessment of these social needs from financial sector, in regard to quality, coverage or cost? Post crisis, there are references to financial inclusion, but are there global standards or benchmarks for the purpose?

The social value of financial sector is brought about indirectly in terms of productive use of capital. There are savers and investors with different risk-reward appetites and time horizons. In regard to the value of the financial sector for enhancing its role in mobilizing savings and allocating resources efficiently, will it be useful to explore empirical evidence? Cross country experience seems to indicate that savings have been low in some of the countries where the financial sector is highly developed. Savings have been moderate or high in some countries where banking system rather than the non banking system in financial sector is dominant. What is the empirical evidence on the link between the level of savings, the efficient use of savings and the level of development or nature of financial sector?

In terms of cross-country flows, the empirical evidence shows that financial sector development brought about a flow of resources to finance more consumption, rather than savings in the developed financial sector. In most countries where the financial sector was highly developed, there is a view that inequalities seem to have increased. What is the empirical cross-country evidence on developments in financial sector and their implications for growth as well as equity?

It appears that there is an optimal level and quality of financial sector intermediation and sophistication that seems to enable growth with stability while anything above that has not added fundamentally to the society. In other words, is there an optimal level and complexity of financial sector that optimizes its social value?

How active should regulation and supervision be?

If it is accepted that there is an optimal level and complexity of financial markets, which may be dynamic, then there may be need for rebalancing in the regulatory regimes with increasing regulation in some cases and decreasing regulation in others. It is possible that in some countries, especially emerging market economies, there may be need for some deregulation in financial sector to enable it to facilitate growth, but the extent of deregulation needs to take account of global experience and local circumstances.

It is often argued that one of the reasons for the crisis is that regulatory skills were not able to cope with the market innovations.
The issue is where should the benefit of doubt rest, namely, the market or the regulator in the case of innovations? For example, for a drug, the safety has to be proven by the producer before it is permitted, while in most other commodities there is penalty if the product sold proves to be toxic. Where does a financial innovation lie within these two categories? One approach, adopted in India (by the Reserve Bank, the RBI) was that if the innovation's benefits are not convincing enough for the regulator, it will not be permitted or permitted only with conditions (such as the burden of ensuring fit and proper criteria of the customer will lie on the seller of the financial product).

After the crisis, there are several considerations that appear to warrant greater role for discretion than rules. Counter-cyclical policies would involve assessment of structural and cyclical components. Such an assessment has subjective elements and differentiation between the two is very complex in emerging market economies. The identification of systemically important institutions may warrant judgment. If one financial intermediary which may not be big is a very dominant player in a particular critical segment of financial market, then it will turn out to be systemically important.

The issue in regulation and supervision is often one of effectiveness, and not mere intensity. Effectiveness can be enhanced by a combination of early warning signals, preventive corrective actions, graded escalating scale of effective penalties, a wide range of instruments with discretion. The actions of the regulator against the regulated cannot be based only on the transgression by an intermediary in individual instances or technical compliance with specific regulation but on overall comfort to the regulator about the conduct of business by a financial intermediary, consistent with the spirit of regulations.

How extensive and how intensive should regulation be in normal circumstances, and how much additional discretion should be specifically provided for meeting extra-ordinary circumstances?

Finally, the traditional debate between rules versus discretion in regulation may have to be re-stated. The new question may be: how flexible should rules be, and what constraints should be imposed on discretion?

How to design financial institutions?

It is recognized that there have been financial institutions that are too big to fail – say, in the U.S. and the U.K. There can be, at the same time, financial institutions that are too big to save; and we have examples from Iceland. There may also be institutions that are not too big but too important for a sector in real economy or a segment in financial markets and they may be too important or too critical to fail. There may also be financial institutions that are too powerful to regulate. They may be too powerful due to compulsions of domestic political economy or diplomatic considerations. When there are a few globally systemically important financial intermediaries, operating out of and with strong governmental support of globally significant countries, they become too powerful to regulate. The situation is worse when the infrastructure, such as few rating agencies and business news agencies, are also too important to fail. Can we influence the conduct of business of such entities by focusing regulations on standards of ownership and governance in relevant institutions?

Will recognising systemically important institutions and imposing higher capital requirements reduce or enhance the appetite of too powerful institutions for excessive risk? Should such institutions be stopped from emerging or existing?

How to mitigate the effects of crisis?

It is recognized that considerations relating to moral hazard compel large elements of constructive ambiguity in any strategy to mitigate the effects of crisis. It is possible to differentiate between the bail-out of institutions and of its management and shareholders. Should it not be possible to differentiate between institutions whose continuity is critical to mitigate the effects of crisis and the managers and shareholders of these institutions who should summarily be made responsible for the crisis? Powers for summary dismissal of executives, supersession of the Board, and replacement of management, and mandated sale of shareholdings could be part of the package of unconventional measures to mitigate the effects of crisis with minimum danger of moral hazard. In one case in India, a bank approached Reserve Bank of India for liquidity support with full collateral, but there was a suspicion that liquidity was denied to the bank by market participants due to its questionable investments. In the instant case, the RBI made support conditional upon the departure of the Chief Executive, as a pre-condition.

How limited is our understanding?

The cross-border activities of financial institutions are a big black box. The cross-border exposures have been a major source of collapse of many financial intermediaries in the crisis. In fact, it has come to light that much of the Federal Reserve's bailout packages helped resolve cross-border issues. Many financial institutions outside of the U.S. faced crisis due to overseas wholesale funding or lending. The nature of regulation of many cross-border activities of financial intermediaries is unclear. Is it possible that the cross-border activities of financial institutions, directly or indirectly contribute to undermining public policy in particular, in regard to regulations, taxes and occasionally legality? What is the impact of volatility in capital flows, carried out by cross border activities of financial sector on the real sector?

In its evolution, when does a financial sector stop playing the role of enabling growth of the 'real' economy and start injecting negative impulses to the 'real' economy? When does the financial sector create wealth or value, and when does it divert wealth to itself from others? Further, should the real economy keep adjusting to the financial economy even when the latter is volatile for a prolonged period, or deviates significantly due to extraneous considerations? What are the differences between financial markets and non-financial markets? How do the two interact to enable enhancement of social value, create wealth or divert wealth from many to a few? What is the interaction between banking and non-banking sectors, and between real and financial transactions in the financial sector?

The approach to conflict of interests in the financial sector is often applied to public sector or regulator and private sector in a somewhat identical manner. There are advantages of coordination and also threats of conflicts of interests when there is expanded mandate for regulators. Recent experience with crisis has shown that in public institutions the benefits of coordination could prevail over the risks of conflicts of interest. In private institutions, despite the firewalls that have been assured, ill effects of conflicts of interests prevailed. Should we change our assessment and consequently regulatory structures relating to coordination vis-a-vis conflicts of interest in the public sector as distinct from the profit-driven private sector?

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