Overview

Usha Thorat

Introduction

The more insular environment of the early 1980s for global finance was followed by an era of liberalisation and deregulation facilitated by the revolution in information and communication technology. This radically transformed the global financial system. The funding requirements of global trade, investment and output were met, in no small measure, by the financial system contributing to the steady growth and prosperity in the world. Regulation in its part evolved and responded to the innovations and the developments in the financial sector. The philosophy underlying it increasingly moved towards deregulation, rather towards encouraging innovation. The overarching view was that that the markets knew best and were self-correcting. But as innovation overtook itself and financial sector growth became an end in itself, the excesses morphed into a global crisis leading to a host of challenges for regulation. In responding to these challenges thrown up by the crisis, regulation has had to evaluate and take a new path, in particular, by looking at systemic risk and systemic stability. This is what has been attempted over the last three years and the end is still not in sight. In the process, stability, rightfully so, has taken the centre stage. But that alone is not sufficient. The other objectives of the society – growth and equity – are equally important to get out of the debt crisis, attain sustainability and ensure equity through employment-generating growth, which is so important for social stability.

While this has been largely a trans-atlantic scenario, the issues for EMEs have been different. EMEs did not contribute to the crisis but had to bear its consequences. For EMEs the imperatives of equitable growth continue to be real and strong. Consequently, regulation seeks to blend in their context the concerns of growth and equity with those of stability.

To what extent does the framework of financial sector regulation adopted globally in the post-crisis period impinge on the growth objective, especially for the EMEs? Should and can equity be a specific objective for financial sector regulation? What are the targets, instruments and institutional arrangements for macroprudential policies to address systemic risk in EMEs? What are the implications of the linkages between the real sector financial sector and sovereign for growth, equity and stability? How does the global financial architecture impinge on national policies? In order to think through these and related questions, the Centre for Advanced Financial Research and Learning (CAFRAL) and the Bank for International Settlements (BIS) jointly organised a conference for regulators and central banks during 15-16 November 2011 in Mumbai.

The symbol chosen to represent the theme for the conference was the tree of life – representing the global ecosystem with its interconnectedness and symbiotic relationship between the different parts, particularly between the real sector and the financial sector.

Regulation and growth

The issues relating to regulation and growth can be seen from a global perspective and from an EME perspective. From a global perspective, three issues emerge as relevant in the context of the discussion on the implications of regulation for growth. The first is whether there is a tradeoff between growth and stability; the second, whether there is any "optimal" size or composition of the financial sector; the third, whether regulation can directly target growth and equity or whether through targeting stability, it provides a necessary but not a sufficient condition for ensuring growth and equity.

The relationship between growth and finance is usually seen as positive but there have been different views. Recent events have shown that excessive growth in the financial sector can become a source of instability and can become a drag on the growth of the real sector . All recent studies on the implication of the new capital and liquidity requirements on growth point out that there could be some adverse impact on growth. However, the sacrifice in growth is negligible – even after taking into account the varying results of different studies – seen in the context of the sharp drop/slowing down in world trade, output and investment in the aftermath of the crisis with its concomitant impact on equity. Hence the trade-offs, if any, between growth, equity and stability are only in the short run. The overwhelming objective of financial sector regulation is stability, so that both growth and equity objectives are met in a sustainable manner.

On the question of the optimal size of the financial sector, Governor Subbarao points out that over the last 50 years, the share of the financial sector in aggregate profits more than doubled from 17 per cent to 35 per cent. "The large share of the financial sector in profits, when its share of activity was so much lower, tells a compelling story about the misalignment of the real and financial sectors." But how does one judge the optimal share (or, for that matter, the optimal scope or composition) of the financial sector? In answering this question, it may be necessary to consider enlarging the scope of the indicators used for determining financialisation. According to former Governor Reddy, financialisation is not confined to measures of credit, leverage and derivatives, it should encompass financialisation of the commodity markets, household budgets, corporate, and the government besides the financial sector itself. He suggests that it would be useful to attempt an empirical cross-country assessment of the appropriate size of the financial sector conducive to sustained and stable growth. Similarly, jurisdictions need to take a view on the optimal structure of the banking system. This involves issues such as the share of the public sector financial institutions and foreign banks; and in both cases an important factor is to what extent the regulator can have sufficient oversight. In the former, this relates to independence of the regulator from the political interests and in the latter, whether the presence of foreign banks is through subsidiaries or branches and the effectiveness of the home-host relationships. In the post-crisis period, the subsidiary route has emerged as a preferred mode of presence from the host country perspective, even though subsidiaries also cannot be ring-fenced completely. The need for subsidiaries may not be there if it were possible to work out a more effective resolution regime.

On the third issue of whether banks should confine themselves to the traditional role of boring banking, the cross-country experience shows that while global finance contributed to growth in world trade, investment and output, some countries have achieved high and consistent growth rates without too much innovative banking or even too much growth in investment banking. The counterfactual would be the continuation of real sector growth in these countries in the same manner without development of sophisticated financial markets. Analysing this would require cross-country comparisons of the composition, coverage and penetration of the financial sector and links with growth, stability and equity. This would help our understanding the optimal composition of financial sector development appropriate to each country. The need for "good" innovation like "good" cholesterol to facilitate both growth and equity and the need for good regulation to encourage such type of innovation needs stressing.

Turning to the EME perspective of regulation and growth, there are two separate sets of issues. The first covers issues of implementation. Regulation should be easy to understand and easy to implement. This is particularly important for EMEs and, it would not be too radical to think of a 'reduced form' Basel framework for EMEs. Implementation of Basel II/III is particularly challenging for EMEs because of the lack of sophisticated risk management systems, appropriate IT and staff skilled in quantitative techniques. There is also a lack of historical data necessary for the estimation of expected credit losses and operational losses. Even if considered more appropriate, EMEs would find it challenging to pursue the sectoral approach for countercyclical provisioning (which is more appropriate for many EMEs than the agreed Basel metric of aggregate credit to GDP). The challenge is that sectoral approaches might be perceived as non-compliant by the markets.

The second set of issues relating to EMEs is the implications of regulation for growth especially for the specific financing needs of trade, SMEs and infrastructure investment. EMEs would gain in general from the new regulations through spillover effects. These measures are expected to lead to a more resilient banking sector in the developed markets which need sound institutions and markets to stimulate growth, which in turn is vital for the growth momentum to be sustained in the EMEs.

It was noted that trade finance was critical for most EMEs and it was the first channel of transmission of the global crisis affecting the real sector instantaneously. The Basel III measures relating to trade credit have been modified recently to take into account the concerns expressed by EMEs, although the ring-fencing of trade credit in the wake of any disruption in global markets could well be considered as part of the international agenda for reform.

SME financing, even in normal times, is considered as non-viable business on risk-adjusted basis especially when banks have the option of investing in risk-free sovereigns. This sector not only faces a liquidity crunch in the wake of a crisis on account of shrinking cross-border flows but also because domestic large businesses tend to hold up payments due to such SMEs at such times. This consideration apart, banks are usually not as willing to reschedule loans for SMEs as for large businesses. Many countries took special measures to support SME financing in the post-crisis period. Such intervention is generally through: policy mandate (directed credit); subsidised credit guarantee schemes assignment of lower risk weights and provisioning (Basel already allows 50 per cent weights); and ensuring the better availability of credit records and credit information. Ultimately, it comes to a more robust manner of assessing credit risk to this sector to improve efficiency even in the presence of State support and guarantees.

The impact of regulation on the financing for infrastructure investment would also be an issue in EMEs. Stipulation of ‘net stable funding ratio’ (NSFR) may increase cost of infrastructure credit. There is also a view that current exposure norms for single/group exposures prescribed under Basel norms need to be scaled down. This could create a problem in jurisdictions where even the current norms are considered to be constraining infrastructure development. In the absence of alternate longer-term sources of finance for infrastructure, the maturity transformation role has to necessarily borne by the banks. Here again State intervention through provision of credit enhancements may be needed to facilitate bank funding of infrastructure while recognising the problems of moral hazard. However, such enhancements may not in all cases eliminate the problem of exposure norms. Banks also have to cope with a lack of information on financing – so they cannot be sure that the assets being financed by them are not being financed in parallel by others.

Regulation and equity

The impact of regulation on equity can be examined at the macro level as also at the micro level. Macroeconomic and macroprudential policies tend to ignore the impact of such policies on the poor. This is echoed in Andrew Sheng’s comment that, over the past 30 years, the growth in the wage rate and the deposit rate have been lower than the real growth rate. This has led to wage and financial repressions that have contributed to the poor subsidising the rich, at the national as also at the global level. In an important sense, the anti-inflationary stance of the monetary authority is the most appropriate “pro-poor” policy. Policymakers must ensure that monetary and regulatory policies curb excess financialisation which can cause undue volatility in exchange rates and commodity prices that become difficult for the small businesses and the poor to sustain. At the micro level, finance by itself does not have a pro-equity bias – indeed the seeking out of collateral to mitigate risk can be said to have an anti-equity bias. Similarly economies of scale dictate serving large and valuable customers rather than the many small customers. Hence, mainstream finance does have a “pro-big and pro-rich” bias. This raises three important questions. Should equity be a specific objective of regulation? If so, will this run counter to the objective of securing stability? How do regulators balance the objectives of equity and stability?

The Chair of the session, Stephany Griffith-Jones, argued that 'Too small to be counted', is too real an issue to be ignored by financial regulation and it is imperative for equity to be an explicit objective for regulation. The important caveat she added is that, if instruments for pro-poor growth are to be effective on a sustainable basis, they need to be supported by broader policy and institutional framework with simplified regulation – reliance on credit alone could be dangerous. This resonates with Governor Subbarao’s reference to the risk to the financial system of using easy credits to keep job creation robust – something that was brought home in the subprime crisis.

The requirement of the financial sector to adopt specific pro-poor policies, according to Reddy, can be justified because of the implicit subsidies to those who have a banking franchise (deposit insurance, bailouts due to the public utility and systemic importance of the banking system etc). There is increasing support for the view that some prescriptions about the allocation of credit and pricing of transactions in order to achieve the equity objective are likely to win greater acceptance than they did in the pre-crisis period. This is not to advocate regulatory forbearance or relaxation of prudential norms, but to support the use of regulatory prescriptions to encourage financing of directly productive activities which support self-employment and small businesses in the real sector. Similarly, there is merit in incorporating incentives for financial inclusion in the regulatory regimes of developing countries.

The provision of safety nets could indeed be one form of protection for the poor. As financial crises of different dimensions recur periodically, regulation therefore needs to ensure that the engagement of poor with the formal financial system is within a framework which supports their survival during downturns. There should be sufficient space for them to limit their losses. This could be achieved through some form of insurance/credit guarantees. Similarly ring-fencing of trade credit in future crises could be an important area for regulatory reform while drawing up living wills of financial institutions entities.

The paper presented by Sriram alludes to the need to expand time horizons for engagement of the financial sector with the poor as the current accounting standards, regulatory guidelines and institutional behaviour focus on the short term. The small stakeholders suffer the worst since their engagement is seen as a charge on current profits, irrespective of long-term gains. It is here that the role of alternate non-bank channels becomes important. Perhaps a different regulatory approach to entities which are not governed purely by market forces and which can afford to take a longer term view – such as social enterprises – can be given appropriate policy and fiscal support to innovate within certain thresholds.

Specific innovations taking advantage of information and communications technology (ICT) solutions to achieve scaling up of outreach, reducing transaction cost while ensuring sufficient safeguards, relate to the use of the business correspondent model and mobile banking. Experiences in Brazil, India and various countries in Africa highlight the win-win aspects of these innovations. The mobile telephone companies have a larger footprint than banks in China and India: getting them to help provide financial services through mobile banking for the poor is both a challenge and an opportunity in these and other EMEs. Both banking regulation and payment system regulation need to respond to the challenge and opportunities of rapid and dynamic changes taking place in the ICT sector that can make financial inclusion a reality.

An important issue raised in regard to 'credit worthiness' of small clients was that banks need to think innovatively beyond credit bureaux and develop a mechanism based on transparency of transactions – much as eBay does for its sellers. Transaction history, based on cash flows, could be a strong indicator of credit worthiness. This could overcome the problem of collateral for small borrowers.

Regulation and stability

The sources of systemic risk in EMEs are several and some of them go beyond the scope of national financial sector regulator/s. Even if EMEs have perfectly flexible exchange rates (and in most cases they do not), the monetary and fiscal policies of significant reserve currency countries have impact of systemic nature on EMEs especially through volatile and undependable capital flows. Hence capital account management becomes very much part of the tool kit to ensure macroeconomic and financial stability in EMEs. Other macroeconomic factors are the nature and extent of cross-border lending, inadequacy of resolution mechanisms for cross-border financial institutions and the perimeter of regulation. The extent of sovereign paper holdings in the financial sector and erosion of confidence in what is otherwise considered a risk-free paper could also threaten financial stability as is currently the case in the euro area. This is an important lesson for the EMEs. The microeconomic aspects of systemic risk relate to externalities – interconnectedness, procyclicality and contagion. Equally important is the quality and effectiveness of supervision.

The practical issues in implementing macroprudential measures pointed out by Philip Turner relate to data gaps, operational targets, choice of instruments and institutional arrangements.

In the case of EMEs, data on system-wide currency and maturity mismatches as also on the highly geared counterparties in the more innovative segments of domestic capital markets need to be collected and monitored at regular intervals. In view of the interconnectedness between the financial sector, macro economy, businesses, households and sovereigns, there could be a problem of choosing the right indicators to measure systemic risk. Each jurisdiction will need to build up an integrated indicator which reflects the global buildup of risk; comparable parameters locally, as also local risk build up including exposures and leverage of local financial institutions. Even if such a metric is built up, a judgment call would need to be exercised on when to invoke the instruments or tools as there is a risk of too early or too late an intervention.

This calls for coordination between monetary and macroprudential policy, and adequate preparation of the market through appropriate communication of the authorities' intention to bring in macroprudential measures unless the risks subside. Usually, the desired change in monetary policy and macroprudential policy would be in the same direction. But circumstances may arise when macroeconomic and macroprudential policies will need to move in opposite directions. It may be difficult to have clear demarcations and in practice the two may have to be framed jointly although there could be a hierarchy in the decision making process. The choice of policy tools is largely a country-specific issue and use of greater number of instruments in a modest way would generally be less distortionary (and therefore more effective) than heavy reliance on just a few instruments.

As regards institutional arrangements for macroprudential policies, there is a dominant opinion in favour of the levers being in the central bank in view of the close link between monetary policy and macroprudential policy, the expertise within central banks due to active participation in financial markets, and the central bank role as lender of last resort. The focus on macroprudential regulation has brought a new equilibrium between central banks and supervisory authorities which may have interesting connotations even where both the activities reside within the same body. There are concerns that the monetary authority may lose some independence in the process. Whatever the model, there would be a need to shield the body responsible for these policies from both political and commercial interests of the financial industry. Central banks, being independent of the political cycle as well as of the industry, are well-placed to "take away the punch bowl" before excess leads to disaster.

While return to the risk-free status of the sovereign is imperative for financial stability, in the interregnum, there is need for supervisors to ensure that financial institutions undertake a realistic risk assessment of sovereign assets. Such assessments will have to be based on more fundamental parameters rather than market assessments which could be extremely volatile. In the euro area, deleveraging by financial institutions which is affecting the short-term interests of the economy is less on account of the demand for recapitalisation but more on account of the overall macroeconomic environment. In the longer term, only well capitalised banks will be able to attract both capital and debt from the markets. The need to bring in systemically important shadow banking in whatever form into the macroprudential framework is strongly underscored.

Macroeconomic policy and financial regulation

In his inaugural address, Jaime Caruana set the tone in broadening the topic of the conference to go beyond regulation to macroeconomic policies impacting the objectives of stability and growth. While discussing the linkages between the real sector and the financial sector he drew attention to the fact that "financial stability depends not only on the link between banks and the corporate and household sectors but also on their links with the sovereign. Given these two-way influences, between banks and sovereigns, there is a clear and present danger of malign feedback from banks to sovereigns and from sovereigns to banks." He drew the analogy with macroprudential policies that emphasise the building up of buffers in good times to be drawn down in bad times. He said that one lesson from the crisis is the need to build headroom in the government budget in good times to be able to have enough policy space to support the economy in a downturn. Otherwise the government itself could become a source of instability "as its credit risk damagingly interacts with that of banks and other private sector entities. Sovereigns must now earn back their reputation as practically risk-free borrowers. And as history has taught us, sovereign solvency is a precondition for the central bank's success in dealing with threats to monetary and financial stability". A sound recovery hinges on having a secure financial system. Businesses and households will not regain the confidence to plan, to invest and to innovate until they have regained their trust in the financial system and its durability. Structural reforms are desirable to allow faster trend growth.

In a wide-ranging speech, Reddy covered the synergies and tradeoffs between the objectives of growth equity and stability and the use of macroeconomic policy and financial regulation to balance these objectives in an optimal manner. He did this against the background of globalisation and the weak international financial architecture. Alluding to Caruana's query about the optimism implied in conference title as to whether we are really in a post-crisis period, Reddy said that the risks have been passed on to the sovereign, and there are now significant threats to economic political and social stability. Re-regulation or rebalancing of regulation by itself may not be enough to achieve the optimal share or size of the financial sector that would be conducive to growth and stability. It may be useful to do a cross-country study taking into account the diverse experiences of different countries in regard to composition of financial sector, growth and stability using five related factors, viz, the macroeconomic environment in which the financial sector operates; the share of financial sector in the total economic activity; the composition of the financial sector in terms of banking, non-banking, derivatives etc; the framework of regulation of financial sector and the quality of supervision of the sector. The possible dualism in growth of the financial sector reflected in underserving of certain sectors and excessive financialisation in others should be analysed by EMEs. Alternative paths of development of financial sector need to be considered, keeping in view the lessons from the global financial crisis.

A lively discussion on the role of global imbalances and persistence of the paradox of the "uphill" flow of capital from the EMEs to developed countries was provoked by John Lipsky. Neither Reddy nor Sheng saw the capital flows to developed countries reversing in the near future: public debt is growing faster than GDP in advanced countries; demographic factors are putting pressure on government budgets; there is limited scope for increased savings in advanced countries; and there is no credible alternate to the dollar as the reserve currency, Nor did they see the euro area problem, essentially being internal, as contributing to global imbalances. But slower growth in Europe could have sizeable adverse spillover effects.

Global financial stability depends on three key infrastructure elements: the reserve currency; the lender of last resort; and the prevalence of oligopolistic conditions in the rating industry, the accounting profession and news/wire agencies. Describing the present system as a non-system, where there is no market discipline on the dominant reserve currency, multiple reserve currencies or fully floating exchange rates cannot be seen to be solving the problem due to presence of network externalities and the absence of a credible global lender of the last resort. There is scope for regulators to ensure that CRAs follow the rules of the game and are subject to market discipline. Equally, informed institutional investors must build their own capabilities for proper risk assessment.

Global finance and the presence of large international banks also bring into sharp focus the issue of autonomy and effectiveness of the national financial regulator. To quote Reddy "globalisation of finance in the context of serious market imperfections and absence of globally enforceable rules could, by virtue of close linkage of finance with other macro policies at national level, restrict the space available for national authorities to conduct macro-policies".

Conclusion

The conference brought to light the intricacies of interrelationships of regulation and macroeconomic policies not only with respect to growth and stability, but also with respect to equity. The conference provided an opportunity for regulators and policymakers to focus on the issues from the angle of the EMEs. Divergent views were aired frankly. We were able to debate the global implications of national policies while making suggestions on regulation and macroeconomic policies in the backdrop of the current global financial architecture. The conference also provided suggestions for initiating several areas of empirical research. It has opened up to CAFRAL new vistas to explore in planning its future activities. And it contributed to the international financial cooperation that is the vocation of the BIS. By sharing knowledge on policy issues confronting central banks and financial supervisory authorities, the aim is to promote not only better regulation and supervision worldwide but also deeper mutual understanding.