Session II: Chair's initial remarks

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At the outset, I would like to thank Usha Thorat, Jaime Caruana and Philip Turner for organizing such an excellent conference. It is really a privilege to be here in India, particularly because it provides an opportunity to get valuable lessons and experiences from India. I like the expression in the theme: "too small to be counted". It is an interesting and rather an unusual subject making us to think not just about growth and financial stability, but to consider regulation in a broader development framework.

In the wake of the crisis, we talked a great deal about the need to curb harmful financial innovation, the kind of financial innovation that seems to be good mainly because it helps to maximize profits for parts of the financial system. It reflected a lot of creativity in financial engineering but has tended to generate more systemic risk rather than leading to better risk management and diminishing risk, which are the goals of the financial system. Many of the innovations developed by the financial sector, especially in the North Atlantic countries, therefore turned out to be problematic.

We have an opportunity in this session to discuss positive financial innovations that could truly serve the real economy, rather than undermining it. We should start from looking at the needs of the real economy and then the kind of institutional arrangements, and the kind of innovations and instruments that can best serve those needs. Such positive innovations are important in a number of areas – such as lending for investment in infrastructure, in renewable energy and growth linked securities for governments – but particularly so in instruments of lending which could provide sustainable financial services to the poor.

It is really surprising that there are simple instruments, sometimes escape our attention. I will just give you one example outside that of lending to the poor. The GDP linked bond is an instrument that would help the government to service more debt in times of high growth and less debt in times of poor growth or recession. It should have been so useful during the European sovereign debt and other crises; and it would have been also useful during booms, because it could help in cooling the economy. I wonder why such instruments have not been implemented.

A number of other positive innovations for lending to the poor can be identified, that have worked well in different countries; these include the use of business correspondents(for example in Brazil, these have very successfully helped extend financial services to remote villages at low transaction costs), the use of mobile phones (successfully used in countries like India, China, Taiwan) combined with the provision of payments services, in particular to women enabling safe keeping of money(in India for example). Provision of financial services goes well beyond provision of credit; it includes for example access to bank accounts, payments services and insurance.

I think lending to the poor and lending to the SMEs are of particular importance and we need to understand more about them. We have to start from the perspective of what is the sector's need and then what kind of credit, and how credit should be made sustainable so as to serve the needs of their growth. I think for example, simplicity is particularly important. I do not think

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that it would be appropriate for the instruments of lending to the poor to assume any level of complexity. I believe that simplicity in financial sector, when introduced would also help in general in simplifying regulation.

It is also important to provide good financial safety nets for the poor; this will avoid the current dilemma, where big financial actors are too big to fail, but the poor are too small to be counted (as the background paper so rightly argues). A key issue therefore is to protect the poor in times of crisis; this was for example not done in the US financial crisis, as TARP bailed out large banks, but did not rescue poorer mortgage holders. The US program was quite effective in saving the financial system which is no doubt important, but it was quite costly and was far less effective in helping the poor people, in particular who held the mortgages. Those people are either still struggling to keep the mortgages alive or actually have lost their houses. Economists like Stiglitz and Krugman have argued that the bailout packages should have been more symmetrical and far more protective of the poor people. Therefore, it is important to think not just about how to lend to the poor but also how to protect them when things go wrong, since they always have a less bargaining position in the financial sector. In this sense, it is important to empower the poor; movements like that of Occupy Wall Street attempt to help with that.

While designing instruments that will be supportive of pro-poor growth, we need to recognize that it has to also work in collaboration with other economic policies. Reducing poverty must simultaneously rely on other policy instruments, such as fiscal policy, redistribution of assets, and measures to increase productivity of the poor; this will avoid exclusive emphasis on credit as a way to raise welfare for the poor. Indeed, poverty alleviation and improved income distribution need to be a central aspect of a development strategy.

More broadly, one of the main causes of the North Atlantic financial crisis, according to eminent economists like Stiglitz and Krugman, is inequality of income; a similar diagnosis was made by Galbraith in his book of the 1930s, The Great Crash. Because incomes of the poorer parts of society do not grow enough, or even may fall, credit to them is seen as a way of boosting their level of consumption, whilst not increasing their incomes. This often may lead to lack of sustainability, and ultimately to problems both for the poor and the financial system. It is essential that lending to the poor is done on a sustainable basis as far as possible, to avoid outcomes such as incapacity to pay by the poor and insolvency of institutions lending to them. For example, sub-prime mortgages, though initially facilitated poorer people to buy homes, did so in an unsustainable way, leading to people either accumulating excessive debt and/or losing their homes. According to the Head of UK regulation , Lord Turner, some financial innovations have made parts of the financial sector ”socially useless”, or –even worse, damaging to the real economy. So, one should not rely exclusively on these kind of instruments, as valuable as they are, but, it has to be done in coordination with fiscal policy and other measures.

One of the key questions posed by Usha Thorat is: should equity or inclusiveness be included as an objective of regulation together with financial stability and economic growth? The answer is a resounding yes. It should clearly be an objective of regulation especially for emerging and developing economies. A very good UN report released about five years ago, which was focused on micro finance, actually said that access to finance for the poor should be a central objective of prudential regulation and supervision. One way to argue in its favour in technical terms is that it may provide some benefits of diversification. By lending to poor and to SMEs, the banking system, more generally the financial system can have a greater exposure to different segments of the economy which may not be synchronized through the economic cycle. In the same way, lending to emerging markets and other developing countries provides benefits of diversification to international banks which should have actually been very useful in the crisis and the post crisis period. So, it is certainly a valuable objective, but with a caveat I have already mentioned, that these have to be done on a sustainable basis. There are also certain pre-conditions for this to work outside the mainstream financial sector and also within it. Such preconditions would include for instance, the establishment of credit bureaux, establishment of measurement, understanding of the measurement of risk profiles and adequate methodologies to evaluate financial services to the poor(See UN , 2006).

Financial regulation is important in a number of aspects that relate to equity. Good regulation must for example ensure the financial stability of institutions, so that the poor do not lose their savings; equally, financial regulation must ensure that the lending instruments used are sustainable, so the poor are not worse off as a result of their borrowing. Any trends that make either the financial institutions or the loans unsustainable need to be avoided; one example is avoidance of currency mismatches, which could arise if foreign lenders finance institutions which are lending to the poor. Should regulation of institutions lending to SMEs or the poor be lighter and less complex? Though this would have advantages, it has the problem that the risk of regulatory arbitrage must be avoided.

Another issue relates to what extent should there be mechanisms like guaranteed funds that will provide some kind of comfort to banks to lend to sectors which can improve equity and inclusiveness. For Governments, this poses the most difficult question, since guarantees generate a contingent liability. So, one need to think very carefully about how to restrict the contingent liability. There is an example from Europe, where the European Investment Bank not only provides loans to commercial banks on the condition that these banks pass on the advantages of cost when they on-lend to SMEs; it also in some cases provides guarantees that it will share first losses up to a certain level(which are financed by EU grants); this encourages private banks to lend more to SMEs than they would otherwise do; to avoid moral hazard, however, risks are shared between the EIB and the commercial bank(Griffith-Jones and Tyson, 2010). This mechanism has worked well particularly during the current crisis by helping to increase SME lending or to soften the reduction of lending to the SMEs.

Yet another aspect relates to the choice of delivery mechanism. An important issue is whether lending to the poor should be done mainly directly through State owned financial institutions or private ones. The experiences from Brazil and India in delivering through public banks are quite positive. The other way is to do it indirectly as I was already mentioning through guarantee mechanism, or through minimum levels of lending required from private banks provided they are done in a sustainable way. It has to be also well supervised. And the other element is to try and shape the kind of instruments that could be used by private banks through regulatory incentives. In this case, how far should regulators go to determine the proportion of lending that should go to the poor or SMEs? If this is not done, how can they encourage cross-subsidization of loans from other lending to that which is made to the poor? There are a number of experiences that seemed to work differently in different countries.

The key point is that the financial sector should be designed and regulated so it serves the interests of the real economy; indeed, the financial sector must not be a bad master, but a good servant of the real economy. Emerging and developing economies have the advantage that many of the vices and dysfunctionalities that have become so pervasive in many Western financial systems do not affect them as much; being a late starter has the advantage of being able to learn lessons, both good and bad ones, form other so-called more advanced systems. One good example is the need to curb or avoid the financialization of loans to the poor, for example via securitization and on selling packages of loans made to the relatively poorer segments of the society.

I do not think we can have an overall response and a lot is further to be discussed. I think the exchange of experiences that we have here should be actually very useful.

To recapitulate, the key questions that this session is aiming to address are:

First, why are equity and inclusion important and are these objectives at cross purposes with regulation?

Second, Can an inclusive regulatory philosophy minimize the risks of a crisis and soften the impact of cyclical behaviour?

Third, how do other elements of the eco-system – the public policy, markets, and regulation - that are outside the purview of the regulator and central bank treat inclusiveness, thereby impinging on the behaviour of the financial sector?

Fourth, how does the regulatory system develop a longer-term horizon to stay invested in the "poor"?

Fifth, in the context of inclusion, what are the implications of technology for regulation?