

B Mahapatra: The global financial crisis – new awakening

Address of Mr B Mahapatra, Executive Director of the Reserve Bank of India, at the Convocation Ceremony of Chetana's Institute of Management & Research, Mumbai, 21 January 2012.

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1. Shri Shirish Choudhary, Honorary Secretary, Chetana Trust, Dr. Ashok Choudhury, Trustee Member, Smt. Madhumita Patil, Chief Executive Officer, Dr. M. V. Deshpande, Director, Chetana's Institute of Management & Research (CMIR), other eminent dignitaries on the dais, guests, and distinguished faculty members, graduating students, relieved parents and family members: It is a great pleasure for me to deliver the convocation address today for the batch of 2011 at the Chetana's Institute of Management & Research, which has evolved as a premier management Institute. It would be in the fitness of things to pause for a few minutes and remember the Founder President of the Chetana Trust: Late Shri Madhukarrao Chaudhari, Philanthropist, Former Education & Finance Minister, Maharashtra and Speaker, Maharashtra Legislative Assembly. His vision was to develop Chetana as a world class Institute of academic excellence and to develop outstanding business professionals who make valuable contributions to the corporate world and society. This vision has been achieved through the rapid strides made by the Institute in the past several years in the field of management education and research.

2. I am privileged to be here today on an occasion which is both joyous and solemn. For many of you, this day will be an extremely happy one and an important milestone in your life. You are graduating from a student life to a corporate life with a splendid future in front of you. Opportunities in India today are at par with the best that the world has to offer. When you reach my age, India will, in all likelihood be in the forefront of nations that have eliminated poverty and entering the ranks of advanced economies. Some of you would have created companies, while some others would have climbed your way to the top of the corporate ladder. Some among you may have chosen to become academicians and a number of you will choose to dedicate your life to social work.

3. Undoubtedly, you will also have feelings of sadness today and in the days to come. Campus life creates a cocoon around you, only to tear it apart today. You will bid goodbye to the Institute which has nurtured and chiseled the talent in each one of you, where you have developed lifelong bonds. You will feel the loss of friends. But rest assured, you will enjoy the challenges ahead when you enter the real world.

The new awakening

4. As you move to the threshold of a new phase in your life, I am reminded of the clarion call of Swami Vivekananda, "Arise, awake and stop not till the goal is reached." I do not know how many of you are aware that the birthday of Swami Vivekananda is officially observed in India as the National Youth Day. The Government of India, while declaring January 12, his birthday, as the National Youth Day, said, "it was felt that the philosophy of Swamiji and the ideals for which he lived and worked could be a great source of inspiration for the Indian youths". Swami Vivekananda was not only a monk, he was a scholar and teacher too and his teachings are very relevant for the youth even today. He wanted the youth to combine character with capability, values with effective actions and ideals with a practical mind.

5. With this in mind, I would like to leave some thoughts with you on the topic that I have chosen for the evening – ***The Global Financial Crisis: New Awakening*** – in the

backdrop of the unprecedented economic turbulence faced by the world today and the social revolutions underway. It is no mere coincidence that “Chetana”, the name of your Institute means consciousness. The starting premise of my talk today is the urgency for awakening our consciousness. The first thing you must know in order to awaken your consciousness is to know that you may be asleep. The youth revolutions – driven by the passion and zeal of the youth – happening the world over reinforce this fact and are partly the reason for my choice of the theme for today.

6. As you surely know, the last few years have been very turbulent for the world economy and have shaken the foundation of some of the unquestioned beliefs of economic theories. The global financial crisis has called into question the ethical foundation of the financial world. Even as we grapple with these challenges, the world has seen revolutions in the Arab world to topple long standing despotic regimes. The Euro zone crisis with the unemployment and welfare cuts in some European countries has added to frustration of the people of Europe. 2011 will be particularly remembered as a year of revolution, the beginning of the end for an unsustainable global financial system based on greed, inequality, misdoings, and lack of leadership. Is it a coincidence that you belong to the batch of 2011 that stands on the threshold of a new awakening?

7. In this backdrop, I shall dwell on the three most prominent youth protests that marked the year 2011 – the *Arab Spring*, the *Occupy Wall Street*, and the *Spanish Indignados* (indignant) Movements.

The Arab Spring

8. The Arab Spring, otherwise known as the Arab Awakening, as you are aware, was a revolutionary wave of demonstrations and protests across the Middle East and North Africa (MENA) that began in December 2010. It was sparked in Sidi Bouzid, a neglected Tunisian town by a young man like you, twenty six year old fruit vendor Mohammed Boulazizi who only wanted to make a simple living. But when his fruit cart and produce was confiscated by the police and the town’s governor refused to hear his plea for return of his wares, he set himself on fire. A fortnight after his death, unprecedented anti-government protests raged throughout the country, and the dictator of Tunisia had to flee. With one tragic act, he awakened a generation of Arab youth and altered the course of Arab history.

9. The flame lit in the little known town of Sidi Bouzid led to the toppling of the country’s dictator and soon spread to Egypt and Libya, Yemen, Bahrain and Syria as youth-led uprisings fractured decades old authoritarian order. The geopolitical implications of the protests have drawn global attention, with one (Tawakel Karman) of the three laureates of the 2011 Nobel Peace Prize being a prominent leader in the Arab Spring.

Occupy Wall Street

10. Building on the momentum of the Arab Spring movement, another movement popularly known as the *Occupy Wall Street* began innocuously in another part of the world. I used the word “innocuous” because here there was no brutal crackdown by a dictator, no crushing of demonstrators, no police firing and no self-immolation. In fact, the movement did not start in the United States of America, the world’s prominent democracy. In July 2011, the Canada-based Adbusters Foundation, championing the cause for an ad-free and anti-consumerism society through its magazine Adbusters, proposed a peaceful occupation of Wall Street in Manhattan, the citadel of modern finance, to protest corporate greed and misdeeds, growing income inequality and absence of legal action against bankers blamed for the global financial crisis. It was followed with great interest in the US, especially in the social circles, and the movement kindled the spirit of disenchanting Americans. But where the Arab Spring was a longing for democracy romanticized by the blood of the youth on the streets,

the American protest was a cry for accountability and justice, and protest against all the misdoings of the financial system and the corporate world.

11. What began as a motley crowd in a park in Manhattan gradually went viral on-line. As per one estimate there are now more than 2,500 physical Occupy sites around the world today. The movement rode the social media to generate a public discourse about its objective and did push inequality to the centre of the debate in the US. Its slogan – “We are the 99%” became the phrase of the year. The phrase refers to the vast concentration of wealth among the top 1% of the income earners compared to the other 99% and indicates that most people are paying the price for the mistakes of a tiny minority. One of the highlights of this movement is that it has spread to the elite universities of the US, which fall in the one per cent category. The fact that the students of the elite universities are now identifying their interests with the lower 99% is surprising, but inspiring.

12. What this movement has done is to bring the issue of economic injustice and disparity to the open. In fact Time magazine chose the “Protestor” as the person of the year. Occupy Wall Street is now turning out to be contemporaneously the most well-chronicled dissent in the history of mass movements, with even the political class in America being forced to respond to these new age protests. “Occupy” and “Tea Party” have been almost in competition to grab headlines.

Los Indignados or the 15 M Movement

13. Let me now talk about the *Indignados* (meaning “the outraged in Spanish”) Movement that started in Spain in 2011. Since the beginning of the recent global financial crisis, Spain has been hit hard with the highest unemployment rates in Europe, with the unemployment rate amongst the under 25s crossing 40%. It was therefore not surprising to see the wave of youth protests hitting Spain also. While the disappointment and frustration in youths was building up gradually against the political and banking system since the global financial crisis, it took shape in the form of a movement on May 15, 2011 when lakhs of young people gathered in Madrid calling on more people to act against the follies of the financial markets. The protests reflected the angst of the youth at the efforts of government to contain European sovereign debt crisis through bailouts of banks responsible for the crisis while continuing to announce cutbacks in social programmes.

14. The protests attracted wide reactions from political parties and earned broad support from the public at large and many famous personalities. The Noble Prize winning economist Joseph Stiglitz participated in the protests held in Madrid in July 2011. Former Spanish Prime Minister Felipe Gonzalez considered the protests as “an extraordinary important phenomena”.

15. On October 15, 2011, exactly after 5 months since the first protest in Spain began, global protests against corruption and power of economic elites were held in 950 cities and 82 countries, with maximum number of people gathering in Spain. One of the things that are striking about all these protests is the fact that on the face of it they were targeted at political and banking system, but if you look deeper you will find that these were more than that. They were about changing the civil society and about transforming the relationships amongst people.

Youth power

16. There may be a question in your minds as to why I have spoken in such detail on these revolutions. The idea is to highlight the power of youth and the positive change that it can bring to societies and nations when used constructively. The fact that these movements overthrew some of the governments, attracted wide reaction from political parties and garnered support of the public at large is enough to prove the youth power. As youngsters,

you are filled with enthusiasm and straining at the leash to get on with life. While these protests do speak volumes about the power of youth when unified, there is also a related issue of herd mentality which needs to be considered. I personally believe that in these protests individuals do not lose their own identity, but they start acting as per a group's identity. Group identity creates agreement through debate.

17. However, while it is very common to become a part of a movement (or say a situation in corporate world where you choose to go with the group's opinion), I would caution you against being taken in by the extant fashions of the world. Define what you stand for and understand that success can become enduring only if it is built on a strong foundation of values. You cannot enjoy the fruits of success if you have to argue with your own conscience. Values are a matter of trust and must be reflected in your actions. Trust takes time to be built but can be lost quickly in a moment of weakness.

Global financial crisis – Lessons to be learnt

18. As management graduates, it is important for you to understand the economic, strategic and ethical factors behind the global financial crisis that is causing much of the revolutions among the youth world over.

19. It is often said that those who do not learn from history are doomed to repeat it. We will have more economic and market turmoil if our financial experts, political leaders, regulators and nation as a whole have not embraced lessons from the past. It is therefore important for all of you to read as much as possible about the crisis that the world has faced over the years, the genesis, the reasons and most importantly the lessons that can be learnt from them.

20. To quote John Kenneth Galbraith, "let it be emphasized once more, and especially to anyone inclined to a personally rewarding skepticism in these matters: for practical purposes, the financial memory should be assumed to last, at a maximum, no more than 20 years. This is normally the time it takes for the recollection of one disaster to be erased and for some variant on previous dementia to come forward to capture the financial mind. It is also the time generally required for a new generation to enter the scene, impressed, as had been its predecessors, with its own innovative genius."

21. A report by the Chartered Financial Analyst Society of UK condemns what it calls "financial amnesia" among finance professionals, arguing that a failure to heed the lessons of the past led to the most recent crisis and will likely lead to future ones. Every time a crisis occurs, experts are confronted with the question why they could not foresee it. The experts argue that "this time is different". However, evidence show that all financial crises can be traced to the same fundamental causes as if we learnt nothing from one crisis to another. There is therefore an emerging thinking that the study of financial history should form a major part of all compulsory education for finance professionals. I will be interested in knowing your views on this.

Micro economic and macro economic factors

22. So, what were the causes of the crisis and the reasons therefor? There are several causes and reasons for the crisis. It will be foolhardy on my part to cover all of them. I will only touch upon the important few. One reason is that the financial sector grew too big, partly because risks were misunderstood and partly because it was encouraged by policymakers to expand. In other words, the crisis was an outcome of the interplay between both macroeconomic and microeconomic factors. From a macroeconomic perspective, the crisis has been attributed to the persistence of global imbalances, excessively accommodative monetary policy pursued in major advanced economies and lack of recognition of asset prices in policy formulation. From a microeconomic perspective, the crisis has been attributed to the rapid financial innovations without adequate regulation, credit boom and the

lowering of credit standards, inadequate corporate governance and inappropriate incentive system in the financial sector and overall lax oversight of the financial system. The lessons that we should draw from the crisis is that the reckless pursuit of profits without considering the possible risks, has the potential of destabilizing the markets.

Corporate governance

23. One issue that has engaged the attention of policy makers has been that of corporate governance. Corporate governance, at its most basic level deals with issues related to the separation of ownership and management and reconciles the interests of owners, managers and other stakeholders. The practice of strong corporate governance standards assures investors that the business environment is fair and transparent and that companies can be held accountable for their actions. Empirical studies show that investors are willing to pay a premium for companies with superior governance practices.

24. However, there were several weaknesses in corporate governance in the run up to the crisis. Corporate governance arrangements, when put to test, failed to curb excessive risk taking in banks and financial services companies. Studies have shown that risk management systems failed in many cases more due to poor corporate governance than due to the inadequacy of the mathematical models used. The Board and even senior management, in some cases, failed to establish an informative and responsive risk measurement and management reporting framework. The institutional arrangements in many instances conferred importance and status on the risk takers at the expense of independent risk managers and control personnel. Where strategy was in place, boards did not establish suitable metrics to monitor implementation.

25. Reform measures have been initiated in the area of corporate governance. Major structural changes in the areas of risk management, compensation policies and transparency in operations with regard to the Board and top management have been introduced in several countries to improve the overall functioning of the financial institutions and enhance governance.

26. The lesson to be learnt from the recurring corporate governance crisis in both the developed and developing economies is that eternal vigilance must be exercised at all times. A study of the governance failures in different institutions in different countries also helps in understanding that the measures and reforms to address the governance failures in one context may not be as effective in another, and that the timing and focus of reforms should reflect the economic and institutional realities of the country concerned.

27. Where India is concerned, although our banking sector has emerged largely unscathed from the crisis, there is definitely a need to do some introspection as there have been some issues of corporate governance failure here too. The incidents of banks mis-selling forex derivatives to clients have been well publicised and is one such example. There is therefore a need on the part of banks and financial institutions to be more responsive to their obligations towards the larger public interest.

Compensation practices

28. Out of the many issues that have arisen in the context of the global crisis, executive pay and compensation practices in the financial sector have perhaps invoked the maximum public outrage. There has been wide spread criticism that incentives and pay packages were set inappropriately, encouraged irresponsible risk taking, were inconsistent with the firm's capital bases and focused on short-term profit maximization. Compensation for senior executives has been perceived to be excessive with little correlation to the long term performance of the institutions concerned. Particularly glaring was the multi-million dollar payments and bonuses to the executives of failed firms which had received public funding. The most outrageous case is probably AIG, the insurance and financial services giant. It was

reported that AIG lost \$61.7 billion in the fourth quarter of 2008 and received more than \$170 billion in federal bailouts. However, AIG paid over \$165 million in bonuses to executives by March 2009 as part of a total payout of \$450 million.

29. It is now widely acknowledged that the flawed incentives and compensation structures in banks and financial institutions in the advanced countries also played a major role in the crisis. While investors have borne the bulk of the losses and taxpayers have shelled out trillions of dollars to keep financial giants afloat, executives and employees of these banks appropriated disproportionate shares of the profits when the market was booming. This has reinforced the public perception that bankers have got away scot free, while the real economy suffered unprecedented output loss and growth.

30. Following the financial crisis, efforts are afoot to make it harder for bad bosses to walk away with a fortune. A further key trend regarding executive pay that has emerged since the start of the crisis is that its regulation has taken on an international dimension. Two G20 summits were held in 2009 that both substantially addressed the issue of executive pay. Further, the Financial Stability Board (FSB), a body of regulators to oversee the global financial system, has evolved a set of principles to govern compensation. The proposed framework involves increasing the proportion of variable pay, aligning it with long-term value creation and instituting deferral and claw-back clauses to offset future losses caused by the executive. We have recently advised our banks in India to initiate similar steps.

Ethics

31. What is the common thread running through these causes of the crisis and the swathe of reforms to prevent another? It is the ethical dimension. What the crisis highlighted was the massive breakdown of trust – trust in banks, in financial system, in rating agencies, in investment advisers and in politicians. Trust is an important element in the functioning of financial markets as the very nature of financial contracts requires a high level of trust. This trust which takes time to build up was eroded during the crisis. Several questions come to mind in this context. Was the behaviour of the players across the chain of the financial system fair and ethical or was it influenced by the greed to make quick profits and fat bonuses? Did the bankers and investment advisers explain the risks in the complex financial products they sold to their clients? And what about the credit rating agencies? Did they compromise on their standards?

32. The crisis has triggered an interesting, if also a soul searching debate on whether the malaise that we have seen in the financial sector might in fact be a result of degradation of value systems in the society as a whole. This brings me to the issue of leadership. Did leaders in the field of high finance let us down? Whether the leaders were lulled by the phenomenal success of modern financial engineering and got carried away by “irrational exuberance” and could not see the “black swan”? Probably; the leadership qualities required is to keep the financial system stable so that it can serve the real economy.

The MBA Oath

33. It is in this context that I will leave with you an important issue to ponder about. I hope you have heard of the MBA oath. For those of you who have not, this oath represent a small step towards professionalizing the management field in ways similar to the medical and law professions. It is the management equivalent of the Hippocratic Oath taken by doctors. It is a voluntary pledge that asks graduating MBAs to commit towards the creation of value “responsibly and ethically”. Two professors at Harvard are working to create an MBA Oath that can later be possibly used as a global template.

34. Although the oath is a formalized written version of an ethical code of conduct for managers, the concept behind ethics in business can be traced back to the initial formation

of management education in the early twentieth century. The original intent of instituting a management degree was to educate a managerial class that would run corporates in a way that would serve the broader interests of society rather than the narrowly defined interests of capital or labour. In recent years, management graduates have been blamed for constructing a financial system with complex products without adequate controls. This compelled a team of Harvard Business School graduates to lead a student-based initiative to encourage all graduating students of the class of 2009 to sign on to the MBA Oath. It is understood that more than half of the graduating students in that year signed the Oath.

35. True professions must bear a code of conduct and the meaning and consequences of those codes ought to be taught as part of the formal education of their members. I have personally brought up this topic here today to leave these thoughts with you as I believe that youth is a dominant section of our society. The value system that you practice in your personal and professional conduct influences the value system of the society. There is thus a great responsibility on your young shoulders to observe high ethical standards throughout your life.

36. Some of the most successful and profitable companies in the world have also been those which have been known for observing very high ethical standards. Idealism or ethics without ambition may not achieve much but ambition without idealism or ethics can play havoc. May you combine the two in right proportion, only then can you work in a manner which is mutually beneficial to you and the society.

Conclusion

37. Let me now sum up. I started with the Arab Spring Movement – a social revolution. I thereafter discussed the growing frustration of the public with corporate greed and wealth disparities that symbolised the Occupy Wall Street Movement. I touched upon the Los Indignados Movement in Spain reflecting the angst of the public which has grown resentful of the economic and political systems. These have been the three standout “awakening” movements of 2011. All the three movements have used social networking platforms effectively to arouse public opinion and thus highlight the power of the youth when unified. I have thereafter touched upon the economic, strategic and ethical factors behind the crisis and the lessons to be learnt. I have particularly underscored the ethical dimensions which you must keep in mind throughout your life.

38. My congratulations to all of you on completing an important milestone in your journey today. You represent some of the very best that we have. As you step out into the real world, please remember that when you reach the limits of analysis, it is this inner sense – your moral consciousness or “*chetana*” – that would guide you. I wish you all the best for a bright future and may all your aspirations and dreams come true.