G Padmanabhan: India's regulatory approach to sophisticated financial products

Comments by Mr G Padmanabhan, Executive Director of the Reserve Bank of India, at the Award Ceremony of Dufrenoy Prize for Responsible Innovation in Finance, Paris, 18 June 2012.

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Ladies and gentlemen,

C' est en effet un honneur et un privilège d'être ici ce soir, dans une des plus belles villes du monde, d'accepter au nom de l'une des Banques centrales les plus respectées du monde le prix Dufrenoy de l'Innovation décerné pour l'année 2012, à la Reserve Bank of India (pour nos calibrage politique dans le règlement des produits financiers). Je remercie tous ceux qui ont contribué à nous choisir pour cet honneur. Maintenant avant que l'on me décerne le prix pour l'innovation dans la langue française, je voudrais continuer mon discours en anglais. (It is indeed and honour and a privilege to be here this evening, in one of the most beautiful cities in the world and to accept, on behalf of one of the most respected Central Banks in the world, the Dufrenoy Prize for innovation, awarded for the year 2012 to the Reserve Bank of India, for our calibrated approach to the introduction and regulation of financial products. I thank all those who have contributed to conferring this honour on us. And now, before I am awarded the prize for innovations to the French language, let me continue my speech in English.)

Let me begin by referring to the citation of the jury who decided on this prestigious Dufrenoy Prize to the RBI. The observations of the honourable jury members about the Indian regulatory approach being precautionary and gradual, with a culture of testing and paying attention to potential negative effects of sophisticated financial products before facilitating them, precisely encapsulates the culture and methodology of the Reserve Bank of India, as it seeks to fulfill its mandate – by juggling the multifarious roles assigned to it – of maintaining stability of both prices and the financial system and supporting economic growth. In all the roles that we play, the common thread that underlies any policy is that it should promote growth. Not just growth, but sustainable growth, which in turn can be brought about only with inclusive growth, benefiting the society at large, but without undermining financial stability. Now, a few words about what RBI does.

Apart from the quintessential central banking roles like formulation of monetary policy and printing and distribution of currency, we also manage the external sector, regulate and supervise banks, non-bank finance companies and segments of financial markets (money, forex, government securities). We also regulate the payment and settlement systems. We are banker to banks and to the Government – federal and state governments. We are also the debt manager of the government, managing all their market borrowings, calibrating both the amounts and the timing to ensure that this does not crowd out other players. Added to all this, and perhaps unique to Central Banking anywhere in the world, we are mandated to pay special attention to the agricultural and allied sectors and have created and hived off several institutions for channelizing credit to agriculture, industry, small and medium enterprises, housing, mutual funds, settlement of trades, etc., etc.

We also have a key role at very micro levels in the development process. We are currently in the process of ensuring empowerment to a hitherto voiceless segment of society by facilitating their entry into the mainstream of economic activity by trying to bring them into the ambit of formal banking channel (financial inclusion) by customizing certain products and services for them. We are following up this objective by also educating the people (financial literacy) about the benefits of being part of the formal financial sector and the host of facilities and benefits they can demand from it. We are also following up with the Government to include financial literacy in the curriculum of educational institutions so as to equip the young ones with the necessary skills before they enter the real world.

Having given you a bird's eye view of our myriad functions, let me walk you through our policy formulation processes. Before introduction of any new concepts, regulations or financial products, we generally elicit the opinions of various segments, i.e., stake holders, academicians, financial institutions, researchers, and laymen. We do this by placing a discussion paper on our website and the paper is converted into policy only after factoring in the various inputs so received. This serves the dual purpose of (i) preparing the market for the new product/dispensation and (ii) negating to a large extent the unexpected consequences that a possibly one sided regulation could have brought about.

Since we have been awarded the prize for the gradual introduction of new financial products into the markets, let me illustrate with an example on the guided, gradual, sequenced and calibrated development and integration of markets in India, one of which, namely, the forex market, Mrs. Gopinath and I have been privileged to witness almost since the very beginnings. Forex markets started in India with the banks being required to maintain square or near square open exchange position and the central bank announcing the buying and selling rates. Today the country can boast of a market with a daily turnover of USD 60 Billion, with most of the products and their variants being traded and a Central Counter Party (CCP) arrangement for settling inter-bank forex transactions. Even today, corporates are allowed to access the market only to hedge an underlying exposure and not to take any punts on the currency. They are still not allowed to write options and thereby take on open ended risks. In recent times, the same thumb rule has been followed even while enabling Credit Default Swaps (CDS) contracts. In other words, little skeptical of the globally accepted, almost axiomatic belief in the self correcting mechanism of markets, but also conscious that too much regulation could throttle, we have put in place certain safeguards, which while allowing normal free play would guard against the ability of individual market makers to move markets in directions beneficial to them but detrimental to the stability of the system. We, therefore, prescribed limits on positions and leveraging keeping in view the interconnectedness of institutions in the financial system. The recent global meltdown occasioned precisely on account of these factors of excessive leverage coupled with lack of regulation have vindicated our stand that no systems that undermine the real economy should be allowed unbridled freedom as any ravages to the real economy take years to repair.

At the same time, recognizing that well developed, efficient markets are a prerequisite for price discovery and critical from a Central Bank perspective for the efficient transmission of monetary policy impulses, the RBI has been playing a proactive role in developing the financial markets in a manner so as to ensure that they are in sync with the real economy. Simultaneously, efforts are being made to develop infrastructure, technology and capabilities of market participants, while evaluating their ability to absorb shocks, and insisting on their putting in place robust risk management systems, since we are conscious that our overarching objective is the maintenance of financial stability.

But should all this mean a total change in approach to financial innovation? At the International Research Conference hosted by us, Mr John Lipsky of the IMF while focussing on the importance of finance for rapid and sustainable growth, observed, and I quote, "While some might consider this topic odd in light of the current crisis, I will seek to draw out some key lessons of recent events for the appropriate policy stance toward financial innovation. Many critics...have concluded that such innovation is to be actively discouraged. But I would claim that this is precisely the wrong lesson to draw. Despite the unsettling and even dramatic recent global experience with "cutting edge" finance, I believe that without a renewed effort to foster financial innovation in the global economy, all countries – including emerging market economies – will underperform their potential. The principal challenge for policymakers, then, is to strike an appropriate balance between financial openness that supports growth – enhancing innovation while at the same time implementing regulations and effective supervision that limit the potential risk of financial instability...” The recently published report by the World Economic Forum titled “Rethinking Financial Innovation” (2012) concludes, “Successful innovation in financial services can improve capital productivity with beneficial effects that permeate through the wider economy. Unsuccessful innovation can have the opposite effect. It is important, therefore, to face up to the challenge effectively...” The report advocates that effective risk management systems need to be put in place and goes on to argue that “aside from explicit risk-management frameworks, governance mechanisms (should) also include new product development and approval processes employing various safeguards against unwise innovation…and an extensive regulatory infrastructure”. This is a daunting challenge and has indeed been challenged, but the Indian regulatory approach to financial innovation has always endeavoured to be on these lines.

In concluding, I would once again like to convey gratitude of the Reserve Bank of India to Ecole des Mines de Paris for recognizing and appreciating us for the very reason we were criticized not so long ago. It is indeed an honor and we are here to accept the award with all humility and are deeply conscious of the fact that we have miles to go yet. I would also like to thank all those who are present here today to witness this award ceremony.

Merci beaucoup and a bientôt.