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**Rethinking Regulation in Light of the Financial Crisis**

**A re-thinking and re-making of financial policies and the role of financial institutions is urgently needed. This was the theme of the 2012 Per Jacobsson Foundation Lecture on 24 June presented by the distinguished former Governor of the Reserve Bank of India, Yaga Venugopal Reddy, which was made in conjuncture with the 2012 Annual General Meeting of the Bank for International Settlements held in Basel, Switzerland. Below is the third part of the lecture on Regulation of the Financial Sector. Previous issues of South Bulletins published the first 2 parts of the lecture.**

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**By Yaga Venugopal Reddy**

There is a recognition that policies relating to regulation of the financial sector must optimise the benefits of the financial sector while minimising the costs or risks associated with it. There are several dimensions to striking this balance, which this august audience is well aware of and involved with. I selected three themes for consideration today: the optimal level of financialisation, appropriate innovation in the financial sector, and the effectiveness of financial sector regulation.

**Optimal Financialisation**

Not long ago, many countries recognised the costs of excessive regulation of finance and of financial repression. More recent events seem to indicate that excess financialisation of an economy may also contribute to the crises. It may be that finance is good for economic development over a certain period, but only if practised in moderation. The idea of optimal financialisation seems to have been accepted implicitly by the financial sector reform measures being contemplated in many advanced economies. At the same time, several developing and emerging economies are considering measures to develop the financial sector, in particular financial markets.

In their quest for optimal financialisation, the countries that are attempting further deregulation and development of financial markets would benefit from an understanding of how excess financialisation manifests itself. However, the manifestation of excessive financialisation may not be confined to finance, and may extend to commodity markets, corporates and households.

The financialisation of commodity markets happens both by virtue of deregulation of trade in commodity market exchanges and by virtue of the excessive liquidity that happens to be readily available. The correctives in public policy with regard to excessive financialisation of commodity markets may be at times beyond the scope of financial sector regulation.

During recent years, there has been a significant financialisation of household budgets, particularly in advanced economies. The changes in demand for certain goods are often dependent on credit conditions. Future cash flows are often determined by the market value of pension funds and other sources of social security over a lifetime. It is not clear whether limiting the leverage of financial intermediaries would by itself constrain the excess leverage in household budgets.

There has also been financialisation of corporates. Corporates are not only exposed to the financial markets in relation to their underlying operations in terms of what they produce or sell, but also in terms of treasury operations.

This excessive financialisation occurred in many advanced economies for other reasons. Incentives were created to multiply the transactions in the financial sector in the form of income from commissions related to transactions. Further, complexity was introduced with regard to some of these innovations, often to undermine the regulatory prescriptions regarding transparency or capital adequacy, or to mislead the counterparty. Shadow banking enabled undermining of regulatory prescriptions. Most recent initiatives with regard to reforms in regulation address these issues.

For many developing and emerging economies, who are progressing on the path towards optimal financialisation, it is necessary to avoid excessive financialisation, and more importantly to explore the impact of finance on growth, ideally on the basis of empirical evidence. Research has associated higher growth with the development of the financial sector, but more recent evidence on trade-offs between growth in the real sector and the financial sector is equivocal. The experience of Asian emerging economies so far indicates that the beneficial effects of deregulated finance relative to free trade may be overstated. Further, institutional rigidities and the state of factor and product markets vary between countries, and they do interact with level of financialisation.

This subject is explored in a recent paper titled “Reassessing the impact of finance on growth” (Cecchetti & Kharroubi, 2012). The paper investigates how financial development affects growth at both the country and the industry level. The paper shows, based on a sample of developed and emerging economies, that the level of financial development is good only up to a point, after which it becomes a drag on growth. It also shows that a fast‑growing financial sector can be detrimental to aggregate productivity growth. This is a line of enquiry which should be further explored to arrive at what constitutes the optimum level of financialisation.

A recent Working Paper of the International Monetary Fund entitled “Too much finance?” seems to confirm some of the broad conclusions of the BIS Paper I referred to (Arcand et al, 2012). Let me summarise the main findings.

First, there is a positive and robust correlation between financial depth and economic growth in countries with small and intermediate financial sector. Second, beyond a threshold there is a negative effect of financial sector; that threshold is when credit to the private sector reaches 100% of GDP. Third, the negative effect is not confined to crisis periods, but extends to tranquil conditions also, possibly leading to misallocation of resources. Fourth, it is possible but not clear that bank lending and asset based lending components of credit will have positive effects. Finally, analysis suggests that there are several countries for which a smaller financial sector would be desirable.

The global financial crisis also brought into focus the downside of excess debt, but then the issue is: what is excess debt? Debt sustainability in terms of sovereign debt has been analysed extensively in the past, but the issue is the real effects of debt – not only of sovereign debt but also other elements of the national economy. This has been explored by an interesting paper which poses the question, “When does debt go from good to bad?”

Using a data set of OECD countries over thirty years, it concludes that the threshold is around 85% of GDP for government debt, 90% for corporate debt, and 85% for household debt (Cecchetti, Mohanty and Zampolli, 2011). The subject should be researched further, since the issue of excess debt is closely related to excess financialisation, and the thresholds for excess debt may be lower for developing and emerging economies than for the advanced economies.

Excessive financialisation can also occur due to public policy failures in achieving socioeconomic development, resulting in the passing of an undue burden to the financial sector in the form of generating a range of quasi-fiscal activities. Improvements in overall governance structures and efficiency in the provision of public services can also contribute to limiting excessive financialisation outside the fiscal ambit.

My submission is that more research is needed on what constitutes optimum financialisation and leverage, which could be different for developing and emerging economies than for advanced economies, despite signs of some convergence in macroeconomic and financial sector issues. In any case, the direction of public policy relating to the financial sector in the near future will be characterised by increasing financialisation in some countries which have less developed finance, and restraining financialisation in others where it has gone too far.

**Appropriate Innovation in the Financial Sector**

Operationally, an important issue is the point at which an innovation requires regulators’ attention. Should it be before introduction in the market, or after receiving complaints from an affected party? Or should it rely on monitoring of every innovation and assessing *suo motu* whether there are harmful effects? Often, many innovations look attractive in the short run because risks are back-loaded on some and rewards are front‑loaded on others. In finance, pressure on regulators to regulate is also back‑loaded, and is often too late. Different industries have different approaches and tools to regulate, and the point at which regulators’ jurisdiction is activated varies across industries. For example, in pharmaceuticals, the regulator has to approve *ex-ante*, while in regard to restrictive trade practices it may be *ex-post*.

In many industries, regulations address issues relating to innovations. For example, in the pharmaceutical industry, considerable experimentation is demanded and *ex-ante* approvals are required for marketing. In engineering systems, the consistency of innovations with network in which they are to be applied is often required to be certified, by either an industry body or the regulator. In many others, innovations are left to the market test, unless they happen to have *ex-post*, negative effects, in which case public policy may consider intervening. In brief, there are several industries which have been subject to different systems of regulation, and they have stood the test of time. The financial sector should be able to draw lessons from such experiences, recognising the unique characteristics of the financial sector. Such lessons will also help in differentiating between technological, process and product innovations.

Markets are, indeed, a source of many innovations, but there are examples in many industries where the public sector has been active in promoting innovations. There is merit in central banks encouraging innovations in the financial sector that have the potential to serve the public. I agree with Chairman Ben Bernanke when he said, referring to striking the right balance between consumer protection and responsible innovation, “our goal should be a financial system in which innovation leads to higher levels of economic welfare for people and communities at all income levels” (Bernanke, 2009).

My submission is that central banks in particular, and regulators in general, could be more proactive in promoting and incentivising appropriate innovations in the financial sector, and drawing on the experience of other industries may be of considerable value in evolving policies towards financial innovations.

**Effectiveness of Regulation**

There is considerable agreement that better and more effective regulation is of vital importance to the financial sector, and that more regulation is not necessarily better. At the same time, the experience with self‑regulation, principles-based regulation, and the use of internally generated models of risk management have proved to be sub-optimal. Hence, there is a need to consider mechanisms to make regulation more effective, to limit unnecessary regulatory burdens or to contain the cost of compliance with regulators’ prescriptions. I wish to explore some practical ways of enhancing effectiveness.

A possible reason for deficiencies in regulation in the pre-crisis period may have been the loss of information as part of a process of deregulation and a lack of mechanisms to monitor events in the fast‑changing world of finance. Regulatory effectiveness can be improved by enhancing the monitoring of transactions, and analysing them rigorously. No doubt, technology enables market participants to operate in a fraction of seconds, but the same technology is available for regulators too, to collect information, monitor and analyse in an equally fast manner. Modern technology minimises the costs of reporting and, to some extent, analysis by regulators. Close monitoring by regulators may enhance compliance with regulations and help in fine tuning the regulatory prescriptions on on-going and timely basis.

In debates relating to public policy on public utilities, issues of regulation, competition and ownership were considered in an integrated manner. That used to apply to the finance industry also, before deregulation and privatisation became the preferred policies. The global financial crisis is leading to a serious reconsideration of the extent, nature and effectiveness of regulation. There may be merit in considering, in an integrated fashion, appropriate regulation and its effectiveness in relation to competition and public ownership.

First, there is a recognition of the danger of “too big to fail” and “too powerful to regulate” financial conglomerates. Resolution regimes and the adoption of living wills are being considered to address this issue. It is often argued that it is difficult to unbundle them in a non-disruptive fashion. Under the circumstances, the option of public ownership of those too-big-to-fail institutions could also be reopened, keeping in view the advantages of diversity.

Second, the crisis necessitated an increase in public sector ownership in the banking industry, mainly due to large bail-outs. The exit from this unintended expansion in state ownership of banks ought to consider the costs and benefits of options that may include divestment or continuing with state ownership along with appropriate participation in management.

Third, a case for an approximate mix of public sector and private sector banks in a financial system could be examined. Such a mixed model for the structure of the banking sector or financial sector in general would lend stability through diversity. Differing priorities and practices enabled public sector institutions to retain a public sector character and not merely to replicate the functioning of private sector counterparts. The problem of information asymmetry may be moderated if public sector banks co-exist, assuming that they have fewer incentives to withhold information from regulators, and are often subject to legislation relating to the right to information. It is not necessary that a bank or a non‑bank financial entity should be owned entirely by government or only by private shareholders. A variety of combinations of public and private ownership and control can be considered.

In revisiting the issue of regulation in conjunction with competition and ownership, it is necessary to recognise the lessons from public sector banking in the 1970s and 1980s, particularly in developing and emerging market economies. The problems in the past with public sector banking were due to financial repression attributable to macroeconomic policies, the lack of appropriate global standards of regulation, the existence of monopoly status, and technological obsolescence, in addition to standards of governance in public systems in general, and public ownership in particular. In the context of the global financial crisis, the practices of some entities that were virtually public sector, such as Freddie Mac and Fannie Mae, do not provide reassurance that public sector character would in itself be benign. Experiences with some banks in the public sector in Europe may also be instructive.

The temptation to politicise public sector banking may persist, but the need for professionalisation in the public sector should not be underestimated. The new realities consequent upon the crisis indicate the potential for a redefined role for public sector financial institutions, provided that the experience prior to deregulation and privatisation, as well as select cases related to the global financial crisis, are also kept in mind.

The use of fiscal and related instruments to supplement regulatory effectiveness could be considered in earnest. Information generated for purposes of taxation is likely to be of great practical use for regulators in monitoring financial sector activities. Levying financial transaction taxes could be considered, with rates that discriminate against excessive speculation. The cross-border activities of financial intermediation could be brought within the tax net, and thus the regulatory ambit, by adopting the issuance principle (financial institutions located outside the country would be obliged to pay the tax if they traded securities originally issued within the country) and the residence principle (instruments issued outside the country but subsequently traded by at least one institution within the country would be liable). Further, evasion could be discouraged by adopting the example of stamp duty in United Kingdom, and of Brazil, where non-payment of the tax makes legal enforcement of such contracts difficult.

There is also significant merit in considering anti-avoidance rules in taxation for regulation of the financial sector as well. Thus, if the sole purpose of an instrument or institution in the financial sector is to avoid a regulation, such transactions can be considered void for the purposes of regulation. Thus, a distinction can be made in financial sector regulation, as in the case of taxation, between planning, avoidance and evasion. Above all, taxation and the use of information thus acquired for regulation of financial sector would considerably enhance the effectiveness of both fiscal and financial management.

**Concluding Remarks**

I believe that society expects central banks to ensure trust and confidence in money and finance, and hopes that they avoid the pitfalls of capture, while the common person seeks inclusive finance. It is not easy for central banks to deliver all this, but they should not ignore society’s expectations.

In these efforts, central banks need to preserve space for public policy at the national level consistent with their obligations to the global economy. The financial sector may draw lessons from global coordination in other industries, especially in managing networks.

Global trends in financial sector regulation may see simultaneous re-regulation in some countries and deregulation in others. Innovations, by definition, are difficult to put into preconceived straitjackets, and a disaggregated contextual approach would be appropriate. Above all, better regulation warrants effective regulation. Consideration of regulation, competition and ownership in an integrated manner, enhanced monitoring of financial market activities and the use of fiscal tools to supplement regulation could be helpful in this regard.

Friends, society has put its trust in central banks. Central banks have to ensure that bank managements and the financial sector in general serve the masses, and not merely the elite or the financially active. In the ultimate analysis, central banks are trustees, agents to look after the interests of the masses.

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