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Re-making Financial Policy to Meet Society's Needs

The financial sector has been hit by major crises and scandals, to the point that its credibility with the public has fallen to historically low levels. A re-thinking and re-making of financial policies and the role of financial institutions is thus urgently needed. This was the theme of a lecture 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. The 2012 Per Jacobsson Foundation Lecture by Mr Reddy, made on 24 June 2012, covered three main themes: (1) Society and Finance, (2) Economic Policies and the Financial Sector, and (3) Regulation of the Financial Sector.

Below is the first part of the lecture, on Society and Finance. Future issues of SouthViews will publish the other two parts of the lecture.



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By Yaga Venugopal Reddy

The future of finance, and in particular saving it from a popular backlash against the global financial crisis and related crisis-management policies, has rightly become a matter of great concern. There is broad agreement that finance has, as in the past, the potential to do good, which should be harnessed by all. However, it is essential to minimise its potential to do harm. From a central banker's point of view, there are

several issues in this search for good finance for the future, but there are three inter-related issues that I want to comment on today: (a) how to ensure that the financial sector serves the society better; (b) how to integrate financial sector policies better with national economic policies; and (c) how to ensure that the financial industry functions as a means and not as an end in itself?

My reflections are moulded by not only a decade in central banking but also many years in macroeconomic management in federal government and the Bretton Woods Twins, in addition to a much longer period at provincial and local levels of government dealing directly with the public.

An assessment of the impact of the recent global financial crisis on the trust and confidence of society in the financial sector is a useful starting point when considering ways of restoring the trust. A major reason for the erosion of trust may be a sense that there has been a comprehensive capture of regulation of the financial sector by the finance industry, particularly in the leading advanced economies. A demonstrable commitment to provide reasonable access to essential financial services to all segments of society would reinforce the assertion that finance serves the larger community. This approach, which may broadly be described as inclusive finance, goes beyond the current concerns with providing consumer protection and ensuring systemic stability.

Restoring Trust:

A society's trust and confidence in finance, like in any other sector, is derived partly from formal laws, regulations and procedures, and partly on the manner in which they are implemented, through both formal and informal channels. Trust is, therefore, difficult to measure, but on the basis of surveys conducted and anecdotes reported in the media, there appears to be an erosion of trust in the financial sector as a whole, and banking in particular, in advanced economies. The perceptions of such an erosion of trust, however, differ.

What are the plausible reasons for the erosion of trust in some jurisdictions? We can only speculate.

First, large sections of the population have been affected by the financial crisis, and they consider themselves innocent victims of the crisis in the financial sector. In particular, they feel that those involved in the financial sector have enjoyed disproportionate gains and shifted the pains of adjustment to the rest of the population.

Second, in the discharge of semi-fiduciary functions that are critical to the integrity of financial markets, such as fixation of LIBOR and credit rating, the major global players in financial markets discredited themselves by resorting to questionable practices.

Third, when several irregularities in the functioning of large financial intermediaries were found, the regulators reacted to the wrong-doing by imposing penalties. The public at large was often left in the dark about the details of the malfeasance and the losses they had suffered.

Fourth, the shareholders in a few large financial conglomerates are actively questioning the remuneration of senior management in some cases. This is unprecedented, reflecting the loss of trust by shareholders in the management of financial firms.

Fifth, although public policies provided liquidity, extended bail-outs in some cases, and in a few cases tax breaks, the much-needed credit from the financial sector to the economies is not forthcoming, even after accounting for the muted demand for credit.

Finally, there is resistance from finance industry leaders to suggestions for strengthening regulations. In advanced economies, operational details of important reforms in the banking sector, shadow banking activities and innovations in financial markets are yet to take a final shape. There is, perhaps, what may be described as unionisation of global capital against attempts by public policies to regulate the financial sector effectively.

My submission is that the mandate for maintaining financial stability, which often rests primarily on central banks, has two related dimensions, namely the avoidance of disruptions in the functioning of the financial system and (more positively) the promotion of trust and confidence in the system. If there is any wing of public policy authority that has a stake in building such trust, it is the central bank. Hence, the central bank should be watchful of developments related to trust in their jurisdictions and take a conscious decision whether to monitor and act, as necessary, to ensure continued trust and confidence in the financial sector.

Comprehensive Regulatory Capture:

As noted earlier, the decline of trust and confidence is partly the result of the perception that there has been a comprehensive regulatory capture. While the popular explanations for market failure relate to incentives, and possibly greed, the regulators' failures are generally attributed to misplaced faith in the self-correcting powers of markets, a lack of skills in regulatory agencies and capture by vested interests. Such a capture can be described as comprehensive, particularly in the countries that were most affected during the crisis, in the sense that it was not restricted to the economic concept of regulatory capture, but extended to the overall public policy relating to financial sector.

What could be the reasons for this?

First, the political leadership has a short-term horizon, and financial markets also have a short-term horizon. This creates a natural tendency for their priorities to converge. Available evidence shows that financial contributions to political activity from the financial sector in many affected countries increased significantly in recent years. Moreover, large global financial conglomerates seem to be in a position to influence not only political governance but also corporate governance, to suit their own interests.

Second, regulators, as part of their public consultation process, often depend on the regulated for consultation, which is a feature common in most industries. But the dominant market shares of the few giants in the finance industry, combined with the characteristic externalities of finance, make a difference to the process and outcomes. In the past, the excessive deregulation of the financial sector was often designed to a significant extent based on the advice of the interested market participants themselves.

Third, in cases where academics are advising on the design of reforms, they are often finance experts, sometimes engaged with market participants in remunerated advisory or consulting capacities. A large part of economic research on regulation is funded by the financial sector. In fact, most of the analysis of macroeconomic trends available in the public domain is from economists employed by large financial conglomerates. There may be, as a result of several of these factors, a tilt in favour of the financial sector in media coverage too.

Fourth, in many countries, the finance industry offers prospects of highly paid jobs for those employed in the regulatory agencies and Treasuries or Ministries of Finance.

Finally, finance and its regulatory framework are somewhat intangible and difficult for a common person to fully understand. Hence interested groups can tilt the intended policy changes in their favour by presenting their initiatives to shift equilibria between competing considerations as mere technical issues.

It is possible to argue that capture of regulators is inevitable, and that a case can therefore be made in favour of reducing formal regulation, and encouraging self-regulation and promoting principles-based regulation. On the contrary, there is a widespread feeling that those were the very prescriptions that brought about the global financial crisis. The biggest challenge for the future of finance lies, therefore, in designing governance practices that avoid the dangers of comprehensive regulatory capture.

I would, however, hasten to add that public policy failures cannot at the same time be wished away by placing undue blame on regulatory capture. It is evident that public authorities in major financial centres genuinely believed that the financial system, even in its complex evolution, was contributing to the public good. But this faith *ex post* proved to be misplaced. Professor Levine observes that the absence of an informed, expertly staffed and independent institution that evaluates financial regulation from the public perspective is a critical defect in the governance of financial regulation (Levine, 2012). He suggests establishing a body that would submit a periodic report to the legislative and executive branches of government assessing the impact of financial regulation on the public. The body would be politically independent, independent of financial markets and staffed with experts, while having no official power over the central bank or other regulatory bodies. This may sound utopian, but is worth trying in the present day turbulent market environment.

Consideration may also be given to the formulation of a "fair practice code" for finance professionals, regulators and academia, extending the idea mooted by the American Economic Association on a Code of Ethics. A similar approach has been suggested by Professor Shiller in the context of financial innovation supporting the stewardship of society's assets.

He observes that "the best way to do this is to build good moral behaviour into the culture of Wall Street through the creation and observance of best practices in its various professions – CEOs, traders,

accountants, investment bankers, lawyers, philanthropists” (Shiller, 2012, p. xi). However, experience suggests that there are limits to the effectiveness of such codes. In fact, ethical behaviour can be felt and understood, but it is difficult to formulate it fully in a code intended for day-to-day organisational purposes. Moral behaviour, in the final analysis, is a matter of individual choice. But what best practices can do is to exemplify the inherent morality in the individual.

My submission is that serious consideration should be given to evolving trustworthy institutional structures and adoption of best practices to re-assure the public that the scope for comprehensive regulatory capture is being minimised. These assurances could be further reinforced through improving the public image of central banks and, in particular, of the Governors.

Inclusive Finance:

Inclusive finance implies that the objective of financial sector regulation should be as much about protecting consumers as ensuring the availability of essential financial services to all sections of society, keeping in mind the expectations and needs of the common person. Emphasis on financial literacy by central banks has been advocated to enable consumers to take advantage of competitive efficiency. However, the issue is not one of financial literacy but of the behavioural patterns of common people dealing with finance.

In this regard, it has been rightly observed: “By properly deploying both incentives and nudges, we can improve our ability to improve people’s lives, and help solve many of society’s major problems. And we can do so while still insisting on everyone’s freedom to choose” (Thaler and Sunstein, 2008, p. 8).

It is useful to provide a default option of financial products for those large sections of society that have neither the inclination nor the tools to make those choices. It could be argued that a competitive financial system which is well-regulated, keeping in view the needs for stability and consumer protection, would automatically ensure inclusive finance. Experience so far does not support such a view. Public policy in relation to the financial sector therefore needs to consider the expectations of large sections of the community, typically those of a common person. They are bound to be different depending on the society, but a few broad generalisations may be attempted.

First, common people need a place to keep financial savings in safe custody (e.g., wives often need to keep them safe from wayward husbands in rural areas in developing countries). They should be able to place and withdraw such savings with ease and at minimal cost. While a range of instruments with a host of risk-reward profiles may be provided by the financial sector, access to one safe and simple instrument is essential for a common person. Often, this is a deposit in a recognised deposit-taking institution, traditionally a retail bank-branch in the neighbourhood. The edifice of trust in the financial system, including leverage, is built primarily at this level.

Second, reasonable demand for credit for smoothing consumption between days/periods of income and of expenditure has to be met by the financial system at a reasonable cost. Smoothing of consumption may also be longer-term, including over lifetimes.

Third, remittances or payments may have to be made within families over different locations or for various other purposes, and such services should be available and accessible at affordable cost. These services are often a monopoly of the officially recognised or regulated banking or payment system, and hence regulators need to accept some responsibility for delivery of such services.

Finally, from a common person’s point of view, public policy should ensure the easy availability of simple-to-understand instruments in credit, capital and insurance markets. Consumer protection is important in the financial sector, but ensuring the supply of simple-to-understand products should be an obligation of regulators; it is an essential step to gain the trust of the common person.

In some advanced economies, regulators are already paying attention to excessive charges on retail financial services, in particular credit cards. Experience in some developing countries indicates that the involvement of public policy in expanding coverage of finance among the general public has had a beneficial impact. It is true that public policy experience with subsidised credit in some developing economies, and with housing credit in some advanced economies, has not been good. But inclusive finance emphasises affordable access to simple products, and not excessive leverage or at the cost of prudence. Inclusive finance is not a substitute for the primacy of fiscal policy with regard to social welfare.

My submission is that we are in a world of expanded mandates for central banks, and inclusive finance should not be excluded from such mandates. Perhaps central banks could satisfy themselves and the

society at large that, between the markets and regulations, finance is serving the minimum needs of most common people while maintaining efficiency and stability. That would be the cornerstone for restoring trust and confidence in the financial sector. Central banks could explore avenues for using technology and financial innovations that meet the needs of common people.

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