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Objectives, Philosophy and Principles of Financial Regulation for the Post-Crisis World

Regulators around the world, especially in the North Atlantic world, have been shaken by the global crisis which has still not ended but is now assuming a new incarnation or what we call in India a new avatar. There is anger amongst the common people that the regulators have failed them- we have failed not only to ensure public trust and confidence in the financial system but also to avert the significant fiscal and welfare costs arising out of the global financial crisis.

Hence it is appropriate that ICFR has called for this regulatory summit to introspect and question as to what constitutes "good regulation". I believe that in doing so, we should challenge the received wisdom of the pre crisis period, sift the grain from the chaff and learn from the residual applicable lessons. In doing so we can also make an attempt at reexamining the objectives, principles and philosophy of regulation?

The lessons are familiar but worth recounting

- That markets are not self-correcting and are prone to excesses

- That regulating individual institutions is not enough, there is a need to regulate the system and assess the impact of externalities

- That global integration of markets and interconnectedness in the financial sector implies huge contagion risk that casts responsibility on the world leaders to think globally as opposed to nationally

- That over reliance on ratings has proved to have disastrous consequences

- That excessive leverage, wherever it exists, will inevitably come to roost and the system will then require bailing out in the event of a systemic crisis

- That prudential prescriptions based on ex-post measures can be pro cyclical with spiraling downturn effects

- That ‘too big – to – fail’ institutions proved to be exactly that and their bailing out implied huge moral hazard

- That untamed greed can conveniently free ride on implicit sovereign underwriting of the financial system

- That prolonged easy monetary policy can create asset bubbles and volatility in financial markets which then feeds into commodity markets and the real economy

- That large and volatile capital flows can create instability not only in developing but also in developed economies

- That mistaking the growth of financial markets and financial institutions as real economic growth can lead to undermining both stability and equity concerns

- That misplaced confidence in light or soft touch regulation and relying on competition and markets to meet regulatory objectives may boomerang

- That to be effective macro-prudential polices and measures must be pursued in addition to and in conjunction with monetary and macroeconomic policies

- That responsibility for financial stability has to be shared and coordinated between governments, central banks and regulators

During the two odd decades prior to the global financial crisis, regulation in developed countries was characterized by progressive deregulation of various aspects of the functioning of the financial sector premised on the efficiency of markets. The contours of deregulation included removal of overall policy constraints on banks' ability to perform their core functions, encouraging of universal banking, permitting non-banking financial entities to undertake financial intermediation, placing greater emphasis on financial markets to allocate resources and increased integration of financial markets facilitated by the developments in communication and computing. Financial innovation and financial engineering in areas such as structured finance and derivatives were encouraged through minimal use of intrusive regulatory policies consistent with the philosophy that regulation generally stifles innovation.

Another important feature of the financial regulation in the developed countries was an almost exclusive institution-specific focus on micro-prudential regulation coupled with a near absence of macro-prudential regulation despite the size and complexity of activities of large banks, exposure of banks to lightly regulated or unregulated activities, leverage of banks and growing inter-connectedness among financial entities within and across borders increasing the contagion risk. All parts of the financial system having the potential to leverage were not similarly regulated and as the Geithner Report noted , no regulator saw its job as protecting the economy and the financial system as a whole. In short, as Claudio Borio has put it in a recent paper . "Advanced economies with sophisticated financial markets were not necessarily self-correcting. Low and stable inflation was no guarantee of financial and macroeconomic stability. And a prudential framework focused on individual institutions, supported by a sound payment and settlements infrastructure, was not sufficient to ensure financial stability."

In contrast to the developed world, the focus of regulation in the developing economies over the two decades prior to the crisis and more particularly after the Asian crisis was on strengthening the financial system, regulatory practices and capacities and developing markets and market infrastructure. The Asian crisis brought in the realization that without a strong domestic financial system and forex/debt markets, deregulation and liberalization of the financial system and capital account could have disastrous consequences.

In the above context, it would be interesting to have a look at the internationally accepted principles, philosophy and objectives of regulation in the pre-crisis period and their relevance today.

In the United Kingdom, the Better Regulation Commission refers to the principles of proportionality, accountability, consistency, transparency and appropriate targeting. The FSA's approach is premised on efficiency and economy, role of management, proportionality, innovation, international character, competition and public awareness. According to the OECD recommendations, good regulation should serve clearly identified policy goals, and be effective in achieving those goals ,have a sound legal and empirical basis, produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account , minimize costs and market distortions, promote innovation through market incentives and goal-based approaches, be clear, simple, and practical for users , be consistent with other regulations and policies and be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels. Interestingly, the ASEAN principles are very similar to the OECD principles but omit the provision about promoting innovation.

The philosophy underlying 'supervision' prior to the crisis, premised on the self-correcting nature of markets, focused on the assessment of the ability and inclination of senior management in financial institutions to follow the principles of risk management but did not take into account the externalities and market failures. Considerable discretion was given to supervisors in the matter of forming judgments on risk management and financial capacity of banking institutions. It is now clear that even when the buildup of risk in the system was quite apparent, the regulators and policy makers were not prepared to intervene on account of their belief that markets 'would somehow get it right'.

Turning to the objectives of regulation, these have been safety of depositors or public funds, investor protection and fair treatment of consumers of financial services. The crisis has demonstrated that the objectives have to be much wider as public confidence in the entire system has been shaken. Hence apart from ensuring public trust and confidence in the financial sector to meet the needs of stable and equitable economic growth, averting crisis and mitigating impact of downturns through pro-active action, is a very much a part of the objective of regulation today. Equally in geographies like India, financial inclusion is an important objective of financial regulation.

The objectives, the principles and the philosophy of regulation could have slight differences in emphasis across sectors and geographies. Financial stability may be a more dominant objective for the banking regulator, whereas considerations of fair and transparent markets, and investor protection will still drive the securities regulator while fair treatment of consumers and preventing mis-selling will perhaps be more relevant for the insurance regulator. No regulator can however afford to ignore the systemic risk on account of interconnectedness excessive innovation and the moral hazard on account of operations of TBTF institutions.

Coming to the philosophy of regulation in the post crisis period, there is a move to disincentives excess innovation by significantly increasing the capital for market risk acknowledging the correlation risk and the need to measure risk in a stressed scenario. Similarly there is a move away from unfettered capital flows especially in EMEs and varying degrees of capital controls are no longer considered to be bad especially when sought to be achieved through prudential measures. However we are yet to see the emergence of a philosophy of regulation that requires a country that plays an important role in the global economy and financial system to take into account the impact of its macroeconomic and regulatory policies on global financial stability and take appropriate actions.

An example of the change in the supervisory philosophy is articulated by the FSA and I quote "in the period from the FSA's creation through to 2007 the prevailing view of industry, society as a whole and government was that market disciplines would in general prevent the development of systemically damaging excesses in the economy and the risk of proactive regulatory intervention far outweighed the benefit particularly in terms of inhibiting innovation, competition and growth in the financial sector. The recent events have led to a change in society's expectation from its regulators and this is a major driver in the FSA changing its philosophy. The historical philosophy was that supervision was focused on ensuring that the appropriate systems and controls were in place and then relied on management to make the right judgment. Regulatory intervention would thus only occur to force changes in systems and controls or to sanction transgressions which were based on historical facts. It was not seen as a function of the regulator to question the overall business strategy of the institution or more generally the possibility of risk crystallizing in the future. In the future the FSA's supervisors will seek to make judgments on the judgments of senior management and take action if in their view those actions will lead to risks to the FSA's statutory objectives. This is a fundamental change. It is effectively moving from regulation based on facts to regulation based on judgments about the future." Unquote.

Within this framework, I would like to propose five principles of good regulation suited to the post crisis world.

The first principle is that of the golden mean – the Asian concept of the middle path. Many thousand years ago a mendicant in search of himself who had subjected himself to the most rigorous austerities, heard a passing bard say this about the string instrument which he was tuning, ' tighten it too much and it will snap, leave it loose and it will not play'. The mendicant meditated on this as a principle of life and attained enlightenment. His name was Siddhartha, better known in history as the Buddha. The middle path as a principle of regulation would mean restraining or preventing excesses – excessive leverage, excessive reliance on markets, excessive innovation, excessive growth of the financial sector in relation to the real sector, excessive remuneration, and equally excessive controls and excessive caution. Exercising this golden mean would require regulators to be continuously alert, have the necessary expertise, possess an excellent surveillance system and have the capability of taking proactive action using judgment based on analysis. The golden mean also implies not looking at corner solutions, to take a contrarian view when required and promote countercyclical behavior. For EMEs it would mean taking the right lessons from the crisis and enabling the growth of markets with appropriate safeguards rather than trying to prevent innovation.

The second principle I would suggest is that of 'regulatory courage'. Morris West, the Australian author, once defined courage as "the capacity to confront that which can be imagined". In the regulatory space this would translate as the courage to take away that famous punch bowl; the nerve to take appropriate regulatory measures even when there is pressure from powerful industry and media groups not to do so. While macro prudential policies are very much a part of the regulatory parlance today, taking macro prudential measures involving judgment about the current and future status of the economy would call for courage to exercise the judgment.

In a speech in April 2009, Andy Haldane from Bank of England drew an interesting parallel between the recent global crisis and ecosystems. He uses the natural relationship between diversity and stability to show how lack of diversity was a reason for collapse of the financial system. In explaining the collapse in marine systems and finance, lack of diversity seems to be a common denominator. I would like to therefore cite the third principle of good regulation as 'bio diversity' which encourages the presence of heterogeneous institutions and market participants having differing business models and risk appetites

thus leading to a better diversification of systemic risk. Regulation can also be differentiated across participants as proportionality is already recognized as a principle of regulation. Simpler institutions can also be regulated under simpler approaches with lesser costs. The principle of bio diversity would also mean that all participants need not necessarily have the same accounting rules, with variance being permitted according to business models and the time horizon of their clients and funders.

The fourth principle is communication. We have talked about the accountability of regulators and who will oversee the regulators. Ultimately, the accountability of regulators is to the public whose confidence in the stability and efficiency of the financial system is the ultimate test of regulation. Regulators need to enjoy public confidence and public understanding of their actions. For this they need to communicate effectively. This is especially necessary in a world where the nexus between media and markets is not unknown. In a way communication is part of the principle of transparency which is already a well-accepted principle of good regulation. Equally, we need to be careful that in the framing of regulations, communication and consultation while essential, do not lead to dilution of the regulation.

The fifth principle is coordination and cooperation – both nationally and globally across governments, central banks and regulators. To rephrase Buddha ' what we should strive for is a position where all are equally victorious and there is defeat for no one'. Positioned as we are in a global world, we must learn to swim together and be mindful of the global implications of national policies especially if you are a systemically important country.

I will now briefly illustrate each of these principles in terms of the action taken by the Reserve Bank of India in the recent period.

The most outstanding example of the principle of the golden mean has been the manner in which the capital account was liberalized in a gradual and sequenced manner and the exchange rate policy became more and more market determined while managing too much volatility. While liberalizing the external sector care was taken to see that the previously fairly repressed banking system was gradually liberalized and strengthened by putting in place prudential regulations for strengthening individual banks. Interestingly, in doing so, our definition of capital was close to the Basel 3 definition and in some ways, even a bit more stringent!

The second principle of courage was demonstrated when the central bank acted with singular courage when, in 2006-07, it put in place countercyclical prudential measures in the form of higher provisions and risk weights in certain asset classes which it was felt were beginning to overheat. This had the effect of cooling these sectors without hurting the flow of credit to the productive sectors. This was the time when there was a huge pressure on the central bank to liberalize the markets and especially the external sector. Withstanding the pressure and putting in place unpopular measures called for courage and ability to face criticism –which turned to praise when later it was conceded that the stance of the central bank had helped the country.

The third principle of bio diversity is illustrated by the way we apply prudential regulation to the different categories of banks in the system. The internationally active banks were encouraged to go for Basel 2 advanced approaches while other commercial banks were permitted to continue with the standardized approach. Urban cooperative banks which are analogous to credit unions are on Basel 1 while non-banking financial entities have much higher capital ratios at 15 per cent. Rural banks are yet to move to the minimum CRAR ratios but have to maintain positive net worth and minimum liquidity ratios. Banks are allowed to carry at cost their investments in government securities which they are mandated to hold as

part of the statutory reserve requirements to reflect the permanent nature of such investments- MTM valuation would have created undue volatility in their balance sheets and earnings and resulted in behavior that could be disruptive.

While communication with the market and industry through a consultative approach has always been a good principle of regulation, what is increasingly attempted by the Reserve Bank of India is direct communication between the central bank and the public. One example of such innovative forms of communication are outreach programs undertaken by the Governor and the Deputy Governors to remote unbanked villages to get a feel of the grass root level issues and also communicate to common people the relevance of the central bank and the regulator in their lives. This is part of the program on financial inclusion which is very much an objective of regulation as much as financial stability. Another example is holding town hall like events where the top management of the RBI interacts with students or members of public and answers their questions on various aspects related to banking and the economy.

The last principle is cooperation and coordination. In India, there are three separate regulators for banking, insurance and capital markets. In almost all areas of market development and regulation, such as private placement of corporate debt, currency and interest rate futures, financial conglomerate supervision, repos in corporate debt, as also in the area of opening up of the domestic markets to foreign investors, there is a constant dialogue and coordination amongst the regulators. Similarly, in formulation of policies relating to the capital account or the government borrowing program, given the implications of twin deficits for financial stability, there is regular, formal and informal coordination between the central bank and the government.

To conclude, I commend to you the golden mean, courage, bio diversity, communication, coordination and cooperation as the five principles of good regulation.