Transparency and Accountability: Were the Prescriptive Standards for Developing Countries Correctly Set?

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The Central Problem

- Prescriptive standards beamed at developing countries for what constitutes good governance, transparent functioning and accountability, carry some components that are
  - Diagnostically flawed, or
  - Unsuited to the economic structures and/or political economy pressures found in those countries.

A Case Study of India: Weathering the Global Crisis

- Excerpts from some recent diagnosis-based prescriptions for improved transparency, juxtaposed against Indian performance:
  - Report of the (Raghuram Rajan) ***Committee on Financial Sector Reforms,*** 12 September 2008
    - (RR: specific to India)
  - Dincer and Eichengreen, "***Central Bank Transparency: Causes, Consequences and Updates***", mimeo; February 2009
    - (DG: rate 100 Central banks annually over 1998-2006, based on 15 indicators in 5 categories)

Issues

- #1: Commercial bank ownership
- #2: Transparency ratings of Central banks (DG)
  - i) Political transparency
  - ii) Economic transparency
  - iii) Procedural transparency
  - iv) Policy transparency
  - v) Operational transparency
- #3: Basel II norms

#1: Commercial bank ownership

India as a Bank Ownership Outlier

- RR, p.81: “Out of 138 countries only nine had a predominantly state owned banking sector. India and China are in this group…***No high income country has a state dominated banking sector***…”
- RR, p. 91: “The majority of this Committee does not see a compelling reason for government ownership.”

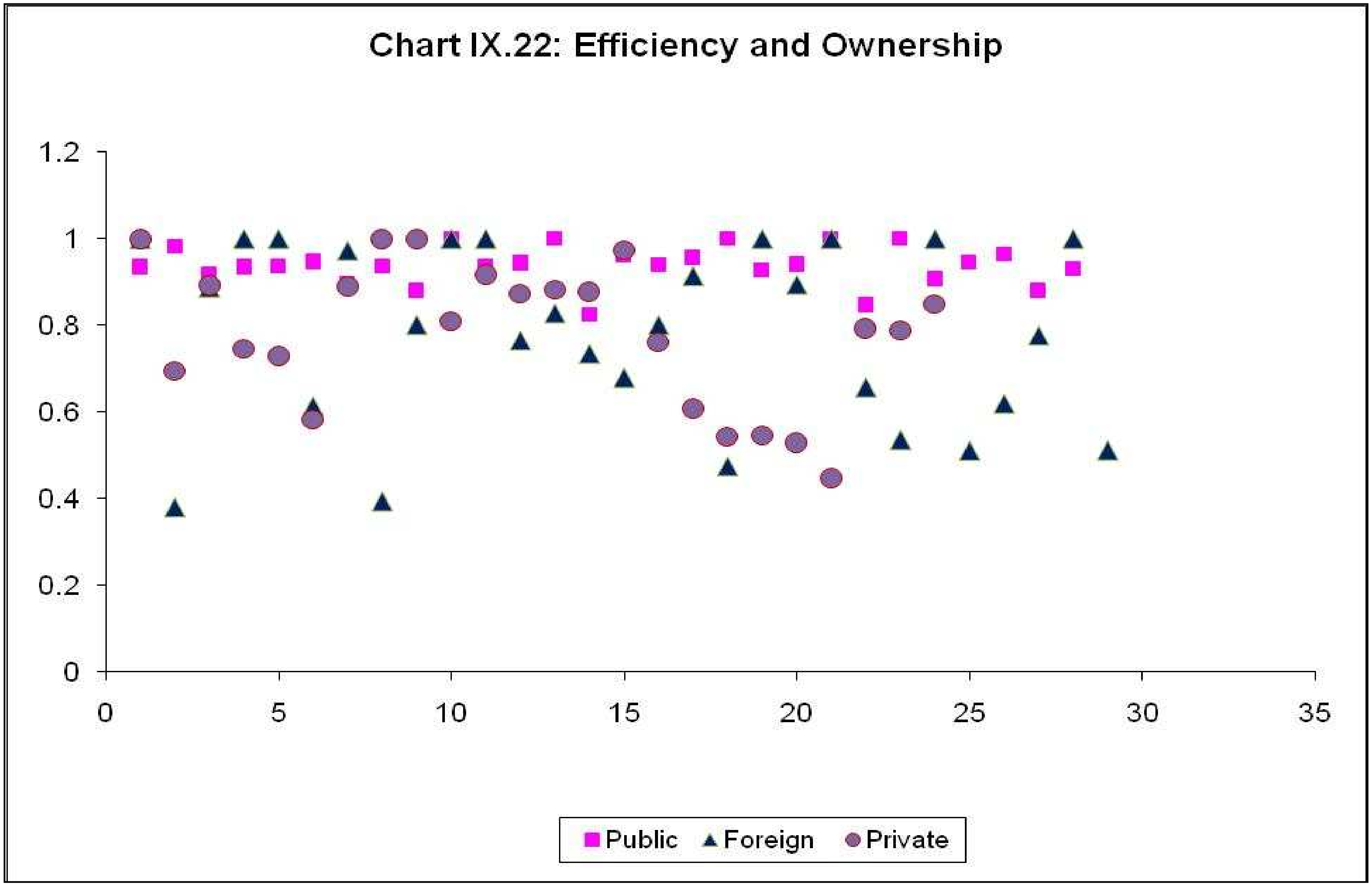
What Makes Ownership a Transparency Issue?

- RR, p.78: "Public sector entities do exactly what private sector entities do, ***though less well because they have more constraints, a poorer skill pool, and poorer incentives***…"
- "… ***the skill deficit will make public sector firms less effective at pricing risk*.** And the costs will partially have to be borne by the government when the under-priced risk eventually hits public sector balance sheets."

Performance of India, the Ownership Outlier

- McKinsey, 2007: “Indian banks have done exceedingly well in providing high returns to shareholders, registering the highest regional growth rate in assets, deposits, and ROE as well as one of the highest total returns globally” (cited in RR, p.82)
- RR, p. 80: “Steady growth has come without significant instability, in contrast to the experience of some other emerging markets. Historically, (Indian) banks have attracted some of the best talent available.”

DEA of Bank Efficiency by Ownership Category (*RCF* 06-08)



Reforming Public Sector Banks

- RR, p.90: “Promotion is typically on the basis of seniority and it is hard to let go of employees for non-performance…”

  [Comment: May be an effective firewall against crony capitalism and political pressure.]

- RR, p.10: “Create stronger boards for large public sector banks…devolving the power to appoint and compensate top executives.”

#2: Transparency ratings of Central banks by Dincer-Eichengreen

Components of Transparency Rating

- Political (3): “quantitative definition of their objectives to the public”
- Economic (3): “disclosing data, policy models and forecasts”
- Procedural (3): “release of minutes and votes”
- Policy (3): “prompt announcement and comprehensive explanation of policy decisions”
- Operational (3): “release of information about disturbances, control errors, etc.” (DG, p.9)

DG Rating of the RBI

- DG assign 100 Central banks a transparency score in the range 0 – 15, annually over 1998-2006
- The average score rose from 3.4 in 1998 to 5.4 in 2006
- The Reserve Bank of India (RBI) scored 2 in 1998 and stayed there (lowest score in South Asia)

(i) Political Transparency

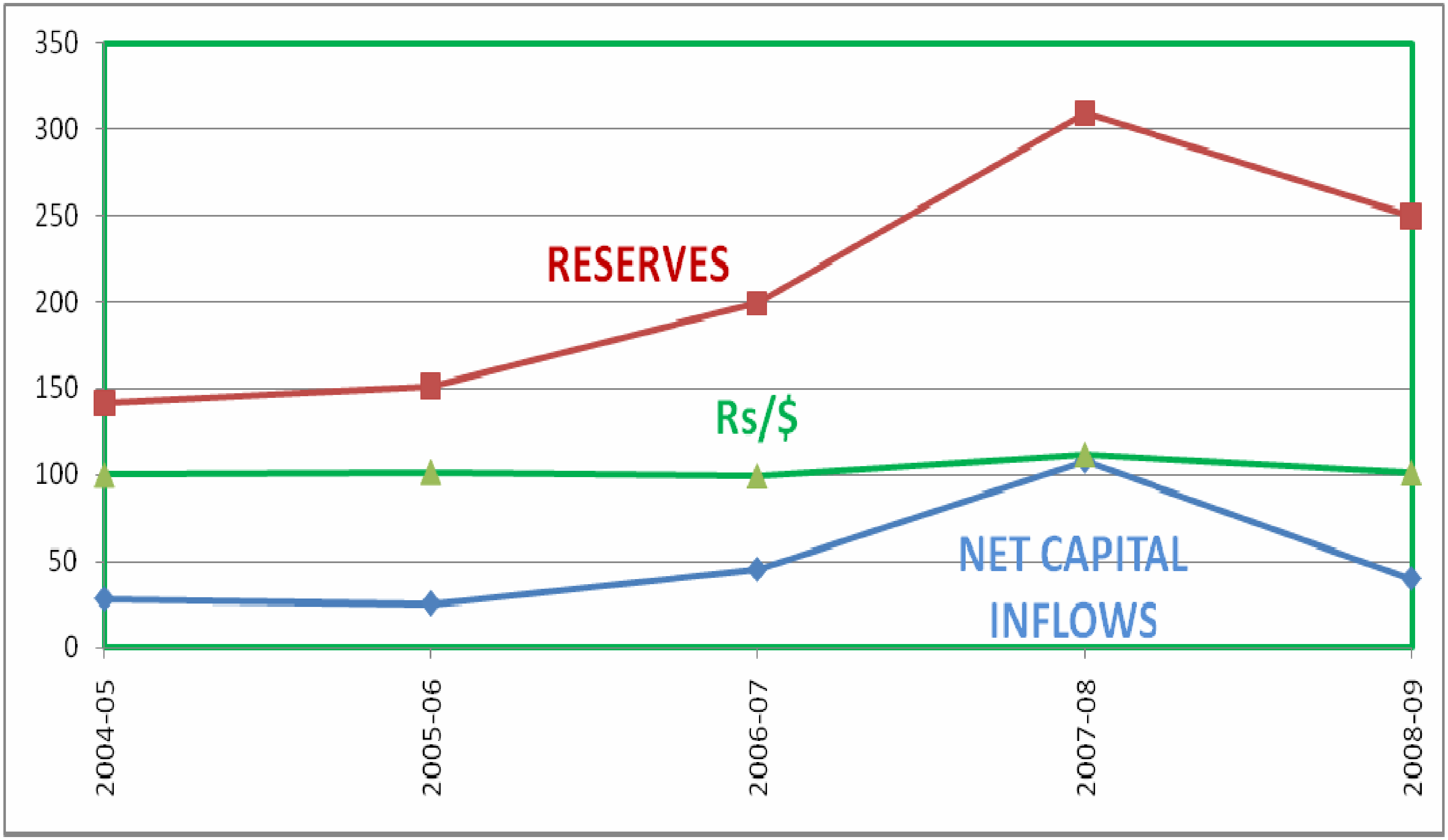
- DG, p. 23: “This comprises a formal statement of objectives, including an explicit prioritization in case of multiple goals, a quantification of the primary objective(s)...”
- RR, p. 5: “The RBI should formally have a single objective…a low inflation number…with a single instrument, the short-term interest rate to achieve it…”

  [Comment: Headline or core? What would a volatile exchange rate driven by capital inflows over 2004-08 have done to financial stability in India? Why focus on price stability alone?]

Coping with a Capital Inflow Surge

- Over 2004-08, capital inflows into India quadrupled. In 2007-08:
  - net capital inflows: 108 b $ (9.2 % of GDP)
  - current account deficit: 17 b $ (1.5 % of GDP)
- RBI engaged in active sterilised intervention to prevent rupee appreciation.
- Sales and purchases of foreign currency and government securities by the RBI, and of other players in currency markets, are routinely published in the monthly ***RBI Bulletin***.

Capital Inflows, Reserves and NEER



RBI Performance

- RR, p.28-29: in the face of substantial capital inflows…"… monetary policy (did manage to) strike a balance between managing inflation and stabilising the nominal exchange rate."
- Even so…"this Committee believes it is neither possible nor advisable to manage the external value of the rupee…"

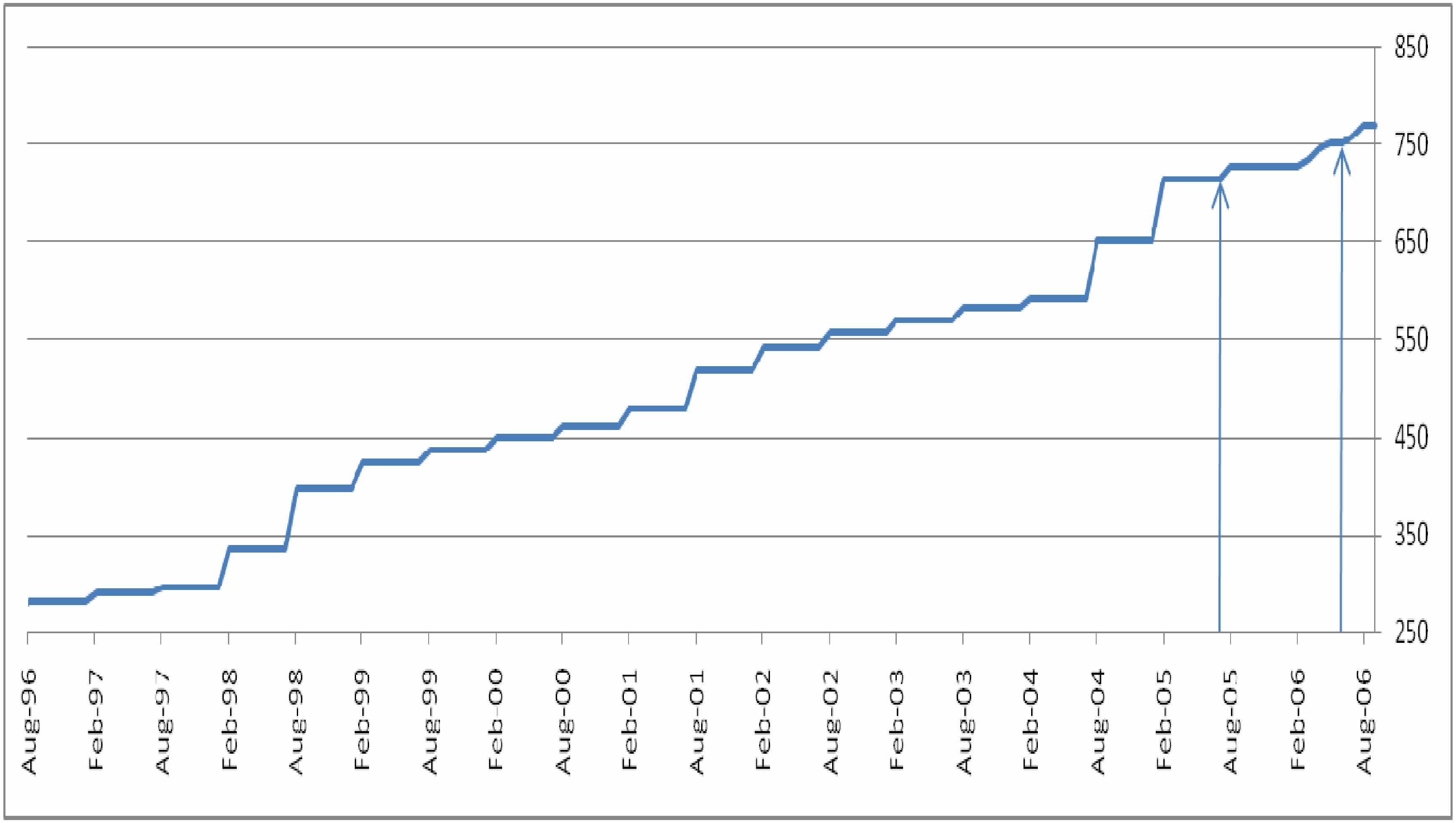
(ii) Policy Transparency

- p.25,DG: "…Prompt disclosure of policy decisions, together with an explanation of the decision, and an explicit…indication of likely future policy actions…"
- RBI actions on risk weights and provisioning requirements for housing finance over 2005-08 were promptly disclosed, but without substantiation, in the absence of a good property price index. Those actions were critically important in preventing build-up of a real estate bubble in India.

Risk Weights on Real Estate Lending and Mortgage Backed Securities

	Individuals	Commercial Real Estate
Before May 2002	100 %	100 %
May 2002	50 %	
December 2004	75 %	
July 2005		125 %
March 2006		Limited to construction
May 2006	(Prov ↑)	150 % (Prov ↑)
January 2007		(Prov ↑)
May 2007	50 % (<2 million)	
May 2008	50; 75; 100 % (function of LTV ratio)	
November 2008	(Prov ↓)	100 % (Prov ↓)

Rental Component of CPI



Safeguards Against "Originate to Distribute" Practices

- Guidelines on Securitisation of Standard Assets dated 1 February 2006 define "true sale" under which the originator would not be required to maintain any capital against the value of assets transferred out.
- First and second loss credit enhancement facilities were to be deducted from Tier I and Tier II capital. Liquidity facilities were to be given 100 % credit conversion and risk weight. Underwriting was to be similarly covered.

Outcomes: Non-performing Assets in the Indian Banking System

End-March	Gross/Loans %	Net /Loans %
2005	5.2	1.9
2006	3.3	1.2
2007	2.5	1.0
2008	2.3	1.0

#3: Basel II Norms

Basel II Norms: Positives for Developing Countries

- Major enabler of financial sector transparency - move towards arm’s length, away from relationship lending
- Flexibly:
  - Accommodates preferential credit weighting for SMEs (under rules for retail exposures).
  - Allows lower credit risk for guarantee backed loans.

Basel II Norms: Caveats for Developing Countries

- Cafeteria of Approaches (Pillar 1)
  - Pressure to move beyond standardised to IRB
  - Lack of supervisory capacity could → dependence on outside vendors without validated data/models.
- Narrow focus on micro prudential: possible pro-cyclicality will need to be offset through dynamic provisioning – beyond Basel II.
- Minimum regulatory capital for securitisation (possible under supervisory discretion of Pillar 2).

India and Basel II

- Guidelines finalised April 2007 (Pillars 1 & 3); March 2008 (Pillar 2).
- All commercial banks (78% total assets) on Basel II by 31 March 2009.
- Countercyclical: Commercial banks advised to build an Investment Fluctuation Reserve, over 2002-07.

Beyond Basel II

- Min regulatory capital set at 9% of risk weighted assets > 8% Basel II minimum.
- Credit risk weights are varied over time (e.g. real estate).
- Regulatory capital calibrated to securitisation exposures.
- Ceilings on access to call money and interbank liabilities as a proportion of net worth

Conclusions

Defining Transparency

- The word "transparency" has been subverted in the financial sector context to mean:
  - Dogma (on bank ownership), in place of competition and disclosure (Pillar 3, Basel II)
  - Rigidity in Central bank objectives, when flexibility is needed to respond to unforeseen eventualities as developing countries open up
  - Predictability in Central bank actions, which denies discretionary actions towards ensuring financial stability

Transparency Correctly Defined Remains Paramount

- Should be calibrated to Basel II norms
- Should require full disclosure of sales and purchases by the Central bank in securities and exchange markets; and full disclosure of policy decisions, with effective dates, and pre-announced finite, or indefinite, durations
- Should permit full range of supervisory discretion under Pillar 2 of Basel II
- Should not require disclosure of internal forecasting models or votes in internal meetings

The Indian Banking System

Type	No.	Share of assets	Regulatory Status
Commercial	79	78%	Basel II CR,MR
Cooperative	3000	9%	Basel I CR
Regional Rural	91	3%	Pre-Basel I

Commercial Banks

	Public	New pri	Old pri	Foreign
Banks	28	8	15	28
Branches	52,880	3,525	4,450	274
Asset share	69.9	17.2	4.5	8.4
Net profit % assets	0.9	1.0	1.0	1.8