Manuscript : Chapter-12

REFORMS IN REGULATION OF FINANCIAL SECTOR: OUTLOOK*

The global financial crisis has led to a reconsideration of the benefits and risks of liberalized financial sector. The first section describes the agenda for assessment and reform of the financial sector in response to the lessons learnt from the crisis. The second section lists the balancing of considerations that is critical for assessment and reform. The third section provides a summary of globally coordinated approach to the reform, and discusses the impact of Basel III proposals. The fourth section narrates the reforms undertaken or proposed (or under consideration) in select countries. The fifth section considers select issues, urges a development orientation to the reform, and makes a brief mention of the outlook for reform.

Agenda for Assessment and Reform

An assessment of regulatory system in financial sector should ideally take account of the purposes of financial system, in view of its facilitating role for economic well being and broader goals of

---

*This chapter incorporates comments made in "Global Economic Governance Conference" sponsored by Institute for Policy Dialogue at Columbia University and Foundation for European Progressive studies at Brookings Institution, Washington D.C. USA on October 8, 2010.

economic policy. To serve that purpose, the regulatory system should be consistent with economic objectives and financial systems. The regulatory systems should have well understood objectives and a given perimeter or scope of operations. There would have to be a structure, a philosophy, and a set of tools for the regulators to operate. These are discernable from features both external to regulatory bodies such as legal framework and internal to it, such as governance approaches and skills. Financial system has three broad overlapping segments, namely, financial institutions, financial markets, and financial instruments. Regulatory system will have components directed at each of these segments but it is extremely complex to compartmentalize them, making coordination, formal and informal, critical. It is possible to argue that in pre-crisis years, some of the regulatory regimes had a somewhat over simplified view of achieving economic efficiency and stability through essentially market driven self regulatory regime, while financial systems were growing rapidly and adding to complexity. Experience with crisis, both in countries severely affected by financial crisis and those less affected, enables a list of general principles for assessment of adequacy of regulatory regimes in this background. In considering the general principles, it is necessary to recognize that the objectives of financial system and of regulatory systems could legitimately be country specific. In view of the systemic risks generated by the individual and collective behavior of firms coming into sharp focus, the critical role of macro-prudential regulation in complementing micro-prudential regulation became evident. Macro-prudential framework should be so designed that there is adequate capital with the financial institutions to absorb a variety of risks both in normal and abnormal times. Hence the regulators have to prescribe a quantity of capital that is adequate to absorb these risks. In computing the requirements of capital, an assessment and quantification of risk is critical. In assessing capital requirements of individual institutions, there is need for a countercyclical approach. In other words during good times capital should be set aside so that in bad times it will be able to take care of the risks. In aggregate, the bank's balance sheet should not be excessively leveraged, and hence the ratio between owned resources and borrowed resources in the conduct of the business should be reasonable. The quality of capital is also important. In other words, the practice of treating borrowed capital also as risk capital may have to be restrained. The regulatory framework should also take a view of systemic risks and not merely the risks of individual institutions. It is quite possible that individual institutions considered separately may be healthy, but as a part of the system they may become vulnerable in terms of capacity to take risks of interconnections in their operations. Hence the regulatory framework should take a view of systemic risks and in that context stricter norms for systemically important financial institutions (SIFIs) and an effective regulation mechanism for such institutions came into prominence.

The perimeter of financial sector regulation has to be well designed. If one segment, say banking, is subjected to rigorous regulation, and the non-banking segments are not subjected to such regulation, such institutions may find ways of performing prohibited banking functions through some innovative mechanisms taking advantage of the regulatory gaps. Further, the banks themselves may finance banking activities outside their own pools. In addition, private pools of capital such as hedge funds or private equity funds could be large and may have systemic implications. Such pools of capital may also have to be regulated, but the extent of regulation cannot be on par with banks. In brief, different segments of the financial sector will have to be subjected to different types of regulations, to ensure that regulatory arbitrage is minimized. In other words, the same type of activity undertaken by different types of financial institutions should be subjected to the same type of regulation. Furthermore, improving transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives (OTC) became a priority in the light of the experience during the crisis.

The recent financial crisis witnessed the collapsing of large investment banks in the US, which rekindled a discussion of optimal banking models. There are three views about the structure of banking institutions. One view is that the economies of scope and efficiencies of scale can be captured by the financial sector if banks are able to perform a range of financial services of which retail banking is one. These are described as universal banks and are recommended on grounds of efficiency. A second view is that universal banking incorporates in itself significant conflicts of interests between different businesses within itself and they may tend to take excessive risks. Further, this institutional structure may neglect retail banking which is of interest for large sections of people. The traditional banking function includes the payments system, which is of considerable significance and therefore, should be treated as a public utility. Hence, some commend banks to devote exclusively to retail banking and this is sometimes described as narrow banking. An intermediate view is that a bank should predominantly be carrying out traditional retail or commercial banking functions and the other riskier activities should be either prohibited or permitted only under stringent restrictions, depending on the nature of financial activities.

The financial intermediaries often have mismatches in regard to maturity between assets and liabilities. It is necessary to ensure that the mismatches are within limits, and the financial intermediaries are not excessively dependent on money markets, i.e., very short-term lending and borrowing. The regulation should, therefore, take into account the liquidity requirements also.

With the improvements in technology, financial service industry has brought about several innovations. These financial innovations, which are in the nature of complex instruments, are expected to spread the risk widely and help in efficient price discovery. In practice, however many of the innovations have tended to circumvent regulations and, in any case, they often inject complexity to financial products. It is, therefore, necessary to ensure that only good innovations are permitted by regulations and bad innovations are discouraged or even prohibited. No doubt, it is difficult to distinguish between what is good and what is bad in advance of their actual working in practice. Moreover, the complexity in regard to some of the innovations warrants protection of consumers of such products from undertaking excessive risks. Transparency by itself may not help if the complexities merely become transparent, but the innovations are not simple enough to understand. To the extent the innovations are new and uniquely designed, it is difficult to subject them to standard trading practices such as on exchanges. While over-the-counter (OTC) transactions enable innovations, they also have embedded risks. Hence, appropriate regulatory framework that ensures good innovations and sound trading practices should be considered.

Although accounting conventions were not the cause of the financial crisis, certain accounting measures, such as the use of fair value accounting for illiquid financial instruments and the important model for loans and debt securities, have been viewed as weak areas that exacerbated the problems. In order to operationalize the principles in a clear and nondiscriminatory manner, accounting standards should be of a quality that are sufficiently standardized, well understood and subject to common interpretation. The accounting standards to the extent they depend on market prices for valuation can be pro-cyclical thus adding to the problem. Hence, they should be stable as also be able to capture the impact of cycles on the financial intermediaries.

The incentive structures to the management and staff in each financial institution should be such that they are not encouraged to take excessive risks. In particular, the remuneration for senior executives when linked to the short-term profitability may have the potential to increase risk taking by the institutions. Mechanisms should, therefore, be found which provide incentives for good performance, but disincentives for excessive risk taking. A major area requiring regulatory intervention is the complex task of avoiding conflict of interests. The erection of firewalls within an organization between functions involving conflicts of interests may not necessarily serve the purpose, since fire-walls in financial transactions have a tendency to be porous and almost invisible.

The legal and institutional arrangements governing the regulatory framework should provide regulators are provided with adequate powers coupled with accountability. Where multiple regulators exist, arrangements are required for coordination, formal or informal, among the multiple regulators. Similarly, in the case of large or systemically important financial institutions, special coordinating arrangements would be required among the regulators. In addition to the structures, the regulators will have to have mechanisms for capacity building of the regulators, to keep pace with the innovations in financial markets.

The credit rating agencies play a vital role in financial sector since they are also used by regulators for specific purposes. However, the rating agencies also have inherent conflict of interests since they are hired by the rated, giving significant scope for conflict of interest. The rating agencies inadvertently contributed to the build-up of systemic risk during the recent times by issuing unrealistically high ratings (BIS, Annual Report, 2009). It is therefore necessary to reduce the dependence of regulators on rating agencies and, at the same time, ensure that the quality of rating is appropriate.

Above all, it is the quality of supervision that is important since it has been found in practice that even though the regulations did exist, but the compliance was poor and supervision inadequate or ineffective. In brief, there is a realization about the criticality of equal emphasis on what may be termed as sound principles on regulating the financial sector and effectively supervising them. An assessment of the financial sector with reference to these sound principles is the first step towards the reform of financial sector in any country. However, in considering the general principles, each country has to take account of the objectives of regulation as part of broader public policy.

Balancing of Considerations:

There is a broad agreement on most of the general principles of regulation and supervision of financial sector, in the light of the crisis. However, conflicting considerations in the actual framing of the regulations and their implementation need to be explicitly assessed and balanced. It is extremely difficult to weigh the benefits and risks with regard to these conflicting considerations. Financial crisis has shown that in the past, in the absence of a good balance between conflicting considerations, private interests have prevailed over public interest, resulting in considerable gains for private interests at great social costs. First, it is generally assumed that market forces and competition will have a tendency to impart efficiency. In the financial sector, however, short-term efficiency may often threaten longer term stability. Second, the interests of shareholders who have to contribute to the capital of the financial intermediaries should be weighed against the benefits of giving higher priority to social goals such as development or stability. Third, assurances of support in times of difficulties would enable the financial intermediaries to assume risks that could add to overall efficiency in normal times, but there is a moral hazard since assurance of support may be encouraging excessive risk taking. Assurances of support should be minimal and only to the extent of not creating a moral hazard, but it is very difficult in practice to say what is an ex ante minimal support. Fourth, it is well known that higher the risks (measured in terms of price), higher the returns in a risk-return frontier. The accumulation of higher risk by several financial intermediaries in the system may threaten systemic stability, especially if the risk is being taken with borrowed resources. An issue is whether the consumer of the product is provided with full information to assess risks and returns. Fifth, there is need for market participants to be fully aware of the rules that they should follow. But, it is not possible to envisage all circumstances and lay down rigid rules in advance. However, giving excessive discretion to the regulations may add a premium for uncertainty, thus adding to the cost of intermediation. It is also possible that the regulators are captured by the regulated. One approach is to depend on rules in normal times while permitting discretion under extraordinary circumstances, though it may be difficult to define extraordinary circumstances in advance.

Sixth, an intrusive regulation may not be commensurate with the costs of regulation and the costs of compliance. On the other hand, soft regulation especially self regulation is less costly since the regulator can state principles that should be complied by the regulated, and leave details to the regulated. Experience has shown that excessive reliance on self regulation has a tendency to be weak regulation, thus defeating the objectives of regulation. Where standards of governance are high, self regulation could be preferred to external regulation and hence the regulatory framework could focus on standards of governance more than external regulation. Defining appropriate governance standards and ensuring their implementation, however is a complex task and may involve subjectivity. Seventh, the regulators have a fiduciary responsibility in as much as the banks are licensed to conduct businesses that are highly leveraged and take deposits without colaterals. Hence, some regulatory prescriptions are essential, but beyond a point they restrain operation of markets that are essential for promoting efficiency, and constrain competition. Eighth, because of the changing circumstances, particularly fast changing technologies, the regulatory framework should be dynamic and be able to cope with changes in the market's products and practices. At the same time, some stability in the regulatory regime is essential for market participants to conduct their operations without imposing a high uncertainty premium. Ninth, consumers of financial services, in particular retail depositors, need to be protected from sale of low quality or toxic products. However, undermining basic principle that buyers should be vigilant about their products is not conducive to efficiency or choice. Finally, the regulatory framework will have to take into consideration the relevant trade-offs in the context of a particular country. However, to the extent, finance is increasingly globalised, these trade-offs will have to be built into a globally applicable framework for financial sector regulation. Financial sector may be increasingly globalised, but its regulation continues to be national since the regulatory system of a country should fit into the financial system prevalent in the country and subserve the objectives set for regulations in public policy. At the same time, regulation and supervision of cross border financial institutions and activities are inevitable and hence some arrangements for coordination among the national level regulations would be essential.

Coordinated Approaches to Reform

In the light of the crisis, there are attempts to design best practices in regulation of financial sector, encourage countries to adopt them and monitor the progress. A reform agenda for financial sector has been set by G-20 for the medium term with a timetable for action. Accordingly, international norms of capital, leverage and liquidity are to be finalized by end of 2010 and phase in their implementation by 2012. Reforms in Over the Counter (OTC) derivatives, their exhange trading and clearance through central counter-parties (CCPs), and trade reporting requirements are to be completed by 2012. A single set of high quality accounting standards should be in place by end 2011. The compensation reforms and prudential rules for the systemically important financial institutions and finalization of architecture of cross border resolution are expected to be completed in 2010. In the meeting of G20 in November 2010, G20 is expected to review implementation of reforms in financial sector in the member countries and consider "Basel III" proposals, described later in the chapter. There is however no agreement in the G-20 on levy of taxes on financial sector or banks to finance the public expenditure relating to crisis and on the regulation of pools of private capital such as hedge funds, though both are under consideration in several countries. G-20 recognizes the need for some emerging economies to develop their financial sector to provide depth and breadth of financial services required to promote high rates of economic growth. Financial inclusion has been identified as a priority item for emerging markets.

It is clear that the financial sector reform will be based on individual country circumstances at the national level but broadly in the direction indicated by the deliberations in G-20. The pace of reforms will also depend on the assessment of the current situation in countries. A peer review put in place by G-20 mechanism imposes some pressure on individual countries to honour the agreed global standards.

The Basel Committee on Banking Supervision (BCBS) in close association with the Bank for International Settlements (BIS) has developed what may be described as minimum standards or guidelines on capital of banks. The prevailing standards, described as Basel II, were exposed to several inadequacies in the light of the recent financial crisis. Hence BCBS decided to update their guidelines on capital and liquidity reform proposals. Collectively, the revised Basel II capital framework and the new global standards announced in July and September 2010 have come to be commonly referred as "Basel III". The Basel III guidelines includes tighter definition of Tier-I capital and Tier-II; minimum norms for common equity component and Tier I, the introduction of leverage ratio; a capital conservation buffer and a framework for counter cyclical capital buffers; enhanced measures of counter party credit risk; and short as well as medium term quantitative liquidity ratios. Some explanation of the improvements suggested, though somewhat technical, may be useful.

Basel III proposals emphasize that the capital base of the banks should be characterized by full loss absorption capacity. Base III has, therefore, proposed that Common equity to be a predominant form of capital. The minimum common equity ratio (as a percentage of risk weighted assets) would be increased from the current 2.0% to 4.5%. The Tier-I capital ratio would be increased from 4.0% to 6.0%. The total capital adequacy requirement will continue at the existing 8.0%. New criteria on certain capital elements would be introduced to make them stronger. There will be no sub-categories of Tier-2 capital such as upper Tier-2 and lower Tier-2. There will be only one form of Tier-2 capital with minimum maturity of five years. Basel III has also proposed measures to reckon counterparty credit risk for derivatives, repos, and securities financing along with capital. The Systemically Important Banks (SIBs) or Systemically Important Financial Institutions (SIFIs) will be subjected to additional capital and liquidity measures (the exact quantum yet to be decided), in addition to exposure limits and intensive supervision.

The Basel Committee is proposing to test a minimum Tier-1 leverage of 3% during the parallel run period covering January 2013 to January 2017. Specific steps have been proposed to ensure that the banking sector is able to maintain the flow of credit to the real economy during times of stress. A capital conservation buffer i.e. a buffer of 2.5% composed of common equity only and established above the common equity requirement is contemplated along with constraint on distribution of earnings as dividends and bonus payments when capital levels fall below this limit. Introduction of contingent capital in the regulatory capital framework is being explored for SIFIs. Contingent capital would be debt or debt like instruments, which would convert into capital on some pre-specified trigger events such as capital adequacy falling below the specified threshold or on the event of a catastrophe. The use of contingent capital in meeting countercyclical buffer requirements and additional surcharges for systemically important financial institutions and introduction of two ratios, namely liquidity coverage ratios and net stable funding ratios have also been proposed.

Impact of Basel III

There is a view that implementation of Basel III proposals may have some macro-economic impact on growth through the cost of capital channel and impact on lending. If banks have to retain more capital (a more costly source of finance), then that will have impact on the final lending rates which may have its impact on the growth of economy particularly at a time when slackness in credit growth is a matter of concern. The other channel could be the overall lending. Since the norms are ratios between capital and risk weighted assets, in the absence of raising of capital or inability to raise capital, the ratios can still be met by contracting the assets such as lending. This in turn could have adverse impact on economy when overall credit supply cannot grow to the requirements of the economy.

There is much agreement on the view that there are clear net long-term economic benefits derived out of the increased safety and soundness of the global system from higher minimum capital and liquidity requirements under Basel III. The benefits of higher capital and liquidity requirements accrue from reduction in the probability of financial crisis and the output losses associated with such crises. The benefits substantially outweigh the potential output costs for a range of higher capital and liquidity requirements. The transition to stronger capital and liquidity standards is likely to have a modest impact on aggregate output as higher requirements are phased in over a medium term time horizon (four years). Further, the burden of mobilizing additional capital will be on those who happen to be severely undercapitalized and sooner the de-leveraging is achieved the better it will be to regain trust in the financial sector.

In view of the criticality of the time-frame in implementing the Basel III norms, attempts have been made to compute the possible impact of adoption of Basel III on aggregate output depending on the pace of implementation of new standards. According to the BIS, if higher requirements are phased in over four years, each one percentage point increase in banks' actual ratio of tangible common equity to risk-weighted asset may lead to a decline in the level of GDP relative to its baseline path by about 0.20% after implementation is completed. In terms of growth rates, this means that the annual growth rates would be reduced by an average of 0.04 percentage points over a four and half year period, with a range of results around these point estimates. A 25% increase in liquid asset holdings is found to have an output effect of less than half that associated with a one percentage point increase in capital ratios. No doubt, there are differences between the official estimates of BCSB and that of banking industry lobby (the latter estimates higher costs in terms of loss of output).

There is hope for reducing the risks of instability in the financial sector since there is agreement on major issues such as leverage, liquidity, counter cyclicality and attention to systemically important financial institutions. Agreement on parameters of capital adequacy is also welcome. The fears of possible adverse impact on growth are possibly exaggerated. The real issue is therefore the challenge ahead of some of the advanced economies that have to deleverage and reach the standards prescribed by Basel III. Notably, many emerging markets already meet these norms. There are apprehensions that Basel III in its present form may not meet the concerns of global community in view of time table that appears stretched till 2017 with scope for dilution as time passes and potential for instability in the interim. It is also feared that the principles set forth appear adequate, but they may be diluted in practice. More important, there is a widespread discomfort with the manner in which the “too big to fail” issue is being addressed by the reform proposals.

Reforms in Select Countries:

In U.S.A, a comprehensive legislation was enacted on July 21 2010. An independent consumer financial protection bureau with jurisdiction over firms that sell consumer financial services has been created at the Federal Reserve. The private pools of capital, namely private equity and fund mangers have to register with Securities and Exchange Commission (SEC) as investment advisors, who may be required to observe disclosures and investor protection. Large hedge funds or private equity funds which are considered systematically important are subjected to the jurisdiction of a council of regulators. Large banks are barred from owning significant stakes in leveraged buyout funds, or hedge funds. In regard to derivatives, there is a requirement that over the counter derivatives be registered with clearing houses, who may put some safeguards, but there are several exceptions to these stipulations. The pay packages and remuneration for senior executives and directors under certain categories are subjected to regulation. A Systemic Risk Council has been created with broad powers to regulate systemically significant institutions. The Federal Reserve is charged with conducting annual stress tests of systemically significant institutions. The proposed Systemic Risk Council has authority to place bank holding companies and other systemically important institutions into a resolution process – a process whereby equity capital may be eliminated, bondholders may be forced to take cuts and management replaced.

In Europe, a pan European financial regulatory architecture has been approved to help develop common European rules for national regulators to follow. Three pan European supervisory authorities have been created for banking, insurance and pensions and for securities and markets. While the European Systemic Risk Council (ESRC) has been setup for macro-prudential regulation the European System of Financial Supervisors (ESFS) corresponds to a micro-prudential approach. Extraordinary regulatory processes have been acquired by the European Parliament when emergency is declared for regulatory purposes. In brief, the regulatory coordination in EU area has been the major focus of reform. However, in regard to several other areas, such as regulation of hedge funds, private equity funds and policy in regard to too big to fail, lack of progress is conspicuous. There are two factors for the reform-process to be different from that of USA, namely, the reluctance of UK in some matters which are critical for Euro Area; and the difficulties of negotiating agreement with member states since they have financial systems with different characteristics.

In U.K., an overhaul of the financial structure has been announced. The Financial Services Authority (FSA), the single regulator and supervisor for all financial services providers in the UK. will cease to exist. The tripartite structure consisting of the treasury, the Bank of England (BOE) and the FSA gets dismantled. The key role in financial structure is now assigned to BOE; which becomes institution in charge of monetary policy, lender of last resort, special resolution regime, macro prudential supervision, and oversight of micro prudential supervision. A new prudential regulatory authority as a subsidiary of the BOE and a financial policy committee within the BOE, have been proposed and both will be chaired by the Governor of BOE. There will also be a new Consumer Protection and Markets Authority and an Economic Crime Agency. An independent commission on competition in banking industry has also been announced. Switzerland which was also severely affected by the crisis has a financial system dominated by very few very large entities. The reforms focused on several relatively stringent regulatory prescriptions to ensure stability. These relate to capital buffers, leverage ratios and safeguards in regard to their systemically important financial institutions.

Some generalizations on reforms in the financial sector in these select countries may be made. First, noticeable reforms have been implemented, in those countries which experienced excesses. That is a matter of comfort. Second, the underlying logic is essentially towards greater weight to stability than before. There is some discomfort about the time path given in some reforms which appears stretched. There could be pressures to dilute the standards over time and in detailing the measures for applications. Third, the design, content and pace of reform are clearly country-specific or Euro Area specific. Fourth, major areas of cross border regulation, and sources of contagion have not been addressed adequately, presumably on the assumption that strengthening regulation at national levels would serve the purpose for the present. Fifth, there have been no cognizable reform initiatives in other advanced economies like Australia, Canada and Japan. Almost all EMEs have not considered it appropriate to attempt reforms at this stage. However, many of them are addressing issues relating to volatility in capital flows by using regulation of financial sector as one of the instruments. Korea provides a good illustration of this approach.

Developing Country Perspectives:

In countries that experienced the financial crisis in acute form, some reforms took place, while in others, especially in developing countries where the impact was not as severe, they are still waiting to the overhaul of the international financial regulatory architecture, so they can consider adapting appropriately their national regulatory frameworks.

The developing countries may view the reform proposals in Basel III and G-20 with a mixed feeling. Measures to strengthen the financial system in the advanced economies should be welcomed. Since many of the developing countries satisfy most of the stringent criteria on banks, there may not be additional regulatory burden on them. They are not over exposed to sophisticated financial products requiring actions stipulated by Basel III in this regard. Infact they may gain by better safeguards in the regulatory framework governing financial innovations. Lesser dependence on credit rating may also be to their advantage. The emphasis on financial inclusion in G-20 is also appropriate though it is not clear how it is being operationalised in the reform-proposals. Further, financial inclusion should not be an excuse for pushing credit or irresponsible lending as it happened in sub-prime lending. It should not be an excuse for circumventing regulatory rigour. There is a recognition that regulatory intervention is desirable for stability but a similar dispensation to achieve objectives of growth with equity through influencing direction and price of credit is not observed. In particular, issues relating to long-term financing needs of development and significance of small and medium enterprises for employment are not recognized.

Adequate weight has not been given to the comfort of relationship lending and collateralized lending prevalent in developing economies.

Impact of Basel III proposals on emerging market economies may be illustrated with the Indian case. The effect of proposed Basel III is expected to be minimal on the capital requirements of Indian banks. For example Tier-I capital in banks at nine percent is above stipulation 6%. Deductions in capital proposed are already in force in India. Counter parity credit risk framework may impact a few private sector or foreign banks which have significant exposures to trading book. The banks are not excessively leveraged and hence stipulations on leverage ratios will have little or no impact. On counter cyclical policies, India follows a sectoral approach. For a rapidly growing economy, credit to GDP ratio in the short run may be too aggregative to reflect building of systemic risks. Indian banks have not faced the type of stress that advanced financial markets did. Assessment of liquidity stress scenarios is a new task for Indian banks. The banks in India are strong for two important reasons namely dependence on more stable retail business and the regulatory requirements, that banks should hold a significant part of assets in the form of government securities.

Select Issues:

It is necessary to set-out the purpose of the developing the financial system in order to assess the appropriateness of the regulatory regimes and design suitable agenda for reforms. The objective is no doubt to maximize output, employment and broader social objectives. Financial sector should facilitate real economic activity, at a minimum cost and on an assured basis. To achieve these objectives, the financial sector has to match savings, investment and liquidity in an optimal manner. Further, in view of nature of externalities in financial sector regulation become inevitable. But, there is a need to look at expectations from the common person, particularly in developing countries, in setting out the objectives of financial system. These are: (a) consumption smoothing, since income stream and expenditure stream may not converge; (b) payment transfers in an efficient and economical manner; (c) safe custody of deposits without serious loss of value of their earnings through enabling supply of at least one instrument of safety; and (d) and making available a choice of institutions and instruments for savings and investments and not merely enable lending or extending credit. Public policy should, therefore, address two sets of issues, namely (i) meeting common persons' needs and providing financial services with sensitivity to price and quality and (ii) facilitating growth by enhancing efficiency, imparting stability taking account of externalities that characterize financial sector.

The financial sector reform debate now is essentially a response to the crisis and the focus is on correcting the excesses of the past; especially excessive deregulation which caused the crisis. Almost all proposals involve tradeoffs, at least in the short run. Tradeoffs are often contextual, to the society, to the economy and to the institutional needs. But minimum and common standards are necessary in view of linkages between financial sectors of different countries. Currently, there are two sets of reform-ideas under debate namely reforms in individual countries especially USA, UK and Europe and minimum standards as per G-20 reform agenda and Basel III proposals. Some advanced economies have brought about changes in regulatory regimes in the light of their experience and these are of systemic importance to the global economy. Emphasis on stability in their reform agenda is inevitable since the reform is in reaction to crisis, but a development orientation is equally relevant for global economy since there is a paradigm shift in the role of regulation of the financial sector. If intervention of the State in markets is necessary for ensuring stability, there is a valid reason for intervention by the State to ensure economic development.

There is a case for development orientation to the design and policies of regulation of financial sector but the skeptics argue that regulation is not the best instrument and in any case it may be difficult to operationalise such a policy. First, the mandate for regulator should include utilizing the regulatory tools to achieve objectives of not only stability but also development as allocation of credit to different uses prescribing differential margins. Second, where subsidies from government are warranted, as in the case of Development Financial Institutions, the regulations should also be aligned to achieve objectives of development. Similarly, a longer term view may be taken in regard to risks assigned to longer term direct financial of infrastructure. Third, the budget of regulators should be used for promoting use of technology or extending financial services to backward areas or remote areas or poorer sections which may not be profitable in the short to medium term. Fourth, in regard to policies such as licensing of branches of banks incentives and disincentives could be considered in favour of under-served areas. Fourth, access to payment and settlement facilities should be ensured at an affordable price and acceptable quality in favour of the poor. Exploitative practices in certain activities such as credit cards should be curbed. Fifth, financial and technological innovations that are likely to favour the poor should be encouraged and, if need be, subsidized by the regulators. Financial institutions devoted to retail operations and without serious systemic implications should be nurtured. Finally, the weight for financial stability should be higher in developing economies where social safety nets do not exist. For example, the practices and products that are innovative, whose risks are indeterminate, should ideally be tested in advanced economies before the regulators allow them to be used in developing economies unless the regulators are aware of and comfortable with implications of innovations.

The experience of China and India with public sector banks and financial institutions in successfully using them as instruments of public policy is relevant in this regard. The trust that people have placed in public ownership under stressful conditions in advanced economies is also relevant. In fact, the presence of some public sector units in financial sector along with private sector helps reduce information asymmetry between the regulator and the regulated since incentives in public sector are conducive to transparency. Further, as experience with crisis has shown, in times of stress on pubic policy, existence of some public sector enterprises improves effectiveness of public policy.

In the agenda for reform of financial sector consequent upon the crisis, taxation of financial sector has been prominent, although no agreement could be reached. As a broad generalization taxation of financial sector should be consistent with the regulatory objectives and burdens or benefits of both should be assessed in a comprehensive manner. Differences in tax burdens and regulatory burdens across countries may not be viewed in isolation. Financial sector taxation as debated in the context of the crisis, may have several objectives, namely to share the burden of bailout expense (which is indeterminate so far); to build a buffer for the future crisis (which should ideally be designed as an insurance fund); to raise resources for budget (similar to any other tax); to discourage excessive speculation or unnecessary multiplication of financial transactions (which exist in some advanced economies also like stamp duty or securities transaction); and to raise resources for global public goods. In the current context, the use of financial sector taxation has been advocated mainly by advanced economies to pay the bail-out costs and to build a buffer for future crisis.

In respect of developing economies, the bail out is not relevant and cost of funding of future crisis is not a priority. However taxation of financial sector for resource-raising, discouraging excessive financialisation and possible funding of global public goods are relevant objectives. The taxation of financial sector as compared to non-financial sector and different institutions or different instruments in the financial sector would have consequences for both development and regulation. The financial sector could potentially be an instrument of development policies and these may impose regulatory burdens, say on banks in the short run. Any view of on financial sector taxation should therefore include an assessment of regulatory burden due to development objectives also. Hence, taxation of financial sector should remain as a national imperative. However, international agreement on levy of Tobin Tax would be in the interest of developing countries since it would moderate excess volatility in currency markets.

On the basis of Indian experience it can be argued that regulation of the financial sector could be used as a tool for macro-economic management. For example, in India the cost of sterilized intervention in forex markets is shared by the banking sector through the imposition of unremunerated cash reserve ratios, as needed. More important, the large borrowing programme of the Indian government is facilitated by a stipulation that deposit taking institutions in financial sector are required to invest stipulated amounts as a proportion of balance sheets in government securities. These stipulations provide reasonable stability to banks and assured support for the borrowing program of the government, as these securities are relatively less risky. The effect of such mechanisms is similar to domestic financial sector taxation.

Prudential regulation may also be used as an instrument of capital account management. For example, limits are set on foreign currency exposures of financial intermediaries, including a limit on their external debt. These stipulations have the effect of tax, but serve the purpose of moderating volatility in capital flows. Use of financial sector for macro-management has elements of tax burden.

Outlook:

The outlook for a globally coordinated and sustained regulatory reform appears to be uncertain. First, there is no clarity on what is a right model for regulation of financial sector though there is a recognition of general principles. Second, there are several tradeoffs involved which are more often than not country specific. Third, the immediate compulsions for urgent reform appear to be for a few countries which were significantly affected by the crisis as a result of excessive deregulation. Fourth, regulation of financial sector cannot be divorced from other aspects of macroeconomic policy, such as monetary and fiscal policies, especially in regard to countercyclical approaches. Fourth, the capacity of countries and societies to bear risks varies, with developing countries being at a disadvantage. Hence, several policies in the nature of self-insurance are inevitable, and such policies may include financial regulation. For example, prudential measures may be used for capital account management in developing countries. Fifth, experience has shown that regulatory capture in a comprehensive manner, and inadequate or ineffective supervision were often sources of fragility, and not necessarily the regulatory framework. Sixth, there may be merit in recognizing that regulation of the financial sector would be essentially at the national level. Search should therefore, be to identify regulatory standards and practices in each country that are likely to have negative externalities to the global economy.

A possible approach to reconcile the need for policy space for national authorities and the need for global coordination may consist of three sets of actions. They may consist of reaching agreement on (a) basic principles of national regulations that could address national level activities of the financial sector (b) standards of regulation for systemically important financial intermediaries at global level and (c) minimum standards for systemically important financial centres for global economies. The basic principles of national regulation may have to identify the 'bad' practices and create mechanisms to persuade countries not to adopt them while continuing a search for the 'good' that is equally good for all countries in a global economy where only nation states are accountable to their people. The regulations at national level are most appropriate for institutions and markets that are predominantly national. To supplement these minimal national standards, focused globalised regulation should be evolved in respect of large financial intermediaries whose activities are predominantly cross-border. A distinction could be made between national and multinational banks whose main activities are within a country's jurisdiction and international banks which are large institutions that operate across financial markets, regulatory jurisdictions and tax regimes. The international banks are the main sources of diluting policy autonomy including regulation at the national level. They need to be subjected to global stringent regulations.

These centers which are having the privilege of being international financial centers have a responsibility to subject themselves to globalised regulation. Such focused approach to regulation of the financial sector in financial centers and banks of international significance will be consistent with differentiated regulatory regimes that have been accepted now for systemically important financial institutions.

There are two views on the way forward in regard to sustained regulatory reforms in the financial sector. One view is that regulators have been excessively defensive in view of the crisis and political pressure has been brought on the proposed framework due to public outcry. This view questions the wisdom of many initiatives for enhanced role for external regulations. The alternate view is that the financial sector lobby continues to exercise influence over decision marking processes and hence the framework is possibly weak and in any case will be diluted in practice. The developing economies have been innocent victims of the global financial crisis and they have every reason to guard against facing adversities in the post-crisis management of financial sector in the global economy. Much of the debate and action so far has bypassed concerns of developing economies despite their recently acquired importance in G-20, FSB and BSCB. This is evident from the reforms that are missing in the agenda, namely, the basic purposes of financial system, the legitimate expectations of common persons, development orientation and finance as a possible supplement to macroeconomic management including capital account management and possibly in supporting the very large borrowing programmes of some governments.

*****