FINANCIAL SECTOR LEGISLATION:
(RANDOM) LESSONS FROM (RANDOM) EXPERIENCES,
Distinguished Lecture on Law and Economics

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Indira Gandhi Institute of Development Research, Mumbai
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Distinguished Lecture on Law and Economics
Delivered at
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April 25, 2011
by
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and
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Professor Mahendra Dev, Respected Professor Schaefer, distinguished scholars and friends,

I am thankful to IGIDR, and in particular Professor Babu, for inviting me to deliver a lecture in the context of inauguration of the Erasmus Mundus Programs on Law and Economics in IGIDR by the Hon’ble Minister, Mr. Kapil Sibal. I do have some affinity to the program since I was part of the team that started working on this idea ten years ago; yes, in 2001. Even then, it was meant to be developed in phases, as agreed when I discussed with the authorities in Hamburg. I am happy that with the approval of University Grants Commission (UGC) a couple of years ago, the program is now on par with the rest of the Law and Economics Programs in the World. I would like to place on record our deep debt of gratitude to Professor Schaefer for his immense and valuable support. I had also requested Professor Jenik Radon of
Columbia University to be a Visiting Faculty to this program and I understand that he has been obliging the Program. Professor Babu has been a pillar of this Program and deserves to be congratulated.

Perhaps, I should explain why I took interest in this subject, despite the strong association of the discipline with the Chicago School of Economics, though with some nuanced difference with the European School. I am not exactly a proponent or a follower of the Chicago School, but I believe that diversity in intellectual predilections is critical to good scholarship in any academic institution, and for that matter in any public institution. As an aside, I would submit that lack of respect for diversity in approaches to economic thinking is one of the reasons for global economic crisis and, perhaps, crisis in economics.

**Crisis and Law and Economics**

Global financial crisis has affected thinking and policy in several disciplines and policy areas, and in this regard the discipline of Law and Economics is no exception. I will not elaborate on this theme except to extensively quote from some sources on the ongoing rethink in the subject.
John Cassidy, the journalist and author interviewed, as part of series of interviews with Chicago School of Economics, Professor Richard Posner. He is known as the World’s most distinguished legal scholar and is an influential figure in the school of law and economics. The question, as well as Professor Posner’s response is instructive.

Question: You are famous for extending economic analysis, and a free-markets approach, to the law. Has the financial crisis undermined your faith in markets and the price system outside of the financial sector?

Answer. No. But, of course, one of the most significant Chicago (positions) was in favor of deregulation, based on the notion that markets are basically self-regulating. That’s fine. The mistake was to ignore externalities in banking. Everyone knew there were pollution externalities. That was fine. I don’t think we realized there were banking externalities, and that the riskiness of banking could facilitate a global financial crisis. That was a big oversight. It doesn’t make me feel any different about the deregulation of telecommunications, or oil pipelines, or what have you.

There was a comprehensive review of the book by Nobel laureate Professor Robert Solow, and I reproduce an extract.

The Seventh Circuit is based in Chicago, and Posner has taught at the University of Chicago. Much of his thought exhibits an affinity to Chicago school economics: libertarian, monetarist, sensitive to even small matters of economic efficiency, dismissive of large matters of equity, and therefore protective of property rights even at the expense of larger and softer “human” rights.

But not this time at least, not at one central point, the main point of this book. Here is one of several statements he makes:

Some conservatives believe that the depression is the result of unwise government policies. I believe it is a market failure. The government’s myopia, passivity, and blunders played a critical role in allowing the recession to balloon into a depression, and so have several fortuitous factors. But without any government regulation of the financial industry, the economy would still, in all likelihood, be in a depression: what we have learned from the depression has shown that we need a more active and intelligent government to keep our model of capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by
exaggerating the resilience—the self-healing powers—of laissez-faire capitalism.

If I had written that, it would not be news. From Richard Posner, it is.

A more elaborate treatment of the subject can be found in the review of same book by well known economist, Professor P. Wladimir Kraus in March 2010. I will take the liberty of giving two important extracts.

There is plenty about economics in “A Failure of Capitalism”, but virtually nothing about law. Reading it, one might imagine that banking is a largely unregulated industry, such that law could not have played any role in causing the crisis. But banking remains highly regulated, and, I shall argue, these regulations can very plausibly be held responsible for the crisis. Thus, the proposals for preventing future crisis largely involve changing the laws that, Judge Posner notwithstanding, closely govern commercial banking. It is unfortunate but true that lawyers cannot intelligently contribute to these proposals if their knowledge of the crisis comes solely from Judge Posner’s book.
Systemic risk reduction is the target of these reform proposals. Reducing systemic risk entails understanding its sources. Posner recognizes this, but since he does not acknowledge the regulatory roots of the crisis, he turns to macroeconomics to explain systemic risk. In his “Failure of Capitalism” blog, he has followed up by encouraging law schools to introduce macroeconomic training as part of the standard curriculum. This is a seismic shift indeed, because the intellectual tools that Posner and the law and economics movement have contributed are all microeconomic.

Written by one of the most versatile social scientists of our times, A Failure of Capitalism is a multifaceted contribution to our understanding of the great recession. But, due to its overwhelmingly macroeconomic character and substance, the nuanced approach of the law and economics scholarship is virtually absent, and so is any plausible explanation of the financial crisis that touched off the great recession. This is puzzling, because attention to the economic consequences of the law seems to provide a much more powerful framework for understanding what caused the financial collapse, and it is a natural approach for scholars of law and economics to pursue.

I have no firm views on this debate, but there is merit in pursuing research in this area of economic consequences of law relating to
financial sector. In particular, we have to focus on the effects of financial laws on economic development, since in the advanced economies the focus now is effect of regulation on financial stability.

Finally, getting it wrong was not the monopoly of market or state or Chicago School. On this, Nobel laureate Professor Gary Becker’s response to a question by John Cassidy is worth recalling.

There are a lot of things that people got wrong, that I got wrong, and Chicago got wrong. You take derivatives and not fully understanding how the aggregate risk of derivatives operated. Systemic risk. I don’t think we understood that fully, either at Chicago or anywhere else..... Maybe some of the calls for deregulation of the financial sector went a little too far, and we should have required higher capital standards, but that was not just Chicago. Larry Summers, when he was at the Treasury, was opposed to that. It wasn’t only a Chicago view. You can go on. Global warming. Maybe initially at Chicago there was skepticism towards that. But the evidence got stronger and people accepted it was an important issue.

But it hasn’t changed my fundamental view, and I think [the view of] a lot of people around here, that, on the whole, governments don’t manage things very well, and you have to be consistent about
that. So I supported, say, the invasion of Iraq. In retrospect, I think that was a mistake, not only because things didn’t go that well, but because I didn’t really take into account enough that government don’t manage things very well. You really have to have strong reasons for going in.

Crisis and Financial Sector Policy

Lord Adair Turner released my book on Global Financial Crisis sometime last year (2010) in London School of Economics. At that time he mentioned that, India weathered financial crisis because it did not forsake the basic principles of regulation of financial sector that U.K. had put in place several years ago, while U.K. went ahead with newly found wisdom of deregulation. He thus attributed the crisis to hasty and excessive deregulation.

Mr. Gordon Brown, former Prime Minister of U.K., in his comments in the Conference of INET in Bretton Woods in early April 2011, admitted that he was wrong in changing monetary and regulatory regimes that gave birth to a single regulator of financial sector, distinct from Bank of England.

As is well known, Chairman Alan Greenspan admitted that he was wrong in putting all his faith in financial markets adjusting
smoothly, though of late, there are signs of his retreat from that position.


The Oscar winning documentary film “The Inside Job” is enlightening: In a way this film led to consideration of a Committee on Code of Ethics for Economists in the recent Annual Conference of American Economics Association. The conflict of interests was obviously not confined to financial markets but academia also – especially financial economists.

The dominance of economic ideology that led to the crisis is evident from the Report of Independent Evaluation Office of IMF on the role of IMF in the events leading to the crisis.

In March 2011, IMF convened a Conference on “Macroeconomics after the Crisis”, which flags several areas that need a rethink. Professor Olivier Blanchard gave an excellent summary of the
discussions at the end of the debate. It highlights the linkages between financial sector and other macroeconomic policies.

The design of legislative changes in financial sector is being influenced by several reports commissioned by multilateral bodies and governments. These included Stiglitz Commission of U.N; G30 (Paul Volcker) Report in U.S.A.; Report by De La Dossier in EU; Turner Report in U.K., and more recently Lord Vicker’s report in U.K. Several Working Papers from IMF, World Bank, BIS and FSB are also playing a role. Institute of International Finance, representing an industry—body of global banks, has also been active in lobbying on the issues.

In brief, there is recognition of failure of many economic policies and a search for new set of policies, particularly in regulation of financial sector.

Changes in Legislative Frameworks

In the light of experience with global financial crisis and on the basis of some rethinking on financial sector policies, several changes have been made in the legislative framework governing the regulation of financial sector in U.S.A. Major areas of relevance for developing countries in the changes made are worth noting. Firstly, a high
level coordinating body has been established to monitor systemic risk and systemically important financial institutions. Mechanisms for orderly resolution of failing systemically significant bank holding companies or non bank financial firms have been put in place. Secondly, a number of changes have been made to regulatory and supervisory framework for banks. In particular, “the Volcker rule” of restricting investment banking activities of commercial banks has been accepted in principle, and necessary legislative backing has been provided. Thirdly, a consumer protection authority has been established. Fourthly, powers to the regulators for stipulating compensation packages and ensuring appropriate incentives have been bestowed. Fifthly, a framework for appropriate regulation of derivatives has been put in place. These are among the more important reforms that need to be considered for their relevance to developing countries.

In European Union, the reform package envisages focus on monitoring system wide risks in the financial system of EU as a whole. They also envisage creation of three new European supervisory authorities to oversee and coordinate national supervision of banking, insurance and financial markets. The other areas which are subject to a new regulatory regime, relate to market infrastructure, shadow banking, credit rating agencies and
compensation practices. The developing countries may consider the changes in regulatory regime as possible good practices.

In United Kingdom, Bank of England has been designated to be the central authority for maintaining financial stability, and thus exercises oversight over all regulation of financial sector. A new Financial Policy Committee will be established in the Bank of England for macro prudential regulation or regulation to ensure stability and resilience of the financial system as a whole. Second, micro-prudential (that is firm-specific) regulation of financial institutions that manage significant risks on their balance sheets will be carried out by an operationally independent subsidiary of Bank of England, the Prudential Regulatory Authority. The responsibility for conduct of business regulation will be transferred to a new specialist regulator called Financial Conduct Authority. This has responsibility for consumer protection across the entire spectrum of financial services. The design of regulatory structures in U.K. has much to commend itself.

**Changes in India**

Indian financial sector was not seriously affected by the crisis, and there were no visible infirmities in Indian structure that are comparable to the seriously affected countries like U.S.A. and U.K.
In fact, many of the reform measures that are being considered in advanced economies are in the nature of rolling back excessive deregulation that had taken place earlier. In India, such extensive deregulation had not taken place in the past. However, it was considered appropriate to learn lessons from the crisis while at the same time pursuing agenda of reforming the financial sector to keep pace with the demands of a growing real sector.

Firstly, Financial Stability and Development Council (FSDC) have been established through an administrative notification. The Council with the Finance Minister in the Chair, and with membership drawn from all the financial regulators is expected to address issues relating to – (a) Financial stability; (b) Financial sector development, including financial literacy and financial inclusion; (c) Inter regulatory coordination; (d) Macro prudential regulatory framework, including regulation of systemically important financial institutions; (e) Interface with international regulatory bodies in the financial sector; and (f) any other issue considered appropriate by the Chair. There is a sub-committee with the Governor as the Chairman, which is expected to assist the Council in its deliberations. The sub-committee replaces the informal High Level Committee on financial markets that existed before the new institutional structure. There was a proposal to convert the informal High Level Committee into a legislative body, but the Council
established now gives a dominant role to the Finance Minister, and thus bestows steep powers to government over the financial sector. There are assurances from the Government that the autonomy of regulators will not be interfered with.

While there could be differences in regard to the composition and powers of the FSDC, it is necessary to appreciate that a high level national body would be desirable to address issues relating to financial stability and development, and in particular to ensure coordination among the regulators. Such an institutional set-up may be redundant if the central bank is placed as the apex body responsible for stability, development and consumer protection.

Secondly, a new law has been passed to settle jurisdictional disputes in regard to hybrid instruments. These functions were being discharged informally by the High Level Committee before the formal legal mechanism has been established with the Finance Minister as the Chair person and the Governor as the Vice Chairman.

The relevant point to note is the recognition of the need for managing jurisdictional disputes in regard to hybrid financial market instruments. It is possible to argue that an apex body like the one envisaged in Bank of England would avoid such issues. It is also
possible to argue that informal or formal mechanisms to avoid disputes should ideally be with the central bank. In fact, it can be legitimately held that ideally mechanisms for coordination should subsume such adjudication rather than treat jurisdiction to be a matter for arbitration.

Thirdly, a working group of Reserve Bank of India has suggested a new law for regulating financial holding companies, which may have one of its arms, a bank. Despite the emphasis on Volcker rule, emergence of financial conglomerates should be recognized.

There is merit in having an appropriate uniquely designed legal framework for regulating holding companies involving a bank as one of its arms.

Fourthly, amendments to “Banking Regulation Act” are being proposed, which strengthen the regulatory and supervisory powers of the banking regulator, namely, RBI. These powers relate to prescribing fit and proper criteria appropriate for ownership and control beyond a prescribed level, powers to supersede the Boards, etc., for banking regulator. These proposals were pending with Parliament since five years, but their enactment is being expedited now.
The enhanced regulatory powers will facilitate effective, graded and prompt preventive-corrective actions.

Fifthly, the government has announced that the mergers and acquisitions in banking sector will not be subject to the jurisdiction of the Competition Commission, but will be decided by the RBI.

After the experience in U.K. with resolution of banking crisis, Governor King had also expressed a view similar to that of Finance Minister of India. For developing countries, such an approach might be more relevant for several reasons.

Finally, constitution of a Financial Sector Legislative Reforms Commission has been announced. The Commission presided over by a former Justice of Supreme Court with membership drawn from academics, central bankers and financial market intermediaries, is expected to study and recommend on the total architecture of legislative regulatory system of the financial sector. The Commission has been accorded a term of twenty four months which should provide opportunity to consider ongoing relevant thinking and developments in global fora.
Changes in Regulatory Institutional Framework: Lessons for Developing Countries

Firstly, reforms in the institutional structures of advanced economies have been essentially in terms of reaction to the financial instability that they have faced. However, in designing the institutional framework, developing countries will have to give equal emphasis to stability issues and developmental issues.

Secondly, the reforms highlight the importance of coordination among the regulatory agencies and also between the government, central bank and other regulatory agencies. The developing countries have to emphasize coordination because the financial sector plays an important role in structural transformation. Further, in view of the limited skills and often small size of several developing economies, it may be desirable to have several regulatory functions concentrated in single institution such as a central bank.

Thirdly, in all coordinated mechanisms related to financial sector brought about in advanced economies, central banks have a critical role, and in some cases they do have a leadership role. In particular, the central role of central banks relative to governments in crisis situations may have to be recognized particularly in
developing countries where financial sector crisis and political instability often happen together.

Fourthly, a mechanistic approach for devising counter-cyclical policies may not be adequate for developing countries since it is difficult to differentiate between structural and cyclical components in rapidly growing economies. Further, coordination with other policies also warrants judgments and accommodation of several points of view. Hence, discretion becomes as important as rules, and the institutional framework should provide for this.

Fifthly, the innovations in financial products call for significant skills. Hence, it may be desirable for developing countries to have a positive list of financial products that will be permitted in the financial sector. Only the financial products which have proven to be non toxic in advanced economies may be included in the positive list in developing countries.

Sixthly, in many economies, the financial intermediaries, in particular banks, may not be too big to fail, but they may be too powerful to regulate, particularly in view of the diplomatic pressures that often accompany financial intermediaries with a multi-national presence. There may be merit in restricting the presence and
activities of such powerful entities through legal provisions and regulatory prescriptions.

**Experience with reforms and legislation in India in the Past**

Major changes in economic policies have been brought about after the Gulf Crisis of 1991, and these reforms included financial sector. Several of the changes were feasible within the then existing legislative framework. For instance, liberalization of external sector took place without waiting for repeal or replacement of FEMA, in the first phase. Deregulation of banking sector, including issue of new branches and new bank licences were possible within the legal framework. However, a major legislative change related to inducting private ownership in public sector banks.

New institutions, such as SEBI and IRDA were first established under administrative law, and then converted into statutory bodies.

Sequencing of changes consistent with gradualism was possible due to an incremental approach to policies followed by legislative changes, as and when essential. Often, new policies were adapted first and then they were made legally binding. An example is that of end to automatic monetization, which was adopted first through
an MOU between RBI and Government. Later, it was incorporated in the Fiscal Responsibility legislation.

Two of the most challenging legislations, requiring a view on some of the fundamental issues of economic policies and institutional dynamics were Foreign Exchange Management Act and Fiscal Responsibility and Budget Management Act. The “FEMA” incorporated three new features: namely, freedom in current account transactions as a general rule with scope for some restrictions, to avoid misuse; freedom in capital account only within prescribed parameters; and violation of provisions could, under certain circumstances be compounded. The initiative for the legislation was taken by RBI.

RBI played a critical role in the evolution and drafting of legislation on fiscal responsibility.

There are several examples of legislative proposals contemplated at one stage but withdrawn. One example is that of restricting the regulatory jurisdiction on NBFC’s to only deposit-taking institutions. The proposal was withdrawn after RBI indicated the potential for shadow banking undermining financial sector.
There are some other legislative proposals which have been pending for several years. Examples relate to dilution of public ownership in public sector banks; regulation of cooperative banks’ and of microfinance institutions. It would be interesting to explore the reasons for such protracted consideration of legislative proposals.

**Some (Random) Lessons**

The debates and experiences mentioned do provide some lessons, as briefly narrated here.

1. Legislative changes in financial sector should be undertaken with great deliberation, since financial institutions and markets have severe externalities;

2. There is considerable merit in focusing on appropriate philosophy and policies that could serve the needs of a highly dynamic financial sector with strong externalities. Experience with crisis, which occurred across different regulatory structures illustrates the importance of common policies that could have caused the crisis.

3. The policy and regulatory framework should emphasize coordination within public-policy bodies and severely restrict
scope for conflict of interests in financial institutions and markets. Major reasons for the crisis were lack of coordination in public bodies; huge conflicts of interests in financial conglomerates and interaction among them to reinforce both state and market failures.

4. There may be merit in bestowing considerable discretionary powers on regulators. (a) Macro-prudential approach; (b) countercyclical measures; and (c) identification of systemically important institutions, that are currently advocated as warrant judgements.

5. As Nobel laureate Paul Krugman warned, there is need to be cautious in considering legislative changes pursued by participants in financial markets and other academics with close ties to financial markets.

6. There is a need to be vigilant about cross-border pressures on the regulatory environment of financial sector. A recent statement by Timothy Geithner, Secretary to Treasury of U.S. is very instructive.

"I don’t have any enthusiasm for ... trying to shrink the relative importance of the financial system in our economy as a test of
reform, because we have to think about the fact that we operate in the broader world. It’s the same thing for Microsoft or anything else. We want U.S. firms to benefit from that. Now financial firms are different because of the risk, but you can contain that through regulation.”

7. Reforms in financial sector should not be considered in isolation but in conjunction with several other aspects—especially those which impinge on fiscal policies, trade policies and standards of governance.

8. Financial products have the potential to be toxic and their regulation should take account of consumer protection, systemic stability and contribution to efficiency to promote inclusive growth. What cannot be confidently regulated should, ideally be, not allowed.

9. After the experience with the crisis, there is uncertainty as to what is the right model for development and regulation of financial sector. There is a virtual revolution in the intellectual parameters, and policy-framework relating to financial sector. The advanced economies recognize what has been wrong, but they are still very very unsure of what is right. We in India may not be wrong, but we may not be very right either.
Hence, there is need for reform but with caution and deliberation in pursuing legislative reforms in financial sector.

CONCLUSION

The appointment of a Financial Sector Legislative Reforms Commission in India a few weeks ago, with distinguished chairman and membership, representation from several stakeholders and a reasonable time frame is indeed a wise and welcome step. The commission will, I am sure, seek professional and intellectual inputs from a wide variety of institutions and ideas both within India and globally. IGIDR, with its remarkable intellectual and ideological diversity as well as expertise in wide areas of economics, finance and law will provide valuable inputs to the Commission.

I am convinced that the Commission will add to enlightened debate on financial sector reforms and appropriate legislative measures. I do not agree with those who believe that the Commission is a solution in search of problems.

Thank you, ladies and gentlemen.

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The Financial Sector Legislative Reforms Commission (FSLRC) is a body set up by the Government of India, Ministry of Finance, on 24 March 2011, to review and rewrite the legal-institutional architecture of the Indian financial sector. This Commission is chaired by a former Judge of the Supreme Court of India, Justice B. N. Srikrishna and has an eclectic mix of expert members drawn from the fields of finance, economics, public administration, law etc. Start studying Financing Decisions (12-13). Learn vocabulary, terms and more with flashcards, games and other study tools. Financing decisions differ from investment decisions for which of the following reasons? I) You cannot use NPV to evaluate financing decisions II) The market for financial assets is more active III) It is easier to find financing decisions with positive NPV than to find investment decisions with positive NPV. A. I only B. II only C. III only D. I and III only. Click card to see the definition. Foreign direct investment (FDI) into the financial sectors of emerging economies soared during the 1990s, leaving many countries with banking sectors owned primarily by foreign institutions. While the implications of FDI into emerging markets are well documented, less clearly understood is how the host countries are affected by financial sector FDI specifically. This article argues that many lessons learned from work on FDI into manufacturing and primary resource industries apply directly to host-country financial sectors. In banking and finance specifically, she argues that financial sector FDI can potentially strengthen institutional development through improvements to regulation and supervision. Distinguished lecture by Shri YV Reddy former Governor of RBI on FINANCIAL SECTOR LEGISLATION: (RANDOM) LESSONS FROM (RANDOM) EXPERIENCE - Free download as PDF File (.pdf), Text File (.txt) or read online for free. Distinguished lecture by Shri YV Reddy former Governor of RBI on FINANCIAL SECTOR LEGISLATION: (RANDOM) LESSONS FROM (RANDOM) EXPERIENCE.