

## **20100212 IMF: Managing Financial Innovation in Emerging Markets**

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Remarks by John Lipsky, First Deputy Managing Director, International Monetary Fund at the Reserve Bank of India First International Research Conference.

### **Introduction**

First of all, I would like to congratulate the Reserve Bank of India on the occasion of its 75th anniversary, and to thank the RBI for sponsoring this most timely and useful International Research Conference. It is an honor for me to have the opportunity to participate in the RBI's first such conference. The presence of so many distinguished speakers reflects both the importance of the topics that are being addressed, but also India's growing role in the intense international collaboration currently underway on global financial issues.

My IMF colleagues and I have watched with great interest – and satisfaction – the strides that India has made in its economic policy management in recent years, and that has been reflected in the economy's impressive progress. In particular, I would like to underscore the RBI's adept handling of monetary and regulatory policy in the current financial crisis. This is a testimony to the professional qualities of the RBI's skilled senior staff and to the leadership of Governor Subbarao and former Governor Reddy. As is recognized widely, India is well positioned to continue on its path of strong and inclusive growth, thanks in no small part to the RBI's stewardship.

In my address today, I will focus on the importance of finance for rapid and sustainable growth. While some might consider this topic odd in light of the current crisis, I will seek to draw out some key lessons of recent events for the appropriate policy stance toward financial innovation. Many critics – although notably not including policy-makers in India or in most other major emerging markets – have concluded that such innovation is to be actively discouraged. But I would claim that this is precisely the wrong lesson to draw.

Despite the unsettling and even dramatic recent global experience with “cutting edge” finance, I believe that without a renewed effort to foster financial innovation in the global economy, all countries—including emerging market economies—will underperform their potential. The principal challenge for policymakers, then, is to strike an appropriate balance between financial openness that supports growth-enhancing innovation while at the same time implementing regulations and effective supervision that limit the potential risk of financial instability.

This does not mean that we should return to the exuberant pre-crisis approach to financial innovation. Neither does it suggest a one-size-fits-all approach to the issue. In fact, I agree very much with Deputy Governor Gopinath's observation that innovation “needs to be pursued in the broader context of financial stability and has to necessarily correspond to the level of maturity of the financial system and the needs of the real economy...”

Great strides already have been made in the development of the Indian financial system. As the recent Rajan report noted, “India's financial sector is at a turning point. There are many successes—the rapidity and reliability of settlement at the NSE or the mobile phone banking being implemented around the country indicate that much of the system is at the Internet age and beyond. There is justifiable reason to take pride in this. Yet much needs to be done.”

### **Growth and the Financial Sector**

There is a clear connection between economic growth and the state of development of the financial sector. Speaking late last year at the Bank of Mexico, I reviewed the economic literature on the relationship between finance and economic growth. At that time, I highlighted that for many decades the financial sector largely was ignored in theories of economic growth. In fact, only since the 1990s has the important role of the financial sector been widely accepted.

In modern market-based economies, financial intermediation is a critical determinant of

performance. As economies develop and mature, so do financial markets. The accompanying infrastructure also has evolved to meet the wide range of needs of households, businesses, and government.

Looking forward from the current conjuncture, financial innovation has at least three principal tasks. First, it should address the challenge of missing markets, such as those for the long-term financing that is required for creating long-lived assets, or for efficient risk sharing by providing appropriate insurance and hedging products.

Second, it should deepen liquidity in existing markets, for example by reducing excessive reliance on a narrow base of depositors for funding. And, third, by raising the quantity and quality of investment, it can increase efficiency in the economy as a whole.

### **The limits of traditional banking systems**

A key challenge faced by many emerging markets is their heavy reliance on traditional commercial banking. While such a system may be more than adequate during the early stages of a country's development, it may act as an unintended constraint on growth as the real economy becomes more complex and as the demand for financial services expands. There are several reasons for this:

First, in the absence of robust debt and money markets, the ability of banks to grow their loan portfolio is limited by their access to deposits.

Second, banks are not well placed to meet the significant needs in emerging and developing countries for long-term infrastructure financing. The size, maturity, and illiquidity of such loans make them unsuitable for traditional commercial bank financing. The danger in such operations is that banks would take on inappropriate levels of credit and interest rate risk or else operate under a system where the government provides a financial backstop, and hence, passes on the risk to taxpayers.

And, third, commercial banks often are not well-placed to diversify the credit risk in their loan portfolios—their financial performance therefore typically mirrors the underlying condition of their borrowers and of the local economy.

### **Implications for India**

While India's financial system is multi-faceted, with some world class segments such as its equity market, other segments—notably, the corporate bond market—remain less developed. Because of the limited size of India's debt capital markets, banks are the main source of loans to both firms and households. Moreover, India has enormous infrastructure needs, but infrastructure financing remains largely dependent on bank financing, with all its attendant inadequacies and risks. There are also important issues of access to credit and financial services for Indian corporations, but especially for SMEs, and households.

A recent IMF staff study found that Indian firms increasingly have become reliant on borrowed funds (as opposed to retained earnings) to fund their investments, but the study also found that there are important inefficiencies in debt financing. In fact, firms in industries that are more dependent on such financing have tended to grow more slowly. A lack of financial instruments also has limited firms' ability to manage risks. The limited availability of derivative products leaves corporations to shoulder risk-related costs that they otherwise would not bear and that may stymie their ability to expand. At another level, only 40 percent of India's population benefits from a bank account, as a large number of households still remain outside the formal financial sector.

These issues are well understood here. Thus, several steps are being taken to meet the growing needs for more diverse sources of finance. Notably, the RBI has undertaken important initiatives to promote financial inclusion, with the goal of having a banking outlet in every village of more than two thousand residents by 2011.

Moreover, Indian authorities are targeting an increase in infrastructure spending of some \$500 billion during the current five-year plan. With fiscal space limited, meeting this need in a prudent fashion will require a more developed capital market, and especially a more developed long-term corporate bond market. The India Infrastructure Finance Corporation Limited (IIFCL) has been established with a mandate to co-finance projects and issue local currency-denominated bonds. In

addition, repos for corporate bonds have been introduced, as well as interest rate and currency futures.

Fortunately, there are several successful models of capital market development in emerging markets. The growth of corporate bond markets in Mexico and Malaysia, for instance, has been closely linked to the development of domestic institutional investors. Mobilizing such investors through the gradual liberalization of portfolio guidelines of insurance companies and pension funds would help transform India's large pool of savings into investable funds for long-term financing.

However, liquidity may need to be generated in other ways, as these institutions typically are buy-and-hold investors. In India, increasing foreign participation in the local debt market would provide additional liquidity and more robust pricing of local bond market issues. A recent IMF study of ten emerging markets suggests that foreign participation has lowered borrowing costs. Of course, unfettered access by foreign investors to India's large government securities market would create concerns, hence it would be reasonable to proceed in an orderly manner.

Similarly, further progress in the development of an active securitization market for consumer and small business loans would facilitate greater access to credit, by enabling risks to be shared by banks and other investors. Such securitizations, executed prudently, would help to broaden the investor base and allow for the conversion of longer-term amortizing loans into instruments more suitable for institutional investors. This development would have the added benefit of facilitating better diversification by banks of their credit and maturity risks, while providing institutional investors with the opportunity to earn higher yields by taking on some of the risks of underlying loans. Of course, it is important that securitization include appropriate safeguards—I will say more about that later.

### **Facing Up to Risks**

I recognize that there is a growing skepticism about the merits of moving towards a more modern financial system and away from bank-centric financial systems. It has been widely noted that major emerging markets have avoided the current problems being experienced in the United States and Europe. Some would argue that financial innovation ended up wreaking havoc on advanced economies—and indirectly on the rest of the world—and therefore should be avoided in emerging markets at all costs.

In my view, however, the financial crisis in the advanced economies was not primarily a function of asset securitization or the general growth of securitized capital markets. Rather, the crisis reflected a toxic mix of factors, including:

- Excessive complacency among both borrowers and investors regarding risk – including systemic risks – reflecting an extended period of exceptional economic performance and low market volatility;
- Poor governance and risk management at overly leveraged financial institutions, resulting in the development and spread of excessively complex instruments and of unexamined and unrecognized interconnectedness and fragility;
- The failure of some institutional investors to exercise the due diligence responsibilities inherent in their fiduciary duties;
- Regulatory arrangements that did not adjust effectively to financial market developments; and
- Supervision that failed to enforce standards effectively.

Happily, India is in a favorable situation in this regard. First, complexity of instruments is not currently a problem. Second, governance and risk management appear adequate in the current circumstances, and bank leverage is appropriate. Third, both the RBI and capital markets regulators have fostered a robust financial sector. This suggests that India has significant opportunities for productive and prudent financial innovation, leaving it in the enviable position of learning from the experience of others.

### **Lessons from the crisis**

Perhaps the key lesson of the current crisis is that traditional virtues -- of maintaining adequate

capital, of avoiding excessive reliance on short-term funding, of maintaining proper loan underwriting, of following sound risk management and effective corporate governance -- remain as critical as always. We have been reminded again by recent events that securitization -- an innovation that has the capacity to enhance systemic efficiency and effectiveness -- must be developed within a sound regulatory and supervisory framework, especially when facilitated by intermediation paths outside of the formal banking sector.

In the United States and some other markets, it is clear that the fundamentals underlying some forms of securitized mortgages and other complex instruments simply were inadequate: Underwriting standards in many markets had become lax and were not properly regulated, ultimately harming both consumers and investors. The role in this process of the United States' so-called shadow banking sector also highlighted weaknesses in regulatory cooperation and in the construction of the regulatory perimeter.

Complexity was an element that contributed to the crisis, but excessive instrument complexity in some cases -- and the lack of a clear economic function of some of the most exotic products -- was more a reflection of systemic weaknesses than an underlying cause. It is painfully evident that many institutional investors failed in their most basic fiduciary duties by purchasing instruments whose risks they simply did not understand on the basis of third-party recommendations and ratings. The lack of attention to risk management practices and the lack of understanding of liquidity risks being accumulated played an important role in creating, overpricing, and overleveraging complex assets. Unfortunately, the consequences were nearly catastrophic.

Some aspects of the crisis reflected a lack of transparency in products and markets. A principal example of this is the credit default swap market -- an enormous market that developed almost entirely over-the-counter. In the event, some of the key participants in this market simply failed to assess counterparty risks adequately, with disastrous results. The move to standardize and centrally clear a substantial portion of derivative trading will help to address these risks, as will a redrawing of the regulatory perimeter and an improvement in supervisory effectiveness.

Even in the extraordinarily deep and broad crisis of the last two years, not all major firms and not all advanced financial systems were affected equally. Canada and Australia, for instance, escaped most of the problems affecting the United States and Europe. While their financial institutions were exposed to the same disruption in global capital markets, they weathered the crisis well, underlining the importance of ensuring that as financial systems become more complex, prudential supervision and regulation remains appropriate.

### **The Role of International Cooperation**

This crisis has had at least one beneficial effect: it has galvanized international cooperation in economic policy-making in general and, specifically, in seeking to build a global financial system that can contribute to strong and sustainable growth. The G20 leaders—including India's Prime Minister Singh—agreed at last year's Pittsburgh Leaders Summit to establish a Financial Inclusion Expert Group to identify innovative approaches to enhancing financial access, financial literacy, and consumer protection.

At the same time, efforts are underway at an international level to reduce the likelihood that the current financial sector crisis will be repeated. Regulatory reform, spearheaded by the G20 leaders, is being implemented both at the national level and internationally. The London Declaration on Strengthening the Financial System included a series of recommendations on overhauling the financial sector's regulatory framework. It also established the Financial Stability Board—with both India and the IMF as members— that is charged with implementing the agreed recommendations.

Many of the proposals being considered—notably those on the quality of bank capital, liquidity metrics, and leverage ratios— have been under discussion for several years. The crisis has created a powerful incentive to forge a consensus on these as well as newer initiatives, such as focusing on macro-prudential supervision and on aligning compensation with firms' risk management objectives.

Creativity is called for in these reform efforts. An example of this is the request by the G-20 Leaders to the IMF to prepare a report on policy options for the financial sector itself to cover the costs associated with crisis-related government intervention in the sector. We are exploring options for a financial sector levy that would create the appropriate incentives for reducing risks while at the same time providing the required anti-crisis funding.

## **Modernizing Financial Systems**

Ultimately, each country will develop its own approach to fostering appropriate and useful financial innovation. I would, however, like to offer a few general suggestions for emerging market countries looking to realize the benefits of financial innovation.

First, keep it simple.

Introduce products that are relatively straightforward and that offer clear value-added. Thus, new financial products should be understood by regulators, by sellers and by prospective buyers. Investors should be able to calculate the risks being undertaken without undue reliance on credit ratings agencies or other outside advisors. Close attention should be paid to ensuring adequate disclosure. In this regard, long-term institutional investors—including insurance companies, mutual funds and pension funds—are vital to securitization markets, because they can and should form a stable and sophisticated investor base.

Second, keep incentives aligned throughout the process.

In approving new products, ensure that the interests of the originators of loans and securitized assets are aligned with the interests of investors. As you know, the RBI has adopted a retention rule and a lock-in period for securitized instruments designed to align incentives—although it will be important to see what impact these will have on issuers. After all, the most seriously affected advanced-economy firms in the current crisis were grievously damaged by excessive retention of toxic assets – reflecting their sub-standard risk management and exacerbated by weak supervision.

Third, ensure that banks' risk management systems and the regulatory system keep up with the pace of innovation.

The recently released Senior Supervisors Group report highlighted ongoing problems in the governance, firm management, internal control programs, and risk management in many of the world's largest financial institutions. Notably, many boards of directors appeared to be largely uninformed about or did not understand the risks their institutions were undertaking. It is critical that governance be reformed, and that boards include members with the experience to take a useful role in monitoring and controlling the level of risk taken by their institution.

Regulation and supervision also must keep up with innovation. This requires both adequate resources to hire skilled professionals, together with political support to ensure that regulations and supervisory recommendations are taken seriously. Indian regulators have been a part of the global standard setting process and will continue to be early adopters of new standards. This should help to prepare India for ongoing and even accelerated modernization.

Fourth, develop a robust resolution scheme.

It is inevitable that in every financial market, some financial firms eventually will experience difficulties. A key policy conclusion highlighted by the crisis is that an effective resolution scheme must be created for systemically important firms, so that governments will be able to act promptly and effectively when an institution becomes troubled. Such regimes should minimize potential market disruption as well as dampen moral hazard.

Of particular importance in our globalized financial world is dealing with the cross-border dimensions of large institutional failures. Progress in this important task is taking place through development of contingency plans for global financial institutions by their home and host supervisors, combined with efforts to identify and address barriers to implementation of plans for the recovery or orderly resolution of these institutions. This is a complex undertaking, but it is extremely important.

### **In conclusion**

Despite the current difficulties and challenges, financial innovation will continue to play an important role in promoting global growth, especially in emerging markets and developing countries. The current crisis can provide important lessons, and I am confident that our Indian hosts will draw useful conclusions. Hopefully, this inaugural International Research Conference will

help to promote this process. After all, we all share responsibility for ensuring that the global financial system evolves in a manner that supports strong, sustainable and balanced growth.

Thank you for your attention.

**NovaRes Team**