

**REGULATION OF THE
FINANCIAL SYSTEM
TWO YEARS AFTER LEHMAN**

An Indian Perspective

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(Views expressed here are personal)

Structure of presentation

- The global crisis and its dimensions
- Causes of global crisis
- International response to the crisis
- Agreed next steps
- India

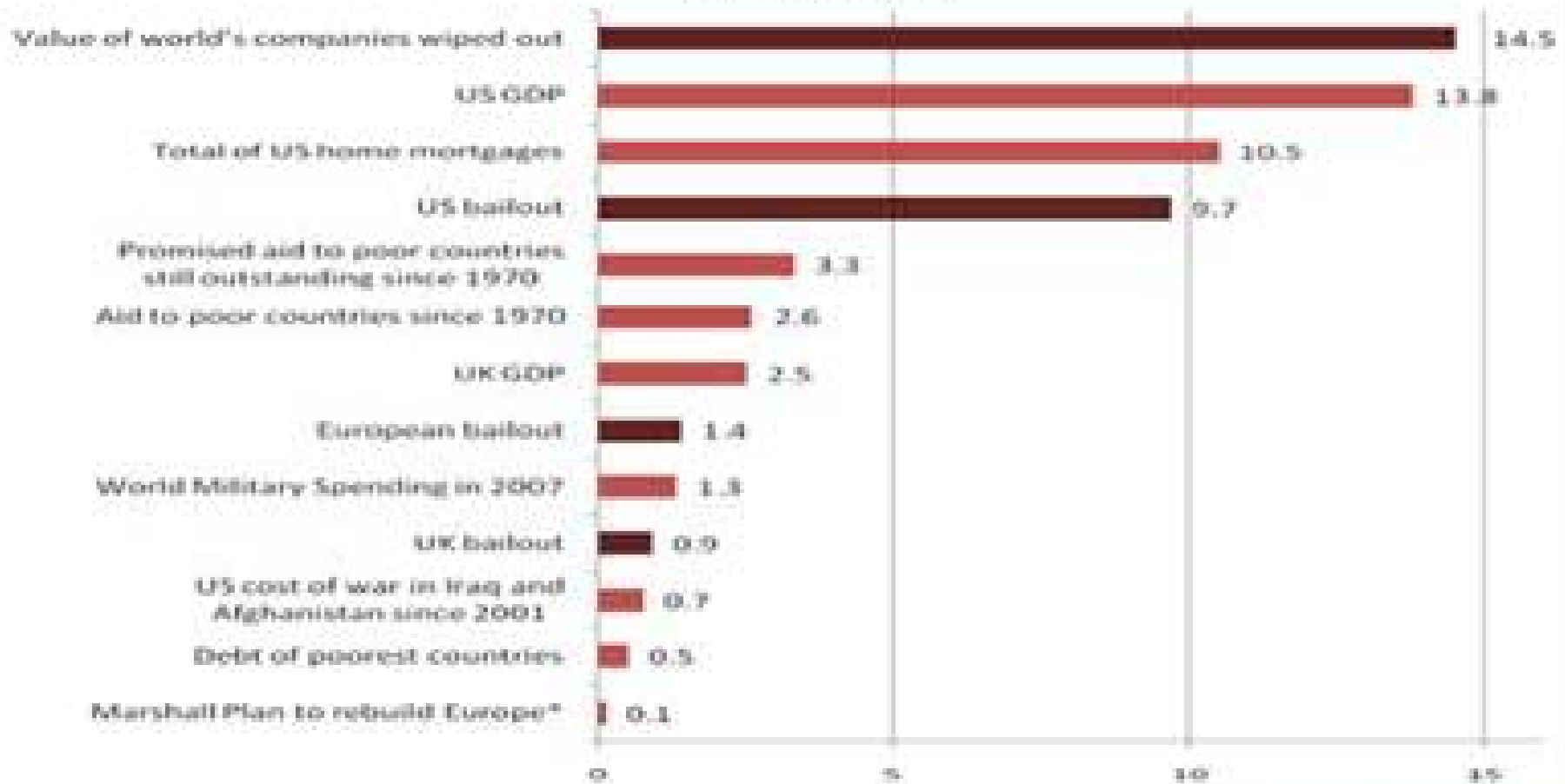
Nature & dimensions of the global crisis

- The global crisis originated in the developed world
- Losses and bailouts (\$ trillion)
 - Value of world's companies wiped out: 14.5
 - U.S Bailout: 9.7
 - U.S GDP: 13.8
 - European Bailout: 1.4
 - U.K Bailout: 0.9
 - U.K GDP: 2.5

The global crisis and its dimensions

www.globalissues.org

Global Financial Crisis: Losses and Bailouts for US and European Countries in Context (\$ trillion)



* Adjusted for inflation

Sources: BBC, Bloomberg, UPI, globalissues.org, Feb 2009

Causes of global crisis- the fault lines

Raghuram Rajan's fault line analysis:

- Domestic political stress of rising inequality & public policy response of easy credit
- Prior patterns of growth and the resulting trade imbalances between countries
- Different types of financial systems coming into contact to finance trade imbalances

International response to the crisis

- Stiglitz Commission:
 - Responsibility of the crisis lies in the developed world
 - Developed countries need to carry out the most fundamental changes
 - Additionally, need global financial stimulus packages directed towards developing countries
 - Reorient macro economic policies (including mandates of central banks)
 - In- depth reform of IMF and World Bank
 - Creation of new global regulatory bodies

International response to the crisis

- NYU Stern Business school white paper
 - Credit boom and housing bubble
 - Behavior of Large Complex Financial Institutions
 - Faulty regulatory architecture
- Developments at the G-20 forum
 - Convert Financial Stability Forum (FSF) into the Financial Stability Board (FSB) in April 2009
 - Commitment of FSB members to undergo FSAP by IMF/World Bank every 5 years
 - Agreement on objective of building high quality capital and mitigating pro-cyclicality
 - Emphasis on development of strong regulatory architecture

Agreed next steps

- Regulation of OTC markets
- Regulation of credit rating agencies
- Reforming compensation practices
- Checking excessive leverage in the system
- Regulation of LCFIs

International regulatory developments

- USA
 - Dodd Frank Act to promote financial stability
 - Creation of Financial Stability Oversight Council & Bureau of Consumer Financial Protection
- UK
 - Scrap the FSA by 2012 & replace it by 3 subsidiaries of the Bank of England
- European Union
 - Establish by 2011 financial sheriffs empowered to overrule national agencies & temporarily ban high-risk financial products & activities

How was India hit by the crisis?

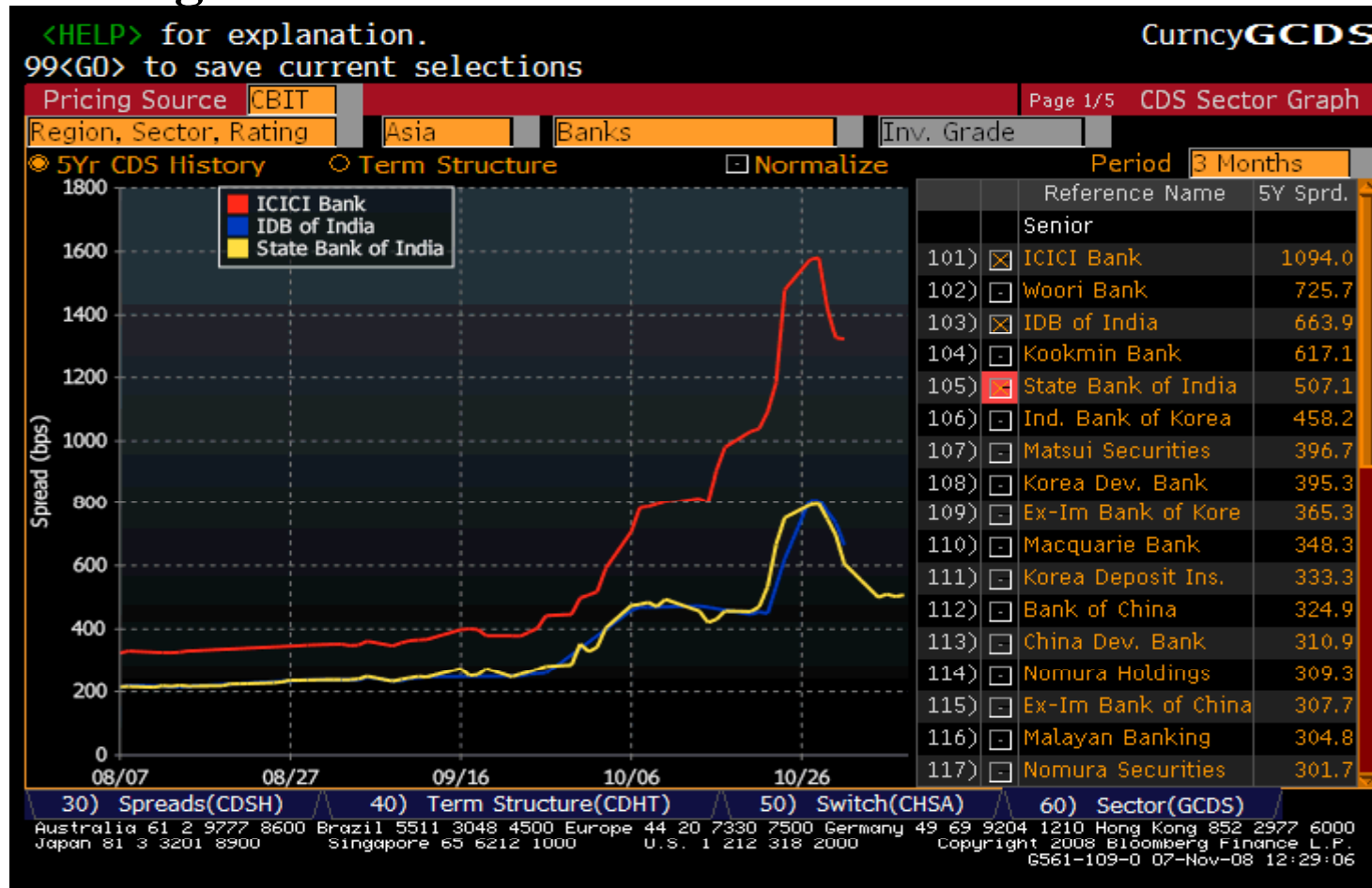
- Indian banking system had no exposure to tainted assets or stressed institutions, but the impact was indirect:
 - Indian trade & finance more closely integrated with ROW than is realized
 - Foreign institutional investment declined
 - Stock market indices fell
 - Current account deficit increased & capital account surplus fell
 - Economic growth declined

Downturn in our equity markets



Source : Bloomberg

Poor equity markets and global credit crisis led to freezing of offshore Indian credit lines. ...

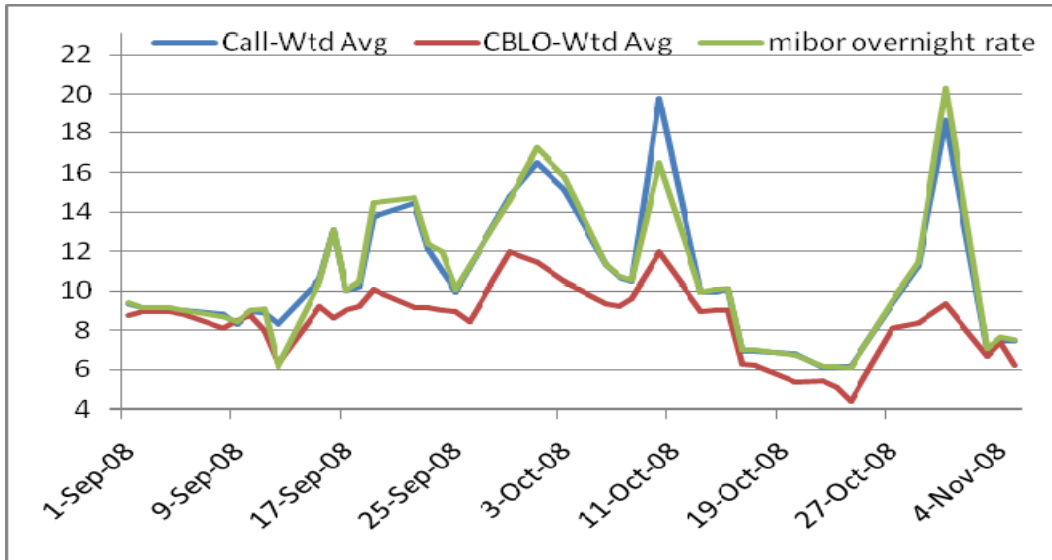


.....CDS spreads of Indian banks spiked up and
 forex requirements were met through domestic funding

Source : Bloomberg

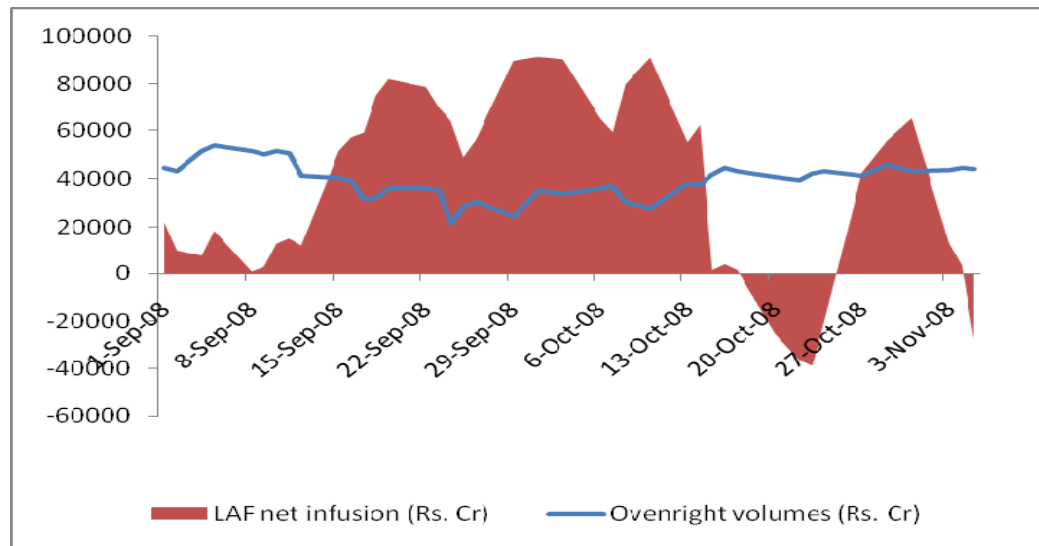
Liquidity scenario tightens

Overnight money market rates



- The tightening liquidity condition was clearly reflected in the overnight money market rates
- Call rates spiked to intra-day high of 23% in Oct.

•RBI had to infuse huge liquidity in the system.



Source : CCIL, RBI

India's response

- Conventional measures
 - Reduction in policy rates
 - Reduction in Cash Reserve Ratio
 - Relaxed norms for external borrowings
 - Raised interest rate ceilings on NRI deposits
- Unconventional measures
 - Rupee-dollar swap facility for Indian banks
 - SPV + refinance window for NBFCs
 - Refinance window for specific sectors

Agreed next steps and Indian actions

| Agreed next steps | Indian scenario |
|---|--|
| Regulation of OTC markets and promotion of Exchange traded products | <ul style="list-style-type: none">•Indian OTC markets are reasonably well regulated . No need to tighten regulatory framework•CCIL has developed a reporting platform to capture OTC transactions in interest derivatives•India has introduced new products like currency futures and interest rate derivatives on exchange traded platforms |
| Regulation of CRAs | <ul style="list-style-type: none">•Even prior to the collapse of Lehman brothers , Govt of India set up the Krishnan Committee to look at the regulation of activities of CRAs.•By early 2010 all major recommendations of the Krishnan Committee were implemented. |
| Compensation packages | <ul style="list-style-type: none">•Public sector Banks account for 70% of Banking activities•Salaries pegged to relatively non-competitive civil service salaries•There is a need for higher salaries for public sector bankers. |

Lessons from India on finance

- The unqualified triumphalism that marks this discussion is not entirely warranted
- If global finance is about flying a 747 we are still cautiously flagging off a Cessna
- A lot of Indian finance is still a waste land e.g. the bond markets
- But there are parts of India where useful things have been done

What did we get right?

- Serious public policy attention to critical financial infrastructure institutions
- Using modern technology to improve efficiency of pricing
- Consolidation and economies of scale as opposed to fragmentation
- Use of public policy to push standardization, commoditization and dis-intermediation

What did we get right?

- Pro-active public policy to ensure competitive markets
- Examples
 - New Pension System (NPS)
 - Screen based IPO
 - Exchange traded derivatives & clearing corporations
 - Ownership & governance of exchanges

Lessons

- Conscious public policy interventions & perhaps lost some innovations in the process
- Economies of scale (NSDL) to drive down costs
- Identify areas of super normal profits and go after them using technology, competition and public policy to promote both
- Political economy of reforms
 - New laws
 - New institutions
 - Right location

Next steps in India's financial sector reform

- Regulatory reform & convergence
- Regulatory coordination and financial stability
- Financial literacy & inclusion
- Banking/insurance legislative changes
- Developing BCD nexus
- DMO

THANK YOU