

## **Managing Financial Innovation in Emerging Markets**

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### **Introduction**

First of all, I would like to congratulate the Reserve Bank of India on the occasion of its 75<sup>th</sup> 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 the strides that India has made in its economic policy management in recent years. 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 rapid 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 implementing regulations and effective supervision that limit the potential risks of financial instability.

This does not mean that we should return to the 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...In emerging markets, the questions are similar to those in more advanced economies: what lessons can we learn from the mistakes of others?”

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

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<sup>1</sup> Shyamala Gopinath “Financial Markets—Some Regulatory Issues and Recent Developments” Inaugural address at the FIMMDA\_PDAI Annual Conference, January 2, 2010, Mumbai

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.”<sup>2</sup>

## **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<sup>3</sup>, 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.<sup>4</sup>

In modern market-based economies, financial intermediation is a lifeblood of the economy. 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, , innovation has at least three key tasks. . First, it should address the challenge of missing markets, such as those for the

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<sup>2</sup> Report of the Committee on Financial Sector Reform, Government of India, Planning Commission, New Delhi

<sup>3</sup> Remarks by IMF First Deputy Managing Director John Lipsky at the Bank of Mexico Conference, "Challenges and Strategies for Promoting Economic Growth" Mexico City, Mexico, October 19, 2009

<sup>4</sup> Raghuram G. Rajan and Luigi Zingales, “Financial Dependence and Growth.” American Economic Review 88, No. 3 (1998).

long-term financing that is needed for long-lived assets, or for efficient risk sharing by providing insurance and hedging products. Second, it should deepen liquidity in existing markets, for example by reducing reliance on 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 that their real economies rely heavily 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. 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, unless banks 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 the taxpayer. And, third, commercial banks often are not in well-placed to diversify the credit risk in their loan portfolios—their financial performance typically mirrors the underlying condition of their borrowers and the local economy.

## **What does this mean 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 still important issues of access to credit and financial services both for Indian corporations, especially SMEs, and households.

A recent IMF staff study found that Indian firms increasingly are reliant on borrowed funds (as opposed to retained earnings) to fund their investments, but also found that there are important inefficiencies in debt financing: Firms in industries that are more dependent on such financing tend to grow more slowly.<sup>5</sup> A lack of financial instruments has also limited the ability of firms to manage risks. The limited availability of derivative products to hedge risks leave corporations with costs they would not otherwise bear and may affect their ability to grow. At a smaller scale, only 40 percent of the population benefits from a bank account, as a large number of households still remain outside the formal financial sector.

These issues are, well understood in India. Thus, several steps are being taken to meet the

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<sup>5</sup> Hiroko Oura, 2008, "Financial Development and growth in India: A growing tiger in a cage?", IMF WP/08/79.

growing needs for more diverse sources of capital. 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.. And the RBI has undertaken important initiatives on financial inclusion, with the goal of having a banking outlet in every village with more than two thousand residents by 2011. But India also is targeting an increase in infrastructure spending of some \$500 billion over 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.

Fortunately, there are a several successful models of capital market development in emerging markets. The growth of the corporate bond market 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<sup>6</sup> 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 may bring its own risks, and hence some

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<sup>6</sup> Peiris, S. "Foreign Participation in Emerging Markets Local Currency Bond Markets," IMF Working paper, *forthcoming*

overall limits may be justified.<sup>7</sup>

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, done prudently, would help broaden the investor base and allow for the conversion of longer-term amortizing loans into instruments more suitable for institutional investors. This 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.

### **What about the 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. These skeptics note that 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 should be avoided in emerging markets at all costs.

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<sup>7</sup> As background, there is currently a limit for FIIs of \$5 billion in the government debt market and \$15 bn in the corporate debt market. The Fund has advised to merge these limits as currently the one on the corporate bond market has very little utilization, while that on the government debt market is close to its limit. This will mainly help to develop the government bond market in the first instance, but by improving liquidity in this market, it will also provide a benchmark for the corporate bond market.

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

- Excessive complacency 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 growth of excessively complex instruments and of unexamined and unrecognized interconnectedness and fragility;
- Regulatory arrangements that did not adjust effectively to financial market developments; and
- Inadequate supervision that failed to enforce standards effectively.

Happily, India is in a different situation. First, complexity of instruments is not currently a problem. Second, governance and risk management appear adequate and bank leverage 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 ongoing financial crisis**

Perhaps the key lesson of the current crisis is that the traditional fundamental virtues of prudent capital levels, of avoiding excessive reliance on fragile forms of short-term funding, of proper loan underwriting, of sound risk management and of effective corporate

governance remain as critical as always. We have been reminded again by recent events that securitization – that has the capacity to enhance systemic efficiency and effectiveness – must be developed within a sound regulatory 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 securitized mortgages simply were not adequate—underwriting standards in many markets had become lax and were not properly regulated, ultimately harming both consumers and investors. The role of the United States’ so-called shadow banking sector in this process also raised questions about regulatory cooperation and the regulatory perimeter.

The complexity of products *was* an element of the crisis, but not an underlying cause *per se*. Rather, many institutional investors failed in their most basic fiduciary duties by purchasing instruments that they 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, with serious consequences. Some aspects of the crisis were the result of a lack of transparency in products and markets—for example in the credit default swap market, an enormous market that has developed almost entirely as over-the-counter. In the event, there was a failure of due diligence on the part of some of the key participants in this market, with significant destabilizing impact. The move to standardize and centrally clear a substantial portion of derivative trading will help to address these risks.

Even in the extraordinarily deep and broad crisis of the last two years, 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 central message is clear: Economies are best served by fully developed financial systems with robust infrastructures – including a strong regulatory and supervisory framework.

### **International cooperation will be key**

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. 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—of which both India and the IMF are members—which is charged with following up on the recommendations’ implementation.

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, and the crisis offers an opportunity to forge consensus on these as well as newer initiatives, for example those focusing on macro-prudential supervision and on aligning compensation with firms’ risk management objectives.

We need to be creative in our policy responses. An example of this is the request by the G-20 Leaders to the IMF to prepare a report on options by which the financial sector would contribute to covering the costs associated with crisis-related government intervention in the sector. We are exploring options to craft a financial sector levy in a way that creates the appropriate incentives to reduce risks and sends a clear message to financial firms that government support of the financial sector will not be costless..

### **How should countries proceed to modernize their financial systems?**

In the end, each country will need to find its own approach to fostering appropriate and useful financial innovation. Allow me, however, to offer a few general suggestions for emerging market countries looking to realize the benefits of more rapid innovation.

First, keep it simple.

Introduce products that are relatively simple and standard and that offer clear value-added.

Moreover, new financial products should be understood by regulators, by buyers, and by sellers. Investors should be able to calculate the risk being undertaken without undue reliance on credit ratings agencies. 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 through 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 have on issuers. After all, the most seriously affected advanced-economy firms in the current crisis were damaged by excessive retention of toxic assets – a reflection of sub-standard risk management 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<sup>8</sup> highlighted ongoing problems in the governance, firm management, internal control programs, and risk management in many of the world’s largest financial institutions. In particular, boards of directors were 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

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<sup>8</sup> Senior Supervisors Group “Risk Management Lessons from the Global Banking Crisis of 2008” October 21, 2009

the experience to take an active 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 will become troubled. A key concern coming out of the crisis has been how to ensure that as institutions take on more risk and are deemed to be systemically important, an effective resolution scheme exists that provides governments with the ability to take action promptly and early when an institution becomes troubled. Such regimes should facilitate the resolution of systemically important firms, in order to minimize potential market disruption as well as to dampen moral hazard<sup>9</sup>. 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

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<sup>9</sup> Charles Calomiris “Financial Innovation, Regulation and Reform” Cato Journal, Washington DC (Winter 2009)

efforts to identify and address barriers to implementation of plans for the recovery or orderly resolution of these institutions.

## **Conclusion**

Despite the current difficulties and challenges, financial innovation will continue to play an important role in raising growth globally, but especially in emerging markets and developing countries. The current crisis can provide important lessons as we move forward, and I am confident that our Indian hosts will draw the correct conclusions, and will continue to play an important role in ensuring that the global financial system evolves in a manner that supports strong, sustainable and balanced growth, --for the benefit of all.