FORTUNE INSTITUTE OF INTERNATIONAL BUSINESS

ARTHASAAR-2010

A Seminar on Finance: The Challenges Ahead

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Venue: Fortune Institute Campus, Rao Tula Ram Marg, New Delhi-110057

Keynote Address

Dr. Alok Sheel

- Prof Puri, faculty members of the Fortune School of International Business, distinguished participants and guests, my young friends, ladies and gentlemen.

- I must, first and foremost, thank the organizers for the honour of inviting me, to deliver the keynote address, at this Seminar, Arthasaar 2010, on future challenges ahead in Finance. Personally, It is always a delight to be amongst, and interact with, bright young minds. They will shape India's destiny, in the years to come, at a time that India steps up, to the high table on the global stage.

- India has grown robustly over the last two decades. This has resulted in a dramatic convergence in average per capita incomes between India and OECD countries. Ironically, it has taken a severe financial crisis to raise India's international profile. India's financial system held up very well during the recent financial crisis. It has also emerged relatively unscathed from the crisis. It has also been an active participant in its global management through the G 20.

- If India can sustain high levels of growth, it can be expected to become a major global player, for which it must prepare itself. To an extent such engagement has already begun through its participation in the G 20. This presents a major opportunity and challenge that we have just begun to think about.

- This is an opportunity and challenge for your generation, I may add. But amidst the euphoria of the rise of BRICs, which includes India, you would do well to consider that our main challenges are at home. And finance, which is the hand maiden of the real economy, and perhaps your future profession, has a major role to play in sustaining high rates of growth.

- My young friends, talking about Finance is both challenging and fascinating at this point in time, as we emerge from the greatest threat to the global economy since the Great Depression of the 1930s. The theme of this Seminar is therefore both timely and of great importance.

- It is challenging because developments in the financial sector are widely believed to be the underlying cause of the current or recent financial crisis. In the process, Finance has lost its sheen and mystique. It has acquired a bad name, with investment bankers as villains of the piece.
- There is an animated and informed debate on its origins. But most experts can be classified into two main camps. The first camp gives greater importance to the buildup of Global Imbalances as the prime mover. The second camp attaches greater importance to the failure of financial regulation in advanced economies, particularly in the United States.
- Be it as it may, there is universal consensus that it was developments in the financial sector that lie at the heart of the crisis. Global imbalances led to excessive liquidity. This drove down interest rates and returns to capital, underpriced risk. This in turn led to excessive risk taking, through high levels of leverage and through innovative, complex and opaque financial products. By a sleight of hand, even as returns on capital employed declined, returns to equity rose smartly. How could this happen? The answer we now know lay in leverage and innovation.

- Financial regulation failed to keep pace with the scorching pace of innovative and intricately structured financial products. Products such as collateralized debt obligations or CDOs, synthetic CDOs, structured Investment Vehicles, Credit Default Swaps, leveraged buyouts, and a wide range of derivative, structured and securitized products. Certainly regulators and governments got overawed by the brilliance of Wall Street. This led to some kind of regulatory capture.

- Post crisis, we are likely to see a vastly different financial landscape in developed markets. Central bankers will look beyond consumer price inflation and stabilizing growth to targeting financial stability through monitoring financial transactions at the macro level – even as sectoral regulators continue to regulate the activities of individual players. They will deploy new macro prudential tools for macro-economic management. Governments, which were called upon to commit massive amounts of taxpayer resources to bail out the financial system, will look upon the financial sector more as a public utility rather than entirely driven by market forces.

- Let me list out some of the main regulatory concerns that are likely to transform the financial landscape:

- **Compensation practices** should not encourage excessive risk-taking: main concern Investment Banks
- **Cross-border crisis management**: supervisory colleges and financial protectionism
- **Too big to fail institutions:** moral hazard, and taxation of the financial sector.
- **Exit strategies for failed institutions**: Living wills
- Capital buffers, liquidity ratios and dynamic provisioning to deal with **procyclicality**
- **Credit Rating Agencies:** conflict of interest
- **Accounting practices**: hold to maturity/mark to market
- **OTC trading:** liquidity, counterparty risks and volumes
- **Restoring the firewall** between traditional deposit based fractional banking and investment banking.
- **Securitization**: origination and risk
- **Tax havens :**Tax evasion and terror funding

- How relevant are these concerns for the Indian financial system? My take is that while these concerns should guide us we go forward, so that we don't repeat the same mistakes in future, at the current stage of development India's concerns are more developmental than regulatory. The cost of capital is high and access is an issue. Asset-liability mismatches queer the pitch for financial closure of critical long-gestation infrastructure projects, that are essential for sustaining high rates of growth. Development of liquid corporate bond markets and continuing reforms in the insurance and pension sectors would release long-term savings for long-term investments. It is therefore imperative that the calibrated liberalization and development of financial markets in India is not derailed by regulatory concerns arising in advanced markets which presently have little relevance in our own markets.

- How the world has changed. A few years ago the Indian financial system was considered some kind of dinosaur or Paleolithic animal. There was a big philosophical divide over how the financial sector was looked upon in India, in several other developing economies, and indeed in some advanced economies such as Canada and Australia. This was the premise that the financial sector is the handmaiden of the real economy.
- In several advanced economies however, the handmaiden had become the queen, the engine of growth with returns

far higher than what were generated in the real sector. In hindsight it seems odd how we could have been so foolish to even contemplate that this was sustainable. For, in the final analysis, returns in the financial sector must be funded by current income from the real sector. Surely, if the returns in the financial sector are far in excess of those in the real sector there is an asset bubble. Yet several central bankers were saying then, and some continue to say even now, that it is difficult to identify asset bubbles.

- Ladies and gentlemen, let me once again thank Dr Puri and the Fore School of Management for giving me this opportunity to address you all. I wish your deliberations every success and hope that you will have a productive Seminar.