TWELFTH NURUL MATIN MEMORIAL LECTURE ON
ETHICS IN BANKING
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TRUST IN BANKING

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Friends,

I am greatly honoured by the kind invitation to deliver the 12th Nurul Matin Memorial Lecture. I believe that I have a very special relationship with Bangladesh. I count, among my best friends, Kibria Saab, former Comptroller and Auditor General, and Mr. M. Syeduzzaman, former Minister of Finance with whom I worked closely thirty years ago while in World Bank. As Executive Director in the International Monetary Fund, I worked closely with Government of Bangladesh on the issue of flow of funds. As Governor, I had excellent rapport with my distinguished counterparts in Bangladesh, when we worked closely in all international fora and cooperated with a spirit of camaraderie. I wish to place on record our deep appreciation for the hands of friendship and mutual regard.

Our family has a special affinity to Bangladesh, since my brother, Dr. Y.R.K. Reddy is a frequent visitor to Bangladesh, as an expert on matters relating to governance.

I take this opportunity to pay my respects to Governor Atiur Rehman who combines in himself deep scholarship, wide-knowledge, excellent leadership and, above all, convincing commitment to an equitable and just society as the goal of public policy.

I am grateful to the Bangladesh Institute of Bank Management for provoking me to ponder over and share some of my thoughts on the issue of trust in banking, in the context of the current global crisis. They have been warm and excellent hosts, and I am grateful to BIBM for the courtesies extended.

I did not have the good fortune of meeting Mr. Nurul Matin, but I gather from others that, during his long and distinguished banking career, he made enormous contributions both to regulating banks and being regulated by central banks, in addition to building and leading financial institutions. That, no doubt, includes founding the Bangladesh Institute of Bank Management. I am privileged to pay my tributes to such a renowned personality, who lived a life of exemplary integrity and inimitable courtesy.

Among the distinguished persons who delivered the Memorial Lecture in the past, I found the Eleventh Lecture on Ethics in Banking to be of great contemporary interest. Dr. Azizul Islam spoke eloquently on "Ethics in Banking". He quoted Mahatma Gandhi, approvingly, that mother earth can cater to everyone's need, but not even one person's greed. He traced the financial crisis mainly to greedy behaviour of banks, and provided us with an excellent list of 'do's' and 'don'ts' to the banks. I am fascinated by the subject and decided to take the debate forward by approaching the issue in terms of restoring and maintaining trust in banking, and more generally financial sector.

I will present before you the possible reasons for erosion of trust in banking, if and where it occurred on account of global financial crisis. This will be followed in the second part by some general observations on trust and finance, incentives and trust, and trust and regulation. I will critically examine post-crisis developments in regard to rebuilding trust. I will conclude with some observations on the way forward, keeping in view perspectives of developing countries.

Erosion of Trust

Consequent upon the global financial crisis and its adverse impact on the fiscal management, employment and output; is rebuilding trust in the financial sector an issue? Has there been any erosion in the trust in the financial sector, in particular, in banking? Have there been any surveys on this? The answer is, yes; there have been a few surveys, and the surveys show that there has been erosion of trust in the financial sector in general, and banking in particular, in the U.S., the U.K. and, to some extent, in Europe. On the other hand, the surveys showed that the confidence in the financial sector and banking has increased in emerging market economies, particularly in China and India.

With the onset of the global financial crisis, some private banks were nationalised in some advanced economies to ensure trust when there was a threat of their collapse. In some cases, governments in advanced economies had to inject capital for the purpose. In China, where there was considerable dissatisfaction with public sector banks, the opinion suddenly seemed to have changed significantly in favour of public sector banking. In India, in the immediate aftermath of outbreak of the crisis, there was flight of deposits from private sector to public sector banks, but that was mostly temporary, though there was no sudden reversal of flows. So, in a way, therefore, the erosion of trust in banking as a consequence of the crisis has not been universal, and in some cases temporary. There is a divergence in the trust deficit consequent upon the crisis between advanced economies and emerging market economies, and between public sector and private sector banks. It is also necessary to note that in some advanced economies, such as Canada and Australia, the confidence in banking sector remains largely unaffected. So, when financial sector reforms are taken forward, there is a need to examine why there has been such a divergence in trust among countries during stress in financial sector.

There are several reasons for erosion of trust in some jurisdictions some of which are briefly mentioned here. Large sections of the population have been adversely affected by the financial crisis in terms of loss of properties, employment, incomes, value of financial assets, etc. They consider themselves innocent victims of crisis in financial sector. They feel that those involved in financial sector have enjoyed large gains before the crisis and shifted the pains of adjustment in response to the crisis to the rest of the population when crisis occurred. In the discharge of semi-fiduciary functions that are critical to the integrity of financial markets, such as fixation of LIBOR and credit rating, the major global players in financial markets discredited themselves as disclosed after the crisis. When several irregularities in the functioning of large financial intermediaries were found prior to the crisis, the regulators' reactions were mooted. The public at large are still left in the dark about the details of malfeasance. The shareholders in a few large financial conglomerates are actively questioning the remuneration of senior management after the crisis. Thus, many segments of the population in most affected countries are disillusioned with the financial sector in general.

Finally, the popular explanations for market failure relate to incentives that promote risk taking, and possibly greed, but the regulator's failures are generally attributed to misplaced faith in the self correcting powers of markets, a lack of skills in the regulatory agencies and, above all, capture by vested interests. Such a capture can be described as comprehensive, particularly in the countries that were most affected during the crisis, in the sense that it was not restricted to the economic concept of regulatory capture, but extended to the overall public policy relating to financial sector. The political leadership has a short-term horizon and financial markets also have a short-term horizon. This creates a natural tendency for their priorities to converge towards short-term gains at the expense of long-term interest. Regulators, as part of their public consultation process, often depend on the regulated for consultation which is a feature common in most industries. But the dominant market shares of the few giants in finance industry combined with the characteristic externalities of finance make a difference to the process and outcomes.

In cases where academics are advising on the design of reform, they are often finance experts, sometimes engaged with market participants in remunerated advisory or consulting capacities. A notable part of economic research on regulation is funded by the financial sector. In many countries, the finance industry offers prospects of highly paid jobs in future for those employed in the regulatory agencies and Treasuries or Ministries of Finance. Finance and its regulatory framework are somewhat intangible and difficult for a common person to grasp or immediately recognise the consequences. So, the interested groups can tilt the intended policy changes in their favour by shifting equilibria between competing considerations appearing as mere technical issues. It is possible to argue that capture of regulators is inevitable, and that a case can, therefore, be made in favour of reducing formal regulation, and encouraging self regulation and promoting principles-based regulation. On the contrary, there is a widespread feeling that those were the very prescriptions that brought about the global financial crisis. The biggest challenge for the future of finance lies, therefore, in designing governance practices that avoid the dangers of comprehensive regulatory capture.

There are serious efforts to take up reforms in financial sector in countries which were most seriously affected and those which are less affected. However, there is a difference in the direction of reforms; in one set, reform means rolling back from excessive deregulation in the interests of stability, while in the other set, it means further deregulation in the interests of efficiency. It is useful to note that in one set, the challenge is to restore trust of people in financial sector, especially banks, and in the other set, it is to maintain trust while deregulating the financial sector.

Simultaneously, there are efforts at the global level to ensure coordination of national regulation of financial sector, and to some extent, national economic policies.

The tasks for markets and policymakers on account of the crisis are: restoring trust in countries where it was eroded and improving the trust further in countries where it was not dented. In addition, to the extent finance is globalised, it is essential to bring about coordination of related regulations and other policies.

Trust and Finance

What is the special relationship between trust and the financial sector? Trust is, in fact, a universal value, but trust is critical in finance since there is no exchange of goods, but there is only exchange of money, which will give the claim for goods and services, in future. Relative to transactions in real goods or services, financial transactions are intangible and have multiple uses as a means to other goods. Exchange of money and financial instruments involves movement of claims over space, over time and across different risk profiles. In banking, transactions are not collateralized, but based significantly on trust. In dealing with financial intermediaries, in particular banks, people are parting with enormous amounts of information about themselves. In the process, the banker knows more customer could ever know about the bank. This information asymmetry make banks very complex and banking a lot more based on trust, than most other activities.

Trust: A Shared Objective

There are several explanations for the occurrence of the global financial crisis. Scholars have said that crisis is on account of loose monetary policies or political economy considerations or global economic imbalances. But in the ultimate analysis, the responsibility has to be taken primarily by the financial system as a whole. The blame has to be distributed between regulators and the regulated, and the other explanations may, at best, be called enabling causes. The burden of restoring, maintaining and enhancing trust in financial sector has to be essentially that of financial sector and should be shared by both, the regulator and the regulated.

Central banks have a special responsibility for ensuring trust in financial sector, especially banks. Experience has shown that, even when the central banks' mandates were confined to maintaining price stability, they had to shoulder the responsibility to ensure financial stability, which itself is critical for maintaining trust in the financial sector. Central bank's role arises not only because it is monetary authority with a stake in the closely associated financial sector, but also because it is a lender of last resort. Further, unless there is some other agency entrusted with a function relating to finance, the society looks up to central banks to fill any vacuum. In brief, maintaining trust may be a shared objective between regulators and regulated, but institutionally the responsibility is most likely to rest on central banks. In this regard, it is useful to note that maintaining stability in financial sector is a necessary condition, but it is not sufficient to ensure trust, since the former refers to absence of instability while the latter refers to presence of trust. However, governments, despite their focus on short-term, should be concerned with maintaining trust in financial sector, especially banking, but the complexities involved, popular sentiments, and the institutional histories, place the central banks at the forefront of the responsibility for trust in financial sector.

Incentives and Trust

The institutional structures also influence the incentives for trust-worthy behaviour. The limited liability form is recognised as a great institutional innovation that enhanced efficiency in the economic system. It enables risk-taking behaviour on the part of the equity holder since the stakes are limited to equity. The equity holder has significant incentives to expand debt or indulge in excess leverage. The debtor is expected to make a judgement on the risks involved while lending and pricing credit to the borrower, especially when the liability is limited to the equity holding.

However, the borrowing entity, with limited liability, has more information on the finances of the business that it is conducting than the lender can normally hope for. This information asymmetry is more acute in the case of banks, where the bank which is a borrower of public deposits knows a lot about the depositors but the depositors have little scope or capacity for understanding the financial position and operations of banks. It may be recalled that banks are permitted to accept non-collaterlised deposits. In brief, the incentives for risk taking are higher for bank-owners and their management; yet, the depositors put their funds with them trusting that the regulators are adequately aware of the risk in the functioning of the banks concerned. To maintain this trust, central banks and regulators often bail-out troubled banks despite the moral hazard implications.

At a global level, cross-border finance moves quickly and easily between different jurisdictions, and move in a way that it can undermine both the fiscal authority and regulatory authority. The public authorities are, sometimes, not beyond pressures of the foreign public policy. When the financial conglomerates happen to be the conduit for not so legal money, their capacity to influence policy behind the curtains is even more limited. When there is a reference to black money lying outside the country, it is necessary to note that such money is not generally carried through suitcases when it crosses borders; it often goes through banking channels that have cross-border operations. It should be obvious that banks which operate cross border have an opportunity and incentives to play an enabling role in carrying out transactions that may not necessarily strengthen the trust of the public at large in the banking system.

Trust and Regulation

Will more regulation bring about greater trust or will greater trust warrant less intrusive regulation? These are difficult questions to answer. There is lack of clarity on the relationship between trust and regulation. Distrust in financial sector creates public demand for regulation, but regulation may in turn discourage formation of trust in the sector, depending on the perceived quality of regulation. This in a way leads to what economists call multiple equilibria. Hence, the role of regulation in nurturing trust has to be highly country specific. It is interesting to note that in countries where people perceive the governments to be corrupt, they demand greater and more intrusive regulation.

According to a recent survey, trust in the financial sector lags trust in government, though trust is the bedrock of financial institutions. Hence, the public trust in finance is a product of complex and dynamic interactions among the government, central banks, regulators and the regulated. Such interactions are more nation-specific in nature rather than global.

Rebuilding Trust: Post-Crisis Developments

Several initiatives have been taken by national authorities in most affected countries to improve regulation and restore trust by enhancing stability in the financial sector. Simultaneously, there are efforts to develop and adopt global best practices for the purpose of minimising the chances of a crisis in future and managing stresses if they arise.

First, risk capital was observed to be inadequate relative to the risks in the balance-sheets of many banks leading to crisis. The agreed solution so far is higher capital standards and better quality of capital. Higher risk capital in financial institutions' balance sheets implies that some debt has to be replaced by equity or risk capital. If a higher risk capital is ensured, and if it gives comfort of stability to the lenders, then the interest rates expected by lenders also should be less than otherwise. The calculations of burden of additional capital requirements due to new standards to impart stability have resulted in two sets of calculations, one official, and other in industry. The lack of trust between finance industry and the official view is reflected in these calculations. In any case, the higher capital standards are expected to come into effect in 2019, possibly with dilution of regulatory prescription in operational guidelines in the meantime.

Second, the issue of size of financial entities has gained significance. During the crisis, public policy concluded that some of the large financial conglomerates were too big to be allowed to fail, and hence had to be bailed-out. The solution proposed is higher level of risk capital relative to others, and drawing up of living wills. There is considerable resistance to the prescription of higher capital ratios on the grounds that it will result in uneven playing field. The recent exchanges in regard to manipulation of LIBOR between central banks and major global conglomerates are instructive in this regard.

Third, the issue of shadow banking to mean bank like activities undertaken by non banks with or without support of banks has gained attention. It is recognised that shadow banking led to weaknesses in the financial system and crisis. Hence, it has been proposed that non-banks should also be regulated as needed. There is a reluctance, particularly in international financial centres to regulate shadow banking adequately, as financial activity may go away from such centres to others. The race to be at the bottom of regulations that seems to continue in the U.S.A. and the U.K. may not entirely be supportive of effective global standards in order to retain their status as international centres.

Fourth, the role of pro-cyclicality in regulation in contributing to the crisis has been recognised. Countercyclical monetary policy and countercyclical regulatory policy have received broad support both from policymakers and market participants. There is an agreement on countercyclical policies now since easy monetary policy meets the concerns of all sections, including financial markets in advanced economies. When easy liquidity is required by financial markets, and regulators and government also want to provide easy liquidity, concerns are shared. If the cycle were to be on an upspring in future, and if financial markets were happy with it, there is bound to be resistance to countercyclical tightening of policy. In brief, there is full agreement on countercyclical policy at this juncture when more liquidity and low interest rates are required by markets, but disagreements should be expected during periods of rapid growth of credit.

Fifth, the desirability of taxing financial transactions and possibly intermediaries is under contemplation. This is intended as a means of paying for the fiscal costs already incurred on account of the crisis, or financing the cost of supporting the sector in future in the event of crisis, and for reducing the incentives that encourage excessive financialisation. On the desirability of taxation, there are differences of opinion among policy-makers while financial markets are opposed to them. Europeans are keen about taxation of the financial sector; Brazil has already introduced; while the U.S.A. and India are not in favour. There is a lack of agreement among countries on international cooperation on taxation of financial sector among countries.

Sixth, in the reform process in most affected countries, there has been a special focus on strengthening consumer protection and arguably making trading in derivatives more transparent. Progress in ring fencing retail or traditional banking from the wholesale or investment banking appears to be work-in-progress with evidence of resistance from large financial conglomerates.

Seventh, there is widespread support for greater global coordination of regulation to restore trust in the financial sector. It is true that there are serious efforts in this direction. It may appear to be good to have global coordination in a world where economies of countries are increasingly integrated into a global economy. But, imagine having global coordination of regulation ten years back or five years back. Global coordination would have meant adoption of the U.K. and the U.S.A. models by India and China also. A simple principle of any management, and in particular financial management, is diversity. To what extent is the principle of diversity which is required for survival, undermined, by insisting on global coordination in financial sector?

Finally, coordination of macroeconomic policies at national level is considered essential for maintaining financial stability. The mainstream thinking before the crisis was that there should not be any conflict of interest in the various wings of public policy. Hence, the monetary authority was to conduct the monetary policy independently, the fiscal authority was to handle fiscal management independently, and the regulator was to do his job independently. In public policy, this approach to avoidance of conflict of interest resulted in sacrificing policy coordination. Simultaneously, the mainstream thinking in regard to the private sector was that their efficiency could be attributed to economies of scale and economies of scope. Hence, it was thought that the bigger the private sector, the better it was. What was advocated was erection of firewalls within such conglomerates to avoid conflicts of interest. The global financial crisis has shown that the firewalls to avoid conflict of interests in private sector broke down.

Perhaps, the firewalls did not work in reality: they never did. Scope and scale was, in some cases, an excuse, used for insider trading, for enabling information asymmetry relative to counter parties and perpetuation of blurred roles within the financial entity. The thrust of the institutional reform process after the crisis in U.S., U.K. and Euro-zone, is to create coordination among regulators in financial sector and with other public policies while reducing scope for conflict of interest in private sector, which may include a bias against too big to fail. In a way, a major challenge for reform going forward is introducing coordination in public policy without blurring accountability; and, avoiding conflict of interest in the private sector, without sacrificing economies of scale and scope.

Way Forward: Some Observations

First, trust is generally important and more so for the financial sector due to several complex factors such as intangibles, information asymmetry, externalities, and risk distribution.

Second, there is a need to rebuild trust where there has been erosion of the trust, and for this purpose it is necessary to learn lessons from both the cases where there is erosion of trust and cases where there is no erosion of trust. It is also important to continuously monitor how the trust is evolving from time to time.

Third, trust is something which goes obviously beyond the slogans, such as, "customer is king", "quality of service", and "efficiency of service". It is all these things put together, and is not easily quantifiable. Trust has close affinity with ethics, morals, values, sense of fairness, etc. which are often country specific and culture specific.

Fourth, monetary management, fiscal management and financial sector are closely related. Experiences of the Euro-zone, the U.S.A., China and India, illustrate importance of the relationship between the three policies. If there is a serious fiscal issue, then the monetary authority has to take some burden, and regulators of financial sector may have to step in. At a time of crisis in financial sector, monetary authorities are the first line of defence but fiscal authorities may have to assume risks arising out of such operations. If the government is constrained in expanding fiscal stimulus in times of economic recession, monetary authorities may have to supplement effort with monetary operations. Perhaps, common persons will have greater sense of comfort if the relationship between policies relating to money, finance and fiscal appear cordial.

Fifth, in a way, the biggest insider game that happens in the world is between the government and the financial markets, especially banks. A bank has to be licensed to accept public deposits and, therefore such institutions are regulated. They are, thus, very dependent on the government for a licence which, in a way, attracts the trust of the people to deposit their money in banks. Government in turn gets resources whenever it wants by virtue of borrowing from the financial sector, especially banks. So, the people trust in banks in which the government and the financial sector reinforce each other. People feel that government ensures the trust in banks, in some way or the other. The financial sector feels that they give money to government whenever feasible. That is, in a way, insider trading. When both of them fail, there is a crisis. One can support the other, but what if both of them fail? That is what is happening in the Euro-zone. Experience in some countries in Europe has shown that weaknesses in financial sector, especially banks, can get transmitted to sovereign risk and result in sovereign debt crisis. Therefore, if a nation is fiscally weak, inherently it cannot have the same amount of capacity to support the financial sector when it is under stress.

Sixth, the restoration of trust in financial sector will also depend on how the burden of managing and resolving the crisis in financial sector is distributed, whether fairly or unfairly. This is the debate which is active in many countries in Europe. When there is a problem in the financial sector, how is the burden distributed? Is there fairness or unfairness?

Seventh, there is a recognition in some sense that the financial services sector is a utility. The dominant view till the global crisis was that financial markets are no different from goods markets. The view that trading in goods is different from finance is now getting greater support than before the crisis. Explicit recognition of the special status of finance industry in relation to the society in the conduct of public policy could enhance trust. In fact, it may be useful if surveys are mounted on trust in the financial sector, especially the banking sector.

Eighth, banking is a long term business and banking is a business based on trust and, therefore, all stakeholders should concentrate on building the trust. The paramount duty of the regulators and especially central bank lies more in maintaining the long-term trust of the people in banks on an assured basis over long-term, than in winning the credibility with the financial markets that are often focused on the short-term.

Finally, are there any lessons that developing countries should draw to maintain trust in financial sector? The goal of financial sector reform in developing countries may not be to replicate the models of advanced economies, which faced stress and are still under review. The path to reform should not be viewed in isolation but in the context of other macro economic

Banks are special and traditional retail banking is most critical to maintaining trust in banking and generally in financial sector without, however, diluting the incentives to exercise due diligence on the part of all stake-holders. The banks should be protected from being excessively mixed up with financial activities or products other than traditional retail commercial banking. Maintaining trust in finance is a responsibility, shared between regulators, the regulated, central banks and governments. To the extent trust is closely linked to morals, values, ethics, etc. there may be large elements of variation in the country context. Hence, a careful view has to be taken on the timing, extent and nature of globalization of finance that would be consistent with the over-riding national priority for maintaining trust in the financial sector, especially banking sector of a country.

Thank you very much, ladies and gentlemen.

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