*Governance Deficit and Financial Crisis**

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It is always a pleasure to return to one's home state, that too if the state is God's own country. Thank you for inviting me to address this august gathering of the cream of professionals and management experts of the state under the common banner of Kerala Management Association. I was, however, slightly apprehensive of what I should talk at a gathering like this. This apprehension started bordering worry when I saw the list of illustrious speakers who have addressed this forum in the past. We are living in interesting times. These days, if any official from the financial sector arrives on any forum like this, the audience expects naturally to hear about the present status of the global financial crisis that is yet to run its full course. So I too chose to speak on this subject. But with so much having been said and written about the crisis, my dilemma was to select issues relevant to a group of management professionals. To me the most virtuous meaning of management is good governance. Good governance more often than not, reduces the risks from an uncertain environment around us. If one is to review the events related to the financial crisis, what emerges encompasses important management and governance principles. These are also important lessons that we perhaps need to keep in mind as the state discusses the 'Kerala 2030' or 'Emerging Kerala' themes.

2. The Global Financial Crisis that began in 2008 has caused large erosion in asset value, failure of financial firms, contraction of output and slowdown in growth, unemployment, and fiscal burden on countries, world-wide. Even as the world was hesitatingly recovering from the crisis through co-ordinated actions of governments around the world, the sovereign debt problem in the peripheral eurozone countries surfaced and now threatens to derail the recovery and has the potential to plunge the world into a fresh crisis. Amidst the sufferings brought on by the crisis, the only positive feature is that it provides all of us with an opportunity to draw the necessary lessons to be wiser and to put in place institutional mechanisms that can avert the possibility of a similar crisis in future. A crisis after all is a laboratory for policymaking where the received wisdom are put to test, old paradigms assessed and new paradigms shaped. Thus, as has been said, a crisis is not wasted if it leaves us wiser.

3. Post the Global Financial Crisis, policymakers, regulators and academics have put their heads together to mull on the fault lines that precipitated the crisis and what remedial steps need to be taken. The extensive reports from official institutions and influential think-tanks as well as the legislative and regulatory reforms that are in various stages of conception and implementation in different jurisdictions are well-known and it is not necessary for me to repeat them here. What I intend to discuss is something more fundamental – the issue of governance, which provides the framework for all forms of human organisations and infirmities which in turn can lead to disastrous consequences. Specifically, analysis of recent crises, as also of those fresh in memory such as the Latin American crisis or the East Asian crisis, invariably point to governance failures either at a macro level or a micro level.

4. In a great deal of academic and policy discourse, good governance has been generally linked to economic growth and development. The growth and productivity in developed nations have often been said to have had their roots in institutions and legal systems of good governance. And as a corollary, the lack of development and crises of the emerging market countries have often been ascribed to the prevalence of oligarchies, crony capitalism, corruption and generally the absence of good governance. Thus good governance has not only

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been advocated as a necessary condition for economic development but for the developing countries, it has been promoted as following the institutional practices of the developed countries. But the crisis clearly shows that even the rich developed countries, with their much coveted institutions can have governance failures that result in crisis of much graver proportion than the failure of a corporation here or there, and bring on great misery on their own people and to the rest of the world.

5. What is governance all about? The subject has spawned reports, legislations and a large volume of research papers. A google search on 'corporate governance' yielded 33,700,000 results and Google scholar, 8,99,000 articles! You will find complex legal-sounding definitions to mathematical equation ridden research papers discussing corporate governance. But what is the central idea behind corporate or any other type of governance? I would put it in one word – 'confidence'. Governance is about commanding confidence of all those we do business with, all those upon whom we depend. Confidence that promises shall be kept, contracts honoured and assurances delivered upon. If your shareholders have confidence in you, they will not be shy of putting money in your venture. If you enjoy the confidence of your lenders, you will not be starved of capital. If your employees have confidence in you, you can attract talent and perhaps would not face attrition. We can go on. What creates confidence, then? If it is an individual, character evokes confidence. If it is an organisation – a corporation, a state or even an NGO – good governance is what creates, and sustains that confidence.

6. If it is about creating and sustaining confidence, we can list three cornerstones for confidence in the edifice of good governance. First, there must be total transparency. Information asymmetry is at the root of all governance problems and therefore, access to complete information for all stakeholders is a *sine qua non*. If a company you have put your money in declares a loss, you will be disappointed; but if it fudges its account to mislead you into believing everything was fine, you will surely lose your confidence in that company when you discover the truth, as you ultimately will. Second, the tension between temptation of immediate gain and long-term survival must be resolved. Lastly, there must be a set of checks and balances to achieve the first two. The salient features of any good governance would therefore require certain basic elements of checks and controls to be enshrined and followed meticulously in the day-to-day functioning of any financial firm or for that matter by any entity which is answerable to a number of stakeholders. These elements are not complex or esoteric by any stretch of imagination. They are governed by, pure and simple common sense, easy to understand, but require a good bit of persuasion, perseverance and patience to be followed meticulously. But often the sheer simplicity of these principles makes the implementer question their very need and dilutes the essence of implementation.

Financial Crisis

7. Let me now turn to the recent crises, and recount some of the most common and rather obvious elements of governance that unfortunately have received scant attention.

8. The seeds of the 2008 financial crisis were sown by the easy and super-accommodative monetary policy practiced by the US for a protracted period of time in the early part of the last decade, which in conjunction with certain other factors led to a desperate search for yields and gave rise to the problem of adverse selection. The adverse selection problem is nothing new in the lending industry and is usually resolved by careful screening and appraisal of the credit proposal. There is possibly no financial firm in the world which does not swear by tight lending standards in order to protect the quality of its balance sheet assets. But this elementary principle was given a systematic go-by by the US mortgage lenders in pursuit of easy returns. It is not that the lenders were unaware of the borrowers' creditworthiness. Indeed, these loans were labelled 'sub-prime'. All of you are aware of the onerous documentation process that precedes a loan sanction. The US mortgage industry had even devised a class of loans called 'Alt-A' loans, where in disregard of all norms of lending, the documentation requirement was diluted. This aggravated the adverse selection problem, because not having to produce any proof and

documentation, the borrowers were inclined to misrepresent or skew their incomes and assets to obtain a larger loan than merited.

9. How could such a folly be committed? The entire mortgage activity was based on the housing sector boom and bubble in house prices. Rising house prices appeared lucrative to the lenders and the borrowers alike. Those rising house prices created positive home equity for the early entrants who merrily drew upon it, not for adding to the asset value but to indulge in consumption expenditure as if the house property was an ATM machine. But there have been bubbles in real estate prices in US and elsewhere in the past which ultimately burst. Neither the lenders nor the borrowers reckoned that the housing boom of the early half of the last decade could also end one day and behaved as if there is only one way for the housing prices to go. This reflects the triumph of obsession with immediate gains and an utter disregard for long-run sustainability.

10. The problem was compounded by the fact that the originators of the mortgages were taking them out of their books and selling it to not gullible, but extremely knowledgeable investors on the strength of ratings accorded by the rating agencies. Now, take the case of credit rating agencies. Any issuer of a debt instrument cannot access the market without first obtaining a rating from an agency. The rating is supposed to serve the investor but is obtained and paid for by issuer. Is this not a clear conflict of interest? What is there to prevent an agency from issuing an unfairly favourable rating against a suitable payment by the issuer? The argument in favour of the arrangement traditionally has been that the agency has considerable reputational capital at stake and therefore would not sell pernicious ratings. But this argument has limitations. Reputational risk will act as a deterrent if the investors have some way of punishing poor rating agency performance or if the long-run downside due to loss of reputation outweighs the short-term gains. Yet as the crisis has shown, there was universal reliance on credit ratings without any mechanism to address the associated infirmities. The Reserve Bank has always been stressing the need for due diligence and meticulous appraisal mechanisms (even if ratings are available) for the banks. That the US mortgage investors were solely led by the ratings in their investment decisions was a major reason for the accumulation of toxic assets, which eventually paved the way for crisis. The governance failure in this case is nothing but the failure of simple due diligence mechanism in asset book build up.

11. Credit Default Swaps (CDS) played a significant role in proliferation of the crisis. CDS, in economic essence, is an insurance against credit risk. The CDS seller buys the credit risk of any single or pool of credit instrument and compensates the CDS buyer for any credit event that reduces the value of the instrument. The beauty of the CDS market is that the protection seller could be anybody. As you are aware, banks have elaborate processes – pre-sanction screening and appraisal, post sanction monitoring, documentation *etc.* – to protect themselves against credit event. What processes does a CDS seller have? The CDS is supposed work on the actuarial principle. But what data goes into computation of the actuarial table? Knowing that credit events depend upon the business cycle, would it not be necessary to exercise care if you are on the ascending phase? Now, if a CDS has been bought for a credit exposure to an entity, it is transformed to a credit exposure on CDS seller and not the entity. If the CDS seller happens to be an institution like the AIG, rated AAA by an approved credit rating agency, there is little residual credit risk on the books of the CDS buyer. This frees the amount of capital held against potential losses due to credit events, which can then be leveraged to acquire more lucrative (and risky) assets-Ad infinitum. The Federal Reserve, in 1996, permitted banks to use CDS to reduce capital reserves. Following this decision, the CDS market boomed and by 2007 the overall CDS market reached a notional value of $ 62 trillion. However, problem arises here because given the active trading in CDS it was sometimes difficult to identify the actual counterparty when the credit event occurs. Also some counterparties like AIG developed massive exposures to CDS which raised concerns about their ability to meet their obligations in times of crisis.

12. The run up to the financial crisis saw a hey-day for financial innovation that saw the creation and exuberant trading of a large number of complex

instruments supported by opaque institutions. The transactions were mostly bilateral, over-the-counter with no common knowledge of who is having how much of which asset. All financial instruments bear risk and when they are ripped and parceled into new products. Hence, it is important to understand what happens to the underlying risk and where it may be residing at any time. Financial markets cannot function unless participants know each other's risk profile. When complex instruments are traded in an opaque market, the problem is further aggravated. Financial distresses require regulatory intervention; the least that the regulator needs to know to intervene effectively is who is affected by how much. Yet, the crisis revealed that not only the market participants had no knowledge about their counterparty's exposure to the toxic assets, even the regulator did not! Fortuitously, The Depository Trust & Clearing Corporation (DTCC) which had created a platform for information on CDS for providing post trade services to its reporting clients could provide the information to the regulators and save the day.

13. The Dealing Rooms have been the epicenter of several governance disasters across the world. Surprise of surprises, this possibility has always been recognised and the practices that govern the dealing room are codified, audit-trailed and audited with unfailing regularity. Yet they remain the most vulnerable to deviations. It has been said that the small derivative trading unit of AIG in London with just 400 employees, virtually brought down this mammoth institution of over 1,00,000 employees in 130 countries. Besides, rogue dealers of financial institutions have virtually ripped the balance sheets apart and yet, the senior managers and the heads of treasuries pay only lip service to the separation of front office from other sequential functions, mandatory leave requirements, broker limits for each dealers, and what not. Even in the post-crisis period, when banks and institutions would have been in a state of high alert, a rogue trader brought on a 2.3 billion loss to UBS that cost the CEO his job. If we sit back and analyse why these governance systems fail, we will come across only a few major issues: the perfunctory nature of compliance, an incredible build-up of trust amongst individuals and often, their activities. If the financial crisis of 2008 could spread its tentacles so easily across the world, the major issue that crystallises is the impunity with which the treasuries of even major financial institutions functioned and the amazing level of complacency that set in over a period of time.

14. This naturally leads me to the issue of compensation. It has been alleged that the non-linear compensation arrangements in vogue in most hedge funds, merchant banks, and other asset managers, where a fund manager's rate of bonus increases with the return he earns was a harbinger of the crisis because it incentivised them to take on more risk. There was an adage in the good old days that lawyers, bankers and doctors should not be soliciting clients. There is a lot of sense in it, because of the perverse social incentives such an arrangement would create. The blogosphere is full of dismay and consternation at the exponential rise in the share of financial sector and the outsised compensations. There is also a view that imposition of restrictions on compensation may have unintended consequences such as migration of financial activities to offshore centers. While the issue is unresolved, the adverse incentives and long run implications of compensation packages need to be kept in view.

15. Another fertile ground for the governance failure has been the complex and sometimes, creative accounting practices employed to hide simple misdemeanors. Financial reporting is at the heart of corporate governance – It is the most important communication between the corporation and its stakeholders. Yet, errant corporations have used, often with active support of auditors and accountants, various stratagems to misrepresent the actual financial condition of the company, thus stalling the stakeholders from taking timely action. Maxwell Communications in UK and Enron in US are cases in point. The Satyam debacle back home is a classic case where an individual-centric top management could hide its misdemeanors for an extended period of time, taking a few audit firms as their accomplices paying a suitable price to buy their honesty.

The European Debt Problem

16. No discussion of crises or governance today can exclude the sovereign debt problem of the peripheral

Eurozone countries. If we take a careful look at the present sovereign debt crisis roiling the Eurozone, it should not take us too long to realise that this crisis also owes its origins to governance failures. The only point of difference between this and the 2008 crisis is that the entities which are at the root of the present crisis are Sovereign Governments and not the usual suspects which are 'profit-seeking' corporations. How did Greece manage to get into the Eurozone? Was there any fudging of figures? How did the others permit this? Again, there was a clear element of acquiescence on the part of core euro members to enlarge the circle of Eurozone at the cost of non-compliance with the tenets of Maastricht Treaty. How did the crisis surface? By admission of the Greek Government that the fiscal statistics it had earlier presented may not be true and the true position could be significantly worse.

17. The European debt crisis has prompted an interesting discussion on governance and sovereign debt. There seems to be interplay between governance performance and the debt level. Better governed countries can afford higher levels of debt. Conversely, badly governed countries can tolerate only lower levels of debt. This hypothesis also helps to partly explain the ostensible paradox of why countries with higher debt levels can carry the burden and why countries with lower debt levels may face a market reluctant to invest in its liability.

18. This view seems to suggest that mere financial and economic measures may not be sufficient to address the problems countries like Greece face, if not accompanied by governance reforms. This is also why even after the Greek parliament passed the austerity measures as a precondition for further assistance, the market is reluctant to accept it as a watershed and displays a great deal of skepticism.

Governance and Regulations

19. Regulations are a necessary adjunct to corporate governance. The processes associated with corporate governance are internal to the organisation. Regulations are designed to serve the same end, but are external to the organisation and seek to provide a nudge to enforce the governance process. While regulation of non-financial firms is structured around the basic themes of disclosure, investor protection and management of bankruptcy, regulation of financial institutions, particularly banks, are usually much more stringent because of the grave consequences of their failure. Prior to the onset of the crisis, there was a critical intolerance for regulation by the proponents of market-based economic systems. This was reflected in the lax regulatory framework governing the financial markets and institutions. It is now widely acknowledged that, weak regulations were responsible for the sub-prime crisis and efforts are under way to make regulations and supervision more comprehensive and robust.

20. Merely having a strong regulatory and supervisory framework is not enough. It is also equally important as to how the rules and regulations are enforced. Manipulation of the due process by incumbent oligarchs or crony capitalists to their advantage has been a recurrent theme in the context of developing or emerging market economies. But the financial crisis has shown that this can happen even in the US. It is well known that the five major investment banks – Goldman Sachs, Lehman Brothers, Merrill Lynch, Bear Sterns and Morgan Stanley – commanded tremendous clout with the policymakers, but they are also suspected of tweaking the regulatory apparatus to their advantage. As reported in New York Times, these five 'big guys'- led by Hank Paulson Jr of Goldman Sachs, who would take over as the Treasury Secretary two years later – met the five commissioners of the SEC in the afternoon of April 28, 2004 in the basement hearing room of the Securities and Exchange Commission (SEC) office in New York to discuss the issue of freeing of capital from their brokerage arms that could be leveraged to buy even more complex instruments. After 55 minutes of discussions the demand was acceded to. As Dani Kaufmann laments, it is a case of 'legal corruption'. No bribe has been paid, no laws broken, yet the effect is the same.

An Indian Perspective

21. Now, let us look at the Indian perspective. The Indian financial sector may not be as sophisticated as those of the developed countries. There are barriers to entry to several market segments imposed by the compulsions of capital account restrictions. The range

of products is narrow and their liquidity limited. Our approach to further development of the markets is marked by cautious gradualism. But as far as governance and regulation are concerned, we can perhaps boast of a resilient system alive to the potential problems we have discussed. Let me recount some of the measures that we have taken in support.

a. With a view to promoting transparency in the over-the-counter (OTC) derivatives market, we had mandated, as early as in 2007, a transaction based reporting system for the only active class of interest rate derivatives, the interest rate swaps and dissemination of information based on such reporting. We are in the process of taking the initiative further by extending the reporting requirements to all foreign exchange and interest rate derivatives.

b. To ensure that there is no laxity in credit appraisal in case of securitisation, we have mandated that the originator of a loan asset has to hold it in its books for at least one year before securitisation and that he has to retain the equity tranche of the securities created.

c. We have introduced not only anonymous, order matching trading system for trading in government securities to improve transparency, we have also introduced central counterparty based guaranteed settlement for government securities and foreign exchange transactions.

d. We have stipulated that ratings of external agencies can complement and not substitute the internal appraisal processes for sanction of loans by banks.

e. Introduction of credit default swaps has been subjected to purchase of protection only by the holders of the reference obligation and sale only by regulated entities.

f. As early as 2005, we have used risk weights and provisioning norms for influencing the flow of funds to the housing sector and moderating excessive growth.

Conclusion

22. In conclusion, let me summarise what we have discussed. Good governance is a necessary condition for not only economic growth and development but for an easy and comfortable society where we can go about our business – confident and unruffled. Good governance is of utmost importance for the financial sector but needs to be complemented by alert and efficacious regulation and supervision so as to build and maintain confidence of the savers and the investors. We, as a nation, have begun our journey and the tryst with our destiny and we need continued confidence of all our stakeholders to reach our destination. Our responsibility towards good governance cannot be overemphasised. In this endeavour needless to mention that members of this august audience are the principal actors.