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Appreciating diversity: Regulatory reform and banking practices in the developed and developing worlds

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The regulatory structures that evolved in financial systems across the world operated to homogenise both financial institutions and their patterns of behaviour. This obviously increased the fragility of such institutions and their susceptibility to contagion. Current regulatory practices and even the proposed changes to them simply do not recognise this feature as a major problem, and therefore do not take adequate steps to counteract it. In the developing world this growing lack of financial diversity has had additional serious consequences, reducing the ability of the financial system to promote the required intermediation between domestic savings and investment and reducing the financial access of different types of firms, particularly small producers and co-operatives – in other words, reducing the capacity of the system to promote development.

1. Sameness and fragility

One of the problems with the incentive structures created by regulatory practices in the financial sector (or the lack of them), in the past decade in particular, has been the homogenisation of financial institutions. It is now widely recognised that this has been an important feature making for greater fragility and accentuating the contagion effects of any shocks to any one particular institution. As Haldane (2009, pp. 18-19) has argued,

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> "Within the financial sector diversity appears to have been reduced for two separate, but related, reasons: the pursuit of return and the management of risk. The pursuit of yield resulted in a return on equity race among all types of financial firm. As they collectively migrated to high-yield activities, business strategies came to be replicated across the financial sector. Imitation became the sincerest form of flattery.
> So savings cooperatives transformed themselves into private commercial banks. Commercial banks ventured into investment banking. Investment banks developed in-house hedge funds through large proprietary trading desks. Funds of hedge funds competed with traditional investment funds. And investment funds – pension, money market mutual, insurance – imported the risk the others were shedding. […] Management of the risks resulting from these strategies amplified this homogeneity. Basel II provided a prescriptive rule-book ensuring a level playing field. Ratings were hard-wired into regulation. Risk models blossomed, with Value-at-Risk (VaR) and stress-testing providing seductively precise outputs. Like blossom, these models looked and acted alike – and may yet prove similarly ephemeral. The level playing field resulted in everyone playing the same game at the same time, often with the same ball.
> Through these channels, financial sector balance sheets became homogenised. Finance became a monoculture. In consequence, the financial system became, like plants, animals and oceans before it, less disease-resistant."

This tendency towards herding across different types of institutions with supposedly different purposes has led to similar portfolios and similar exposure of otherwise different institutions. This is why, as noted by Persaud (2010), various risk models in use that appear to be unrelated in 'normal' conditions become highly correlated under stress. The result has been a peculiar outcome: increasingly complex financial transactions carried out by similar institutions behaving in a similar if not identical fashion.

Goodhart and Wagner (2012) note that in the absence of regulation, financial institutions are likely to become similar for various reasons. Firstly, moral hazard: banks have an incentive to undertake correlated activities because in the event of joint failure they are likely to be bailed out. Second, externalities: there is no reason for a single institution to take account of the fact that if its actions are similar to others, the overall systemic risk (of joint failure) increases – indeed, the incentive is for individual institutions to behave similarly to the others. Third, the herd

behaviour of financial managers reflects both this structure of incentives and the imperfect and or asymmetric information that is characteristic of financial markets. Finally, financial institutions generally have a tendency towards entanglement, with interconnections and cross-insurance that tend to generate correlated failures.

Openness and diversity imply the co-existence of different institutional forms that are made sufficiently strong to withstand the competitive struggle in which different forms of organised banking activities compete with each other (Ayadi, 2010). In Europe, two different approaches to encouraging banking diversity have been evident. One, which owes much to the Anglo-Saxon trans-Atlantic model, emphasises shareholder value as the model for banks to follow and is characterised by highly innovative, complex instruments, high levels of risk and strong profits, undertaken by banks behaving in largely similar fashion. In the other model (more evident in Germany, Austria, Italy, France and the Netherlands) institutions based on shareholder value exist, but alongside them are stakeholder institutions (such as co-operatives and savings banks) that that go beyond profit motivation to also strive to bring value to the community they serve. This in turn also turns out to provide a better cushion against financial stress in bad times.

The 2008-09 crisis was a test for financial institutions, in Europe and elsewhere. Those that survived tended to be those that remained closer to their traditions and their core business, and more likely to employ bottom-up models of governance that allowed for close relationships with their customers. Particularly, both co-operative banks and savings banks that did not conform to universal banking models were found to have played important roles in this regard.

Co-operative banks in Europe have been found to be able to survive well even in a competitive market environment, and responded to shifts in market developments while fulfilling the integral role of contributing to stability and regional growth in their economies (CEPS, 2010a). The function of contributing to financial stability in uncertain times was particularly evident in the recent and ongoing crisis, but was dependent on the extent to which the co-operative banks stuck to their original purpose and patterns of lending and refrained from entering into more

risky but potentially more profitable activities. Thus, according to Ayadi (2010),

> "The Italian cooperatives remained unharmed, with high capital positions of more than 8% of Tier 1 ratio, because they resisted the temptation to hold '*once*' highly profitable toxic assets. Equally, the Dutch Rabobank, came through the storm in an even stronger position than before without the support of any public money. Conversely, France's three cooperative groups recorded significant losses originating from their investment arms, forcing them to accept several billions of Euros in public funds. The Austrian cooperatives met a similar fate due to their risk exposure in Eastern and Central Europe."

Similarly, a CEPS study of savings banks based on case studies on the national savings bank systems of Spain, Germany and Austria concluded that

> "[…] the crisis has made it even more evident than before how valuable it is to promote a pluralistic market concept in Europe and, to this end, to protect and support all types of ownership structures without abandoning the principle of 'same business, same risks, same rules'" (CEPS, 2010b).

The study found no significant differences between savings banks and their commercial peers in terms of profitability, efficiency and earnings stability, even as savings banks contribute to a reduction in social exclusion and offer wider access to financial services. In addition to the benefit of enhanced competition in the financial system, institutional diversity was found to have positive and significant effects on regional growth, owing to the local focus of most savings banks. As a result, the study found that

> "a financial system based on a mixed ownership structure, and which includes a significant savings bank sector, is likely to be inherently more stable and less crisis-prone than one populated exclusively by shareholder value institutions" (*Ibid.*).

2. Additional concerns for developing countries

While all of these concerns with respect to enhanced financial fragility resulting from the homogenisation of financial institutions are

equally relevant for developing countries, there are some additional concerns for such countries. Most of all, such homogenisation enhances the specific problems of development finance and increases the difficulties of ensuring that financial institutions encourage financial widening (rather than often unnecessary deepening) and cater to the requirements and interests of small producers and those who would be outside the reach of formal finance.

Development finance institutions are those usually tasked with financing the sectors of the economy where the risks involved are beyond the acceptance limits of commercial banks. They are mainly engaged in providing long-term assistance, and directed towards meeting the credit needs of riskier but socially and economically desirable objectives of state policy.[1] Besides providing direct loans, these financial institutions also extend financial assistance by way of underwriting, direct subscription and by issuing guarantees. As pointed out by Chandrasekhar (2010) they lend not only for working capital purposes, but to finance long-term investment as well, including in capital-intensive sectors. Because of this longer time horizon, they also tend to be more closely involved with investment and production decisions in various ways, as well as monitoring corporate governance and performance on behalf of all stakeholders.

The need to provide finance to neglected sectors and areas in turn means that standard prudential regulations may be unduly constraining and prevent the development banks from fulfilling their desired functions. This does not negate the need for other instruments and mechanisms to ensure that the interests of all stakeholders are adequately served by such institutions: as Chandrasekhar (2010) notes,

> "[…] there is always the possibility that lending to projects that are neither commercially viable nor socially profitable may occur for reasons other than errors of judgment. Governance mechanisms to ensure transparent procedures, adequate disclosure and participative monitoring involving oversight by democratically elected bodies are crucial."

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[1] Unfortunately, in several countries including India, these functions of development banks have been undermined by moves to transform development banks in to universal banks, which then behave like commercial banks with similar profit orientation and lending patterns (RBI, 2004).

The concerns that exist for development banks in general are particularly pertinent to sector-specific banks such as agricultural banks, housing banks (particularly those that are oriented towards the provision of housing for poor and middle class purchasers) as well as those catering to small enterprises and community development banks. Standard prudential norms can be counterproductive in preventing such institutions from exercising their required functions. Incentives generated by regulatory structures may operate to shift such institutions away from their primary focus and towards more explicitly profit motivated or more risky activities. Regulators need to have different approaches (and different criteria for monitoring and supervising) different types of banks.

The case of microfinance is more complex and requires special attention. A common tendency in recent approaches to financial policy is to treat microfinance as a substitute for the greater extension of institutional finance (so formal finance is for the rich or for companies, and microfinance for the poor or for women). It is important to remember that in its very design, microfinance is *not* the same as financial inclusion ensuring access to institutional finance. While the focus on group lending does allow for financial integration in the absence of collateral, the high interest rates, short gestation periods and (increasingly) coercive methods used to ensure repayment mitigate against its usefulness in poverty reduction and asset creation by the poor, even though it does typically play a role in consumption smoothing. Proper financial inclusion into institutional finance may require some forms of subsidy as well as a creative and flexible approach on the part of the central bank and the regulatory regime, to ensure that different banks (commercial, co-operative, development, etc.) reach excluded groups like SMEs, self-employed workers, peasants, women and those without land titles or other collateral. A secure savings function for the poor in particular is also important and may require deposit guarantees on deposits in community banks and savings banks, as well as other measures.

3. Policies and regulatory practices for greater diversity of financial institutions

The homogenisation of finance that has dramatically increased the proclivity to instability and crisis is directly related to the very structure of regulations that have discouraged different types of institutions from emerging and/or and surviving. In developing countries they have the further limitation of preventing the necessary variation of financial institutions that is required for financing development and enlarging the spread of and access to institutional finance. The rules that apply to commercial banks or investment banks cannot and should not be applied to development banks, savings banks or co-operative banks. This is why O'Connell (2011) has argued that "[…] regulations should be built around an 'un-level playing field', contrary to say Basel I and II practice that emphasised a level-playing-field that precisely encouraged the loss of diversity."

Diversity in the financial system can and should be encouraged at several levels and through several means. In particular, some areas that central banking operations and systems of financial regulation need to focus on are the following:

- Encourage or require financial institutions within one overall system to specialise in different kinds of activities rather than all of them engaging in the same kinds of activities.
- Reduce or eliminate the convergence of risk management systems across different financial institutions, by emphasising different ways of modelling risk not only according to the type of financial institution, but also across similar institutions (e.g. commercial banks or investment banks).
- Encourage the creation and expansion of development banks that are subject to different regulatory requirements than normal commercial banks.
- Ensure that sector-specific banks and client-specific financial institutions are operating under prudential norms and other regulations that are sensitive to the specific conditions under which they operate (e.g. agricultural banks, co-operative banks).
- Create and develop national networks of community development banks that meet the needs of financially underserved communities, along the lines proposed by Minsky *et al.* (1993), that will allow for cross-

subsidisation of activities and the development of synergies across institutions.

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