The Role of Regulation in Economic Development

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Mr. Dinesh Kumar Khara, Chairman, State Bank of India, Mr. Biswa Ketan Das, CEO, Indian Institute of Banking and Finance (IIBF), senior officials from Reserve Bank of India, from the State Bank of India and the banking fraternity, ladies and gentlemen, it is doubly humbling for me to be chosen to deliver the 13th Shri. R. K. Talwar Memorial lecture.

First, it is an honour and an exercise in humility to be able to speak about a distinguished son of India at a lecture instituted in his honour. I have first heard about him from Mr. Vaghul when I was briefly associated with Krea University. He has spoken a lot about Mr. Talwar and how he learned a lot from him during his earlier years in banking. It is often said that in the long run, institutions shape individuals. But people like him were the exception to that rule. Individuals like him shape the institutions, not only of the institution that they headed, but they also inspire other institutions in the process of their functioning. It is not that they go out of the way to do this. It is the intrinsic nature of their personality that brings about this transformative change. I know that, in fact, more than me, almost all of you present here would know the signal contributions he made to the field of banking in India with respect to the analysis of corporate sector when it comes to banking decisions. The initiatives he took to encourage SME financing in the country and launched several new schemes to support small entrepreneurs, businessmen and farmers etc. The list is endless. So, in that sense, it is a very important privilege and I am deeply grateful to IIBF and State Bank of India for having chosen me to deliver this lecture. The second reason to be humble about is that I am following the footsteps of very distinguished speakers, starting from Dr. Shri Rangarajan in 2007. Therefore, I fully understand the responsibility that rests on my shoulders as I begin to speak on the topic that I have chosen today.

It is normally understood that regulation is a response to market failure. I personally believe that is an incomplete statement, even though it is not wrong. Sometimes the very nature of markets requires the inevitable presence of regulators and regulation. So, regulation is not a response only to market failure. Sometimes regulation is indeed a response or a complement to markets themselves. It is a response also to growth and scale.

I heard from a philosopher that progress for humans is their innate ability to complicate simplicity. Therefore, the very development of scale and complexity requires regulation because as things become complex, the inherent limitations of humans come to the fore and it requires some amount of supervision and policing to happen. So regulation is not just a response to markets themselves, market failures, but also to growth, growth in scale and complexity, because as activities explode and become interconnected, we need order to make it flow smoothly and take place

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without too much friction. The need for regulation, therefore, arises as the economy grows in size and with the rate of growth and with the rate of complexity.

As Mr. Khara pointed out, today we are on the cusp of becoming the top three largest economies in the world. Moreover, the scale of financing that we would require to make this growth translate into a difference in the lives of ordinary people means that regulators have to ensure that the growth of the industry, for that matter, any industry, serves the ultimate purpose of making a difference to the lives of the ordinary Indians. Apart from these, regulation is also response to human nature. Are we good at self-policing? We do need the MC (Master of Ceremonies) of every event to tell us to put our phones on silent mode. At the same time, no MC can tell us not to keep looking at our screen every 32 seconds. It has become a part and parcel of our daily existence and behaviour. And humans in general are not very good at self-policing.

We need external incentives, inducements and even disciplining devices to keep us on track with respect to our own chosen behaviour. Therefore, we have to usually find ways to let others hold us to our resolutions. Whether it is on simple matters like weight loss, smoking, alcohol consumption or something as complex as financial sector regulation, we do need an external agency to enforce certain things that are desirable in our own interest.

There is a third dimension to regulation. In general, in the marketplace and that too, in a large country like ours, literacy levels are still in catch-up mode. The relative power of the sellers and producers versus the consumers is often tilted in favour of the former i.e. the sellers and producers. This imbalance is rectified by having the state or the regulator take the side of the consumer, protecting their interests and rights. Therefore, regulation has this important consideration in its favour. Of course, in reality, there is the political economy as well, which doesn't necessarily keep the balance between sellers and producers on one side and the public and the regulator on the other side. The scales are not often evenly balanced and political economy usually tilts it in one direction or the other.

So, I believe I have spent the last few minutes successfully in establishing the principle that regulation is necessary and not a necessary evil. But then it becomes a matter of detail with respect to execution, as always, the devil or the angel is in the details of implementation.

If regulation is indeed inevitable, how do we get it right? And how do we do it right? Let me break it down into two parts- regulation in the financial sector and regulation in the non-financial sector. In the financial sector in particular, given the audience that I am facing, the importance of regulation doesn't even have to be established. It is a given, because at times of failure, like, for example, what happened with the Silicon Valley bank last year and for that matter, in previous episodes of crisis, when the industry goes through periods of stress and failures, public or lawmakers usually turn to regulators and ask the question, "What were you doing?" In fact, it is somewhat amusing and instructive to know that the public and their elected representatives hold the regulators sometimes more responsible than the managements themselves for such institutional failures. So that establishes the necessity of regulation.

Second reason, when financial institutions fail and I am not speaking in particular about India, but more in the global context, they do run to the public sector to help bail them out. And we know that, in the global context, if not necessarily in the Indian context, rewards to risk taking accrue to the private employees and executives of financial institutions and the adverse consequences of failures usually end up on the tax payer. So, it is often said that while the rewards are privatised, the costs are socialised. And given that, therefore, the moment public money gets involved in bailing out or rescuing institutions, it goes without saying that a Government, that is the last resort when institutions fail, also naturally acquires the right to regulate the industry's conduct, so that, such bailout situations become at least infrequent if not absolutely unnecessary or impossible. And that is the reason why in the financial sector we don't talk about need for regulation at all because the principle or premise is established beyond doubt.

The question, therefore, that arises once we accept this basic premise "Should regulations be principles-based or prescriptive in nature?" It is easy given the way the question is posed; it is easy to plum for the former, that is, regulations should be principles-based. But there are some dangers, especially in finance often and I, myself have spent nearly a couple of decades in the financial services industry and I know that the industry can and does run rings around principles-based regulation. It is subject to interpretation, when regulation is largely principles-based. Whether a principle is violated or not is equivalent to the idea of beauty being in the eye of the beholder. In other words, when regulation is structured on the premise of the largely being principles-based, it gives a lot of freedom to the regulated entities to behave responsibly. In that sense, freedom goes with the responsibility because principles-based regulation gives more rights and freedom to the regulated.

In general, in households, children get more freedom if they can demonstrate, at the minimum, no self-harm, isn't it? Therefore, in the case of finance as well, the industry can and should get more freedom if it demonstrates not only no self-harm but also no social harm. But, what about the regulators? What is it that we need to enjoin upon them? Just as humans in general are incapable of self-policing, there is a tendency also on the part of regulators to engage in excess policing. Both tendencies exist. I am sure many of you have heard of the Stanford experiment. A bunch of people on the street was picked up for an experiment. They didn't know each other. Some of them were given the roles of policemen, some of them were given the role of defendants or accused. They were ordinary people. There was no crime that they committed. They were participating in an experiment. But the very idea that someone was given the label of a policeman and someone was given the label of a prisoner, automatically conferred on the people who were labelled the policeman a certain right not only to question, but also to intimidate and even go to the extent of torturing some of the other participants in the experiment so much that the experiment had to be called off for physically endangering the lives of the some participants in the experiment.

So, humans are susceptible to letting labels define their behaviour rather than letting labels only describe their behaviour. Because we allow labels to define who we are, there is also a natural tendency on the part of the regulators from time to time to engage in excess policing. And, it is a rule of human behaviour across centuries over time and across geographies that where there is concentration of power, those enjoying it usually succumb to the temptation of exercising it too much and too often as well. But, in our country there are very good counter examples where regulators have taken a pre-emptive and proactive role rather than abusing the powers vested in them. Let us take the very recent example of the higher risk weights that were enjoined upon the bank for the unsecured personal loans. It is a case of avoiding excess regulation by taking a pre-emptive action so that the need for regulation is actually minimised. And, many of you, I am sure are aware of the stellar role that the Reserve Bank of India played before the 2007-08 financial year crisis. Very well captured in a speech that Dr. Y V Reddy delivered in Manchester, if I am not mistaken, in June 2008, where many pre-emptive actions were taken, which actually prevented regulatory failures. So, in our country we do have good examples of where power vested in the regulator has not often lapsed into excessive policing. In general, principle based regulation is something in the case of this risk weights or personal loans, if you try to apply this example, it would have simply been that excessive growth in unsecured personal loans be avoided. That would have been an ideal example of principles-based regulations. But, then who gets to define what is excessive growth? In other words, it is unavoidable that one has to get down to the details, so one cannot stop at the level of principles. Therefore, the Reserve Bank of India did the right thing; it did not try to define what normal growth is or what excessive growth in unsecured personal loans is. It simply took note of human behaviour and its response to incentives and put up guardrails in the process. Just increase the risk weights, which is exactly what Dr. Reddy did back then for several unsecured loans and also with respect to the incentives for securitisation. He made sure that the incentives for securitisation were paid only after the securitised structures were wound up, not when they were started. That very simple, but important tweak, ensured that the kind of securitised mortgages that failed in the western world did not afflict India.

In other words, if you are taking chances, take precautions. Unsecured personal lending is obviously a risky enterprise, which is what banks are meant to do. But, what the RBI did with respect to raising the risk weights is that if you are taking chances, as you must, take precautions in such a way that losses do not hurt you, nor the society. This is an example of the right proportion of the principles and prescriptive regulations. Can this balance be struck in all aspects of financial regulation? Of course, there is a feeling that it remains a work-in-progress at best and at worst; there is a tendency to micromanage. That is the public perception. Can the temptation to be prescriptive be resisted in areas where the risk of self-harm and social harm is trivial? Regulators must ponder about that question. Can we, therefore, choose between these two modes of regulation depending on the assessment of where the social harm is? That would be a guiding principle from a regulatory standpoint as well.

This is where I believe the honourable Finance Minister's announcement in the budget for FY24, presented last year about a zero-based review of regulations, becomes relevant. The kind of regulatory spring-cleaning is also necessary. It is important to clear the regulatory deadwood, both in terms of rules and practices, just as we do in our homes. Once in a while, you need to take a look at the inventory that you might have accumulated in terms of various circulars, notes, etc. and make sure that they remain relevant or redundant to the times that keep moving on.

But, having said that, let us spare a thought for the regulators. They start with a handicap, in the battle for hearts and minds. It is easy to cast them as bullies by default, since they have authority and wield power. And there are certain things that they cannot speak up in public. Because, if they speak up it would tantamount to shouting, "fire" in a crowded theatre. So, therefore, regulators start with a handicap in the battle for the hearts and minds of the public. And, also for the public servants as well.

It is easy for those who are pulled up by regulators or penalised or punished by them to cast themselves as underdogs. And, it is important that when we analyse and evaluate the actions of the regulators, we must keep this imbalance of public perception and power between the regulator and regulated in mind; when we easily cast doubts on the necessity of some of the actions that regulators take.

Let me now turn to the non-financial sector, where the scale in fact, should be more tilted towards the side of the principles-based rather than prescriptive regulation.

Just to reiterate, in the case of financial sector, I am not in favour of the belief that one should always be focussed on principles-based regulation. It is a judicious mix of the two that is required. But, when it comes to non-financial sector, it is more likely that we should err on the side of the principles-based regulation rather than prescriptive regulations, since systemic harms from the practices of regulated entities are relatively less likely than in the case of the financial system. Actions taken in the financial system by the market participants have the risk of infecting the entire economy. In fact, it is the big difference between the financial sector and the non-financial sector. In the financial sector, if one institution fails, the entire system becomes fragile. In the non-financial sector, if one institution goes down, it actually strengthens the rest of the institutions that are still alive. The contagion effect is usually missing, so it is a welcome thing for the remaining market participants; whereas, in the financial sector, as one institution fails, the public starts questioning on the health and the practices of the other financial institutions. That is what makes the case for regulations in financial sectors to be different from the regulations for the non-financial sector.

But, unfortunately in our country, right now, as we speak, regulations even in the non-financial sector, seem to be erring more on the side of being prescriptive rather than principles-based. And, therefore, that makes compliance costs very high for businesses, especially Micro, Small and Medium enterprises. Much has been done in the last decade to improve the situation by the focus given to the ease of doing business, decriminalisation of laws, rules and regulations, self-certifications, etc. but much remains to be done. The burden of compliance falls disproportionately on those who are least equipped to comply with them – low-income individuals, sole-proprietors, micro and small businesses.

I have personally done a case study, five years ago, on a women's collective based in Thiruvannamalai, down south in Tamil Nadu. That particular women's enterprise having a turnover of about two crores, not more than that, comes under Drugs and Cosmetics rules, Drugs and Cosmetics Act rather and I had an opportunity to go through it in detail. The Drugs and Cosmetics Act prescribes the square feet, the space that the businesses need to dedicate for receiving inventory, the raw material inventory, the space that needs to be allotted for finished goods inventory etc. Now, that is a decision that the entrepreneur has to make, the amount of space they allocate for raw material storage, for finished goods storage, depending on rental cost, depending on their sales volumes etc. and production capacity. The legislation need not have to get into such details, prescribing floor space for businesses. Therefore, in a micro and small enterprise where the management bandwidth is usually very small, it is disproportionately allocated or dedicated towards compliance rather than business development or human resource management, etc. So in that sense, there is a lot of work that remains to be done in the country, both at the national level and at the subnational level, for regulations to become more principles-based rather than prescriptive, especially when it comes to the non-financial sector.

Also, I would love to leave one more question for the regulatory framework. When it comes to the non-financial sector, it ought to be a function of the objectives and the national economic goals that we wish to pursue. The question in front of regulators is this - Is the goal, given the state of development of the country, given the state of per capita income of around $2,500 as we aspire to go towards middle income status, where it is somewhere between $5000 to $11,000, therefore, given this, should the objective function of regulators be- one of the following two - Should it be maximizing economic activity subject to zero non-compliance or minimizing the non-compliance with rules and regulations subject to maximum facilitation of economic activity? These are two different objective functions. One cannot at the same time optimize both, just as you cannot minimize both type one and type two errors. And you have to choose. In quality control, you know what to choose. If you are a very consumer-oriented company, you will obviously err on the side of ensuring that you would not mind one good quality product unit being set aside, but you would not want even a single defective product to reach the consumer. It is like in jurisprudence saying that we may let some guilty people escape the rule of law, but we will never convict an innocent person. So, there is a choice that is being made there.

Similarly, when it comes to regulation and compliance, we have to make a choice. Do we want to ensure that not a single person escapes the rule of law? But in the process, we will not mind putting to harm and inconvenience other innocent businesses and people? Or do we choose the alternative, which is, that I will ensure that 90% of the population, which is largely compliant and law abiding, to be able to pursue their economic activity unhindered and I will not mind letting five or ten escape the rule of law because I am more focused on ensuring that economic activity proceeds unhindered. What is the trade-off? I think that trade-off, that question, has not been fully grappled with or addressed in the context of the regulatory framework that this country needs to have, because both cannot be done at the same time. Governments across the country, not at the national level, but also at the subnational level, must make this choice.

Until now, in the first 75 years of independence or more, we have tilted towards the first objective function, which is we maximize economic activity, but only subject to zero non-compliance, which also gives rise to lot of other adverse consequences such as rent-seeking, etc. But given the country's growth and development aspirations, there is a case to be made for the second objective function to be chosen, which is that we minimize non-compliance, but subject to maximum facilitation of economic activity.

Once this objective function is set and articulated, then it has to be reflected in the governance of regulatory institutions. That means it has to be reflected in the policies made, decisions taken and implemented as well. It means there has to be accountability for governance and that boils down to how public servants are evaluated and appraised for their own compliance with this objective function.

In other words, the regulation of state administration and governance becomes an important task in itself. If this framework is not in place and not followed, then the state will be failing to regulate itself and naturally, it will not be able to regulate non-state actors effectively, as a consequence.

In the final analysis, if the state and its organs can-not regulate themselves, then they can-not regulate the economy efficiently and effectively. Last, but not the least, related to state capacity for regulation, is the question of state capability. How well trained and capable are our regulators with respect to microeconomics - the theory of firm, price-setting behaviour, theory of competition, etc. What are the microeconomic foundations in our undergraduate courses and in the various foundation courses in Lal Bahadur Shastri National Academy of Administration? Of course, this opens up another strand of discussion with respect to regulatory environment in the country - on the need for specialists versus generalists and the length of tenure that civil servants need to have to acquire specialization skills, not just be generalists. Because the economy, as it grows in complexity, we need to ask ourselves fundamental questions as to whether the current structure has served us reasonably well. After all, we were an economy of $300 billion in 1993 and today we are a $3.4 trillion economy, poised to become $3.7 trillion by the end of March 2024. So we have grown more than twelve times in dollar terms, despite rupee depreciating almost 3% every year on average. So we have done very well.

And in fact, many of you will say, or may be thinking as I speak, we might have become a $3 trillion economy, but China that started out at the same time has become an $18 trillion economy. I would simply like you to go back to your computers back home in the evening and divide the nominal GDP by the amount of debt that both the economies carry and figure out what is the per unit of GDP for one unit of debt that India has, compared to China, for example. And, by that metric we have done quite well. So the point is, the structure that we have today has served us quite well, by and large.

But it is always necessary, essential and desirable to ask the question, whether this structure should be evaluated, examined and reviewed for its suitability for the kind of economy that we will likely have going forward with the invasion of artificial intelligence, other forms of technology and climate considerations coming in the way of our economic development and growth aspirations? What is the right mix of generalists and specialists, both in the administrative functions and in the regulatory functions? I know that this is a different topic for a different occasion, but the concept of the role of regulators in economic development is that, while, as I laid out at the very beginning, regulation is necessary and desirable, ultimately the regulatory structure, its functioning, performance and effectiveness also have to be periodically reviewed for it to remain contemporary, purposeful, if it were to not lose sight of the ultimate goal for a developing country. And that is that the living standards and aspirations must continuously make progress and that future generations should feel that not only do they have a life, which is better than their preceding generations, but also their own future generations will have a life better than what they have.

I hope I have left some thoughts with you to ponder about and once again, I thank IIBF and State Bank of India for giving me this opportunity to join a galaxy of very extraordinary personalities who have delivered this lecture and for me to be able to share my thoughts with all of you. Thank you very much.