The Resource Centre

The Indian Express

Date: 30/05/2014 Page No: 12 Location: Main Circulation: 110000

Edition: Mumbai

Banking on ourselves

What we must learn and unlearn from the West's financial overhaul

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INDIAN banks have unfortunately been in the news for the wrong reasons. While it is easy to scapegoat them, the current situation is actually the result of multiple factors. As a result of the financial crisis, the global financial system is under intense scrutiny. It is appropriate to examine the issues and possible policy directions for the Indian banking system while recognising our developmental imperatives and that we function in a globalised world. And while we learn from the financial crisis, we must also understand that crises recur at regular intervals. Over-enthusiasm to solve the problems that caused the last crisis may do more harm than good.

A brief examination of the cause of the crisis is in order. Over time, we moved from a highly regulated commercial bank-centred system to a complicated, highly engineered system. Much financial intermediation started taking place in markets beyond official oversight, and involved highly opaque engineered derivative instruments. The complexity, opaqueness and systemic risks embedded in these markets have still not been understood fully.

At the heart of the problem is the inherent risk involved in financial intermediation, whereby those who need funds get them through an intermediary or the market. The providers of funds insist on safe, highly liquid outlets for their money. Reconciling these requirements involves risks — credit, maturity and liquidity. Managing these risks was once the role of commercial banks, savings institutions and insurance companies, which were subject to regulation and had a safety net — the central bank. But in the new paradigm, intermediation is the domain of the open market. The general idea is that risk can be minimised by unpacking institutional relationships, separating maturity and credit risks, and creating instruments that would meet the needs of people willing to absorb these risks. The rationale was to encourage better pricing and distribution of risk. While this is efficient in theory, in practice it creates unimaginable complications.

The principal gatekeepers in the new paradigm were the rating agencies. But mathematical modelling and drawing inferences from the past to anticipate unexpected events are flawed. A combination of herd behaviour, opaque loan characteristics and the breakdown of market functions at times of crisis requires a reassessment of market participants and their functions.

Globally, regulators agree on the need for reducing leverage, better asset liability and systemic risk management, and oversight. However, a financial system should be a reflection of the real economy. Therefore, while globally, the overall regulatory architecture is moving in the right direction, countries need to be careful in their implementation of the new regulatory system.

The Indian financial system needs to have the sophistication of developed markets while having a base to meet the needs of small businesses, farmers etc. It is asked to do the job of debt markets and banks, and also play a developmental role, which is a tad difficult.

It is clear that for the immediate future, commercial banks are going to remain the bedrock of our financial system. Their orderly development is going to be critical. Given the dominance of our commercial banks, due to which most market-related risks passed us by, we need to examine whether we really need tougher-than-Basel III norms. There is no doubt that we need to improve credit, maturity and liquidity management, but having higher capital adequacy norms than what is globally prescribed could create issues for return on equity (ROE) and capital requirements without making the system more secure. Currently, regulation requires banks to maintain capital adequacy ratios that are between 60 and 90 basis points above international norms.

Additionally, though Indian commercial banking is highly competitive and, in fact, some services are priced below prudent levels, we seem to be further reducing legitimate charges through regulation which will impact the ROE. Government borrowing also strains the system. Requirements related to the statutory liquidity ratio (23 per cent), cash reserve ratio (4 per cent), priority sector lending (50 per cent) etc, increase the cost and reduce availability of funds. Importantly, the government owns 70 per cent of the banking system and several issues related to this need to be viewed afresh. Unless we revamp this sector, we will not be able to alter the market. We also need to revamp the legal system — recovery cases must be dealt with speedily and a Chapter 11-style bankruptcy law must be passed. Pending the development of debt markets, if banks are expected to meet the requirements of long-term project borrowings, we must exempt such debt from SLR and CRR requirements so that costs to borrowers can be brought down while the viability of the banking system is maintained.

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There must be some fundamental problems with the development of debt markets as we have not made much progress over the last 20 years. Perhaps baby steps will not work and we need comprehensive regulations and appropriate market conditions for its development: a liquid and efficient sovereign bond market with an arbitrage-free rupee yield curve, a liquid spot market for rupee-denominated corporate bonds, credit derivatives and bank guarantees for project debt to help encourage institutional investment, and a wide range of essential derivatives on rupee interest rates (do not throw out the baby with the bathwater, all derivatives are not bad).

As far as the equity market is concerned, we have done a reasonably good job. The only issue is that we need more local institutional and retail participation to reduce FII dependency, which leads to volatility and scares retail investors. Similarly, a comprehensive examination of mutual fund regulations, tax laws, capital protection schemes etc is also urgently required.

On the issue of financial inclusion and access, political, economic and social necessities, we need to make substantial improvements. Access refers to every citizen's ability to open a bank account. The primary purpose of this is to inculcate a banking habit in people, make direct benefit transfers possible and create credit histories. Banks have done a good job on this so far and can probably do even better if their demand for being compensated by the government for work taken over were met in a fair and professional manner. Financial inclusion, on the other hand, means making a person financially viable on a sustainable basis. Simply distributing subsidies and loans without helping people use them productively does not lead to sustainable improvement.

While the need for intermediation remains, restrictions are causing the business of intermediation, exchange and payments to move to unregulated or lightly regulated entities. Regulators seem comfortable with this, thinking that there is no leverage and therefore no systematic knock-on effect. This premise is unlikely to hold once the scale of these operations overshadows the banking system and there is an event risk. Ultimately, the game is the same: savers, lenders, intermediaries and investors are desperate for higher returns. It'll be like deja vu when things go wrong — while there is no leverage, the last person holding the fund takes the hit. We have to be careful of the disproportionate rise of loan sharks, pay-day lenders, private equity, Paypal, virtual wallets and asset managers.

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