

Indian Management

The Journal of the All India Management Association

Vol 44 Issue 12: December 2005

A New Currency for Change

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There is need to revamp the financial and banking system. A roadmap ahead.

The Indian financial system is not really discharging its responsibilities. Behind the brave talk and intellectual rhetoric, the fact is loans are not going into those sectors of the economy where they should be going. This is as much due to the lack of risk taking, as of an unimaginative regulatory framework. Both regulators and bankers need to display a new mindset to correct the state of affairs.

Global outlook

The¹ global banking system faces new challenges in the coming years. During the past 15 years or so, the focus of regulators and policy makers has been mostly on the ability of the financial system to sustain shocks. Consequently, considerable importance has been attached to capital adequacy.

Today, many of the world's biggest banks look healthy, with plenty of capital and a good profitability record. A major reason is that they have successfully passed on some of their risks to other players like hedge funds, private-equity firms, insurance companies and pension funds. These entities are prepared to assume such risks as they are under pressure to provide improved returns to their investors. In view of their reduced risk, there is a growing feeling that the regulatory capital banks hold may be excessive and could be better employed elsewhere.

At the same time, today's complex financial system, which resembles a biosphere, consisting of governments, banks, securities firms, corporate treasuries, insurance companies, pension funds, mutual funds and householders poses new challenges for regulators.

When financial risks are passed on or "managed" away by one bunch of risk-takers, they are borne by another bunch of risk-takers elsewhere in the system. In the past 20 years, banks have become good at "unbundling" risk, especially credit risk, which has historically, been the main cause of most bank failures. Banks would increase their lending at the peak of a business cycle and then be burdened with non-performing loans through the next credit crunch. Now many banks have got rid of credit risks but these risks have resurfaced in the portfolios of insurance companies and pension and mutual funds. At the same time, new kinds of risk are becoming more important. That is why Basle II, the new risk management framework being developed by the Bank for International Settlements, has paid so much attention to operational risks.

Unfortunately, few regulators have a sufficiently broad vision of what the financial system is all about. They are not paying adequate attention to the full financial ecosystem consisting of savers, retail banks, investment funds, borrowers and issuers of debt, capital markets, pension funds and insurance companies.

In the past, crises have happened because of the obsession of regulators with banks and their inability to take a more holistic view of the financial system. Take the collapse of the celebrated hedge fund, Long-Term Capital Management (LTCM), which had around 20,000 outstanding derivatives contracts with 75 different counterparties. One of the problems, identified by the US Government Accountability Office (GAO) in a report after the crisis, was that "regulators continued to focus on individual firms and markets but failed to address interrelationships across industries." More coordinated regulation might have spotted a systemic risk earlier.

Whatever be these challenges, in countries like the US, the financial system has become sufficiently sophisticated to price risk effectively. So funds are available at a price even to young entrepreneurs without a track record. For example, many young engineers in Silicon Valley, have succeeded because of the availability of venture capital. Google is a recent example. Venture capital is an expensive source of funding. But the important point to note is that it is available to people with new ideas. In countries where venture capital is not that easily available such as Germany and Japan, the financial system has not been very helpful in promoting entrepreneurship. In most emerging markets including India, many deserving entrepreneurs simply do not have access to the formal financial system. Absence of risk taking, unimaginative regulation and breakdown of the risk pricing mechanisms explain this state of affairs. As we mentioned earlier, a new mindset is needed to ensure that funds go to the right areas to boost productive activities.

Indian scenario

In the light of these global trends, it is interesting to review the banking scenario in India and the challenges the banking system faces today. These challenges are obviously different from those which developed countries like the US face. Yet, over time, our financial markets will become more and more sophisticated and increasingly resemble those in the west. That is why we must be careful at this stage of liberalisation to ensure that we encourage risk taking and innovation within an appropriate regulatory framework. We must also appreciate that our financial system is largely bank driven, not capital market driven. In view of their critical role in boosting economic growth, banks must not abdicate their core responsibility, which is to channelise savings into productive investments.

Notwithstanding the hype about the deregulation of the Indian financial system, the RBI remains a central figure, playing a paternalistic role. Even Alan Greenspan, the governor of the US Federal Reserve would be envious of the kind of media attention the RBI governor gets in India and the superstar image he and his senior colleagues continue to enjoy. You can see them with a smug smile on the front pages of business newspapers every other day. No seminar on finance is complete unless one of them is invited to speak. At a recent seminar in Hyderabad, there was a panel discussion on Microfinance, featuring two speakers from the industry and two from the central bank. The central bank representatives spoke for about one hour, giving a scholarly account of how they were evolving a suitable policy framework to serve the industry

better. The industry representatives got about 20 minutes, in which they had to make a hurried presentation to explain the problems they faced. So much for RBI's liberalisation, deregulation and responsiveness to industry needs!

A tinge of complacency, sometimes bordering on arrogance is also evident in RBI's pronouncements, especially while claiming credit for having kept India out of the financial crisis that swept Asia in 1997-98. There is no doubt that contagion from such a crisis might have cost India up to 15 per cent of GDP over the following few years, as in Thailand and Indonesia. But RBI's cautious approach in undertaking more drastic reforms may now be having unintended consequences. According to a World Bank estimate, the cost of failing to liberalise the banking sector may be as high as two per cent of GDP per year. In short, behind the brave and intellectual rhetoric of our central bank, what is lacking is common sense and flexibility. In the absence of these essential ingredients, the pace at which the financial system is being reformed, is far too slow.

Structural problems

Any serious student of our financial system would realise that the seemingly good financial health of the Indian banking system hides structural problems. Up to 40 per cent of the assets of public sector banks are invested in government bonds and other state-guaranteed instruments, way beyond the statutory liquidity requirement of 25 per cent.

At one point of time in 2002, banks were buying government bonds with tremendous appetite. Nearly 45 per cent of the funds at their disposal were used to buy the bonds that the government was selling to finance its deficit. When RBI started cutting interest rates and the prices of the bonds soared, they made huge profits. Some of these profits were used to write off bad debts.

The current situation with regard to lending can be summed up in one sentence. When they can play it safe by investing in Government securities, why should public sector banks lend to small and medium enterprises or poor rural clients who are perceived to be risky? With capital adequacy norms being tightened further in view of Basle II, further shifts are likely to take place in the deployment of deposits in Government securities and other investments that carry very low risk weighting. This kind of an approach makes a complete mockery of banking. Terms like 'lazy banking' have been coined to describe the state of affairs.

While the loan portfolio of private sector banks is expanding, as mentioned earlier, most of their loans go towards financing housing and consumer durables. Not only are the spreads in the case of such loans attractive, but also the risk involved is minimal. That explains the credit card boom where the interest rates on outstandings can be easily two times or more than what banks pay to customers on their fixed deposits. That also explains the housing loan boom where despite lower spreads, the prospects of locking a customer over a long period of time with big ticket loans are mouth watering.

These structural problems have risen partly because of the unintended consequences of the central bank's substantial reduction of interest rates in the past 15 years. Low interest rates have made banks reluctant to lend to anyone who presents the slightest risk. The best way to deal with higher risk is to charge a higher interest rate. But with interest rates ruling so low and an informal cap existing on the lending rate, the only

way to deal with risk is to deny loans to such customers. The situation is very similar to that in power. Politicians promise free power to farmers. But what happens when power is free is that it is simply not available in the quantity needed and when it is available, severe voltage fluctuations make it difficult to operate pumps. It is good economics to let the market arrive at the right price and ensure that the good or service is available rather than keep a price ceiling which leads to inadequate supply.

Providing finance where it matters

It² has been estimated that some 92 per cent of Indian businesses do not have access to bank finance today, because they are considered too risky. Most of these are obviously small scale units. Similarly, a recent World Bank study, reports that 79 per cent of rural households in India do not have access to formal lending. About 44 per cent of the households surveyed, used informal lending channels such as loans from family and friends and unregulated moneylenders who charge exorbitant interest rates ranging from 50 per cent to 5000 per cent.

Lack of access to formal credit, is particularly felt when meeting unforeseen expenditures. Over 90 per cent of households report financing unusual expenses from cash at home, while the second most important source of financing such expenses is informal loans from family, friends, or moneylenders. Newer sources, such as the recently introduced Kisan Credit Cards, are still playing an insignificant role as far as the rural poor are concerned.

According to the Rural Finance Access Survey (RFAS), 2003, conducted jointly by the World Bank and the National Council for Applied Economic Research, rural banks set up by the government are failing to serve their original purpose. They serve primarily the needs of the richer rural borrowers. While 66 per cent of large farmers have a deposit account and 44 per cent have access to credit, 70 per cent of marginal/landless farmers do not have a bank account and 87 per cent have no access to credit from a formal source.

Some private banks say they are serving smaller customers in a big way. But even these banks are far from penetrating deep into the villages where the really poor people live. In all likelihood, much of their lending takes place in small towns, not the villages. In any case, the foreign and private sector banks just do not have the distribution reach to serve the rural poor in a cost effective manner. The last mile problem, one of providing credit to poor people in the remotest villages, is more formidable than it looks. For example, the median distance to the nearest financial institution ranges from two kms (post office branches) to five kms (commercial banks, co-operative banks). The median time taken to travel to the nearest commercial bank, cooperative or regional rural bank (RRB) is 30 minutes.

Micro-lending, by micro-finance institutions (MFIs) is increasing but as of today has only a marginal impact. In many cases, MFIs also charge much higher rates of interest compared to banks, typically three to four times than that charged by the formal banking system. At the All-India level, less than five per cent of poor rural households have access to micro finance (as compared to 65 per cent in Bangladesh). With the better governed southern states, accounting for almost 75 per cent of funds flowing under micro finance programs, the poor in the north have been virtually left out. Our MFIs are also small. They do not have the economies of scale or scope to cut transaction costs. So it is quite conceivable that they may not be able to

cut interest rates significantly in the immediate future. Given the current political and business environment in the north, it is wishful thinking, to hope for things to improve, at least in the short run.

Most banks consider serving the rural poor to be a high-risk, high-cost proposition. There is considerable uncertainty about the repayment capacity of poor rural borrowers. Their irregular/volatile income streams and expenditure patterns, in the absence of credit information, increase the probability of default. Problems of uncertainty are worsened by the borrower's inability to provide collateral. Transaction costs are high, mainly due to the small loan size, high frequency of transactions and large geographical spread.

Interest rate restrictions further reduce the attractiveness of lending. Government policy dictates that lending rates on small loans in the rural sector be "capped" at the prime lending rate (PLR). So even, our public sector banks, who have been given the mandate to serve the poor, feel their hands being tied. The risk aversion of public sector banks is exacerbated by a pervasive culture of suspicion towards bankers. Their lending decisions are often subject to stringent scrutiny by government bodies such as parliament, the Central Bureau of Investigation, etc. Why would any banker stick his neck out under such circumstances? Especially when incentives for high performers are nil or limited.

As far as the borrowers are concerned, the formal banking system is unattractive because it does not provide flexible products and services in line with their income and expenditure patterns. Because of their irregular/volatile income streams and expenditure needs, these borrowers, prefer to borrow frequently and repay in small installments. Unfortunately, this is not acceptable to the formal financial system. Banks are also unattractive because they demand collateral. Some 89 per cent of households who borrowed from RRBs, and 87 per cent of households who borrowed from commercial banks seem to be providing collateral (RFAS-2003). Land remains by far the most commonly used form of collateral. Banks also insist on documentation. So for fishermen in some parts of the country, who operate on the basis of unwritten lease arguments with the owners of the lakes and ponds, bank loans are simply not available. These fishermen are completely dependent on moneylenders for their funding needs.

Corruption is another problem. Clients often have to pay hefty bribes to access loans. So the ultimate cost to borrowers is very high. According to RFAS-2003, on an average, some 27 per cent (and 48 per cent in UP) of sample households who borrowed from an RRB report seem to be paying a bribe to get the loan. A little under 27 per cent of households who borrowed from a commercial bank paid a bribe, and 10 percent of households who borrowed from a credit cooperative paid a bribe. The bribe amounts appear to vary from anywhere from 10 per cent of the loan amount (in the case of banks) to 20 per cent (in the case of cooperatives).

The procedures for opening an account or seeking a loan from banks are cumbersome to say the least. It takes, on average, 33 weeks for a loan to be approved by a commercial bank. Clearly, that is too long a time to wait for many poor people.

Because of all these factors, moneylenders continue to play an useful role in the rural economy despite the high interest rates they charge. Their loans are attractive to the poor because of flexible repayment, the convenience and frequency with which such loans can be accessed and less reliance on collateral. That is why vegetable dealers all over the country pay interest rates sometimes exceeding 4000 per cent to finance

their day-to-day operations. The success of money-lenders is clear evidence that our formal financial system is not functioning well. It also means that our formal banking system has virtually given up on the most exciting opportunities that stare at it in the face.

The road ahead

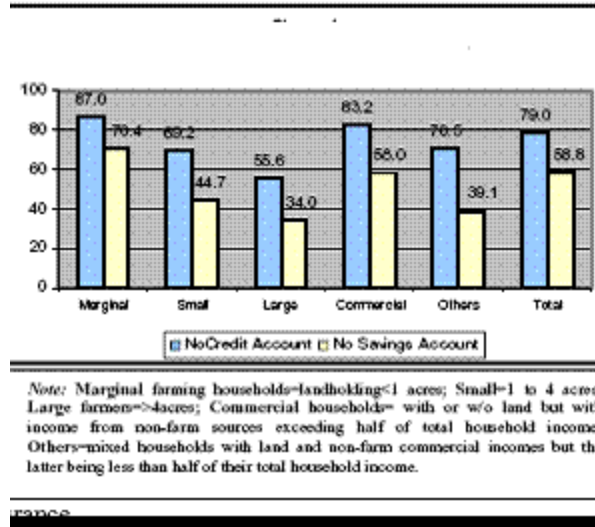
In recent months, the financing needs of the poor have received considerable media attention. Efforts have been made by government, financial institutions, and NGOs, often in partnership, to develop new approaches to deliver financial services to people who are currently denied access the formal financial system. The Union Finance Minister and the RBI governor have expressed their support for these initiatives which attempt to combine the safety and reliability of formal finance with the convenience and flexibility of informal finance. But the impact has been marginal. Much more needs to be done to ensure that loans go to the people who need them.

At a much broader level, credit is not going to the sectors where it should because few Indian financial institutions have an idea of what risk management is all about. This is evident in the kind of disclosures they make in their annual reports. Risk management is all about identifying, measuring and dealing with risk in a systematic way. In some cases, this may involve risk transfer from a party, which does not want to hold the risk to one, which does not mind doing so. But in other cases it means holding and managing the risk within the bank. Few Indian banks systematically, identify, measure and control risk. In the name of risk management, banks have stopped giving loans to people who are much better customers than they are perceived. The poor have volatile income streams. They may also not be able to offer collateral. But often they are trustworthy and strongly motivated to repay the loans they take. A similar argument applies to many first generation entrepreneurs.

Unfortunately, our formal financial system overlooks these factors. This explains why industrial credit and investment have not picked up even though interest rates have come down steadily, almost by about half in the past 13 years. The RBI, through its micromanagement of commercial banks, has been unsuccessful in an encouraging judicious risk taking. Multiple directives of RBI have only confused our bankers and make them pursue a "play-safe" approach.

Banks must follow prudent lending norms. But prudence should not make them swing to the other extreme and pursue what has come to be known as 'lazy banking'. If banks do not innovate and take risk, it will be too bad for a financial system, where banks still occupy a central place. The need of the hour is hard work (traveling to the hinterlands and spending time with poor people in the rural areas and understanding their needs), innovation and calculated risk taking. Only then will loans reach the people who are desperately looking for them. .

Exhibit - I
Low access to formal finance – RFAS-2003



Source: Rural Finance Access Survey (RFAS)-2003

Exhibit – II
Income and Expenditure Patterns of the Rural Poor

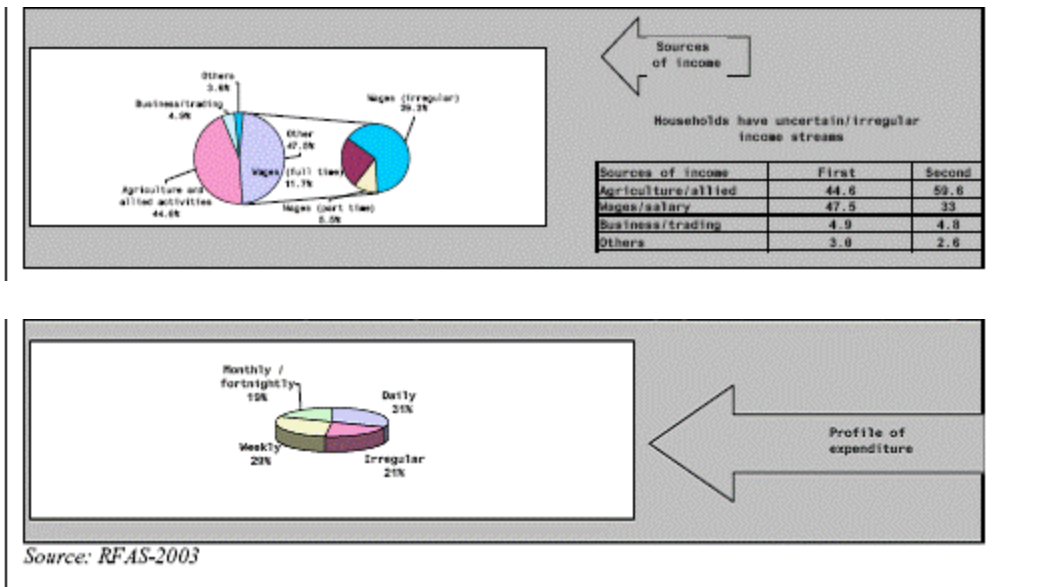


Exhibit – III
Aspects of formal borrowing and its costs

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	Bank	RRB	Coops	Schemes	Others
Interest rate (median) % p.a.	12.5	11	11	14	14
Loan amount received as % of amount applied	91.8	88.2	83.5	86.6	93.9
Percentage households reporting bribes	26.8	27.0	9.7	27.27	23.21
Bribe as % of amount approved	10.1	18.2	19.9	42.3	8.3
Time taken to process a loan application (weeks)	33	28.5	24	89	14.3

Source: RFAS-2003.

Exhibit – IV Incidence and size of informal borrowing by household category

(% of households unless otherwise stated)						
	Marginal	Small	Large	Commercial	Others	Total
Borrowed in past 12 months	48.24	39.84	35.9	39.07	42.82	44.06
Loans currently outstanding	44.58	34.79	31.45	36.13	39.9	40.07
Average debt/ borrower (Rs.)	9152	12523	18572	13075	17885	11136
Average debt/ household (Rs.)	4332	4834	6373	5007	7495	4790

Source: RFAS-2003.

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1 This part draws heavily from the Economist's survey of International Banking, dated 19th May 2005,

2 This part draws heavily from the article, "Scaling up Microfinance for India's Rural Poor" by Priya Basu of World Bank and Pradip Srivastava of NCAER

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