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Revamping The Financial System

Providing Finance Where it Matters.

ABSTRACT

This Article based on the global banking system, which faces new challenges in the coming years. The Indian financial system is not really discharging its responsibilities. 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'. 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. Corruption is another problem. Clients often have to play hefty bribes to access loans. So the ultimate cost to borrowers is very high. Indian financial system wants to deliver finance to the poor, a new mindset is required. 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.

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1. OUTLOOK

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.

2. INDIAN SCENARIO

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 liberalization, deregulation and responsiveness to industry needs.

3. STRUCTURAL PROBLEMS

At one point of time in 2002, banks were buying government bonds with tremendous appetite. Nearly 45 percent 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.

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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

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service is available rather than keep a price ceiling, which lends to inadequate supply.

4. PROVIDING FINANCE WHERE IT MATTERS

It has been estimated that some 92percent 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 percent of rural households in India do not have access to formal lending. About 44 percent 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 percent to 100 percent.

Lack of access to formal credit, is particularly felt when meeting unforeseen expenditures. Over 90 percent 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 percent of large farmers have a deposit account and 44 percent have access to credit, 70 percent of marginal/ landless farmers do not have a bank account and 87 percent 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 medium distance to the nearest financial institution ranges from two kms (post office branches) to five kms (Commercial banks, co-operative banks). The medium time taken to travel to the nearest commercial bank, cooperative or regional rural bank (RRB) is 30 minutes.

5. 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.

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