The Global Crisis and Financial Sector Reforms in India

Unlike any would-be reformer, who would point to the gaps and weaknesses, let me, instead, start by underlining the strength and vibrancy of the Indian financial sector. The Indian financial system, in many ways, is modern, innovative, and growing fast--be it the state-of-the-art trading and settlement systems at the National Stock Exchange, or ATMs catering to the illiterate, or cell phone banking, which aims to enhance the reach of the banking system. Having said that, the financing needs of the Indian economy, whether for infrastructure--estimated at $500 billion over the next plan--or for foreign acquisitions, will be enormous in the coming years and it is time to plug the remaining gaps. First, the causes for concern. And these have to do with the issues of stability and inclusion, both necessary for continued rapid growth. Perhaps the best place to start is with the ongoing turmoil in world financial markets. Some in India have interpreted that as evidence that India’s financial system is fine and what really needs fixing is the United States. While reforms are clearly needed in the United States, the sobering reality is that the Sensex has fallen significantly more than any US equity market [at the time of writing], despite being far from the epicentre of the crisis. Would India’s financial system be equally resilient if it faced losses of similar relative magnitude as does the United States? I think not. And this is points us to the need for reforms.

The financial sector in the US offered excessive credit to the housing sector, financed with excessive short term leverage. The combination was explosive--as real estate prices dropped, credit losses mounted, financial institutions looked increasingly unstable, and it became harder for them to roll over their borrowing. Excessive credit and excessive leverage led to funding difficulties, problems that are now spilling over to the rest of the economy as credit is tightened.
What lessons can we draw from all this? And what implications does it have for India? First, excessive credit growth can emerge anywhere in the system and impinge on the entire system. In the US, the finger is being pointed at unregulated mortgage brokers. India too has unregulated areas: for instance, non-bank finance companies are lightly regulated because they do not take deposits. But they too could impinge on the system because they borrow from banks. By ignoring these links, and by overburdening the regulated banking system, we risk driving more and more activity into the lightly regulated areas.

The response should not necessarily be to increase regulation across the board, as that risks driving activity into even less regulated areas. Instead, we need more buffers. If non-bank finance companies could borrow from the markets, issue medium or long term paper, they would be much less of a systemic concern. Losses, if any, would be absorbed by the market and not transmitted to banks. India urgently needs a deep corporate bond market.

Corporate bonds are typically unsecured paper. More reforms are needed for them to come into existence. Given that the current system affords protection largely to secured creditors, the loss to an unsecured creditor if a firm defaults is virtually the entire amount lent. India needs a functioning bankruptcy system, which will protect the interests of unsecured lenders. There is a bill pending before Parliament which, with a few minor modifications, could bring such a system into existence. It needs to be passed.

The risk aversion of domestic investors also plays in a role in keeping the corporate bond market small. To tackle this, India should allow more foreign investors into the rupee bond market. Their expertise and risk tolerance can help deepen the market, and this will be an important step in financing the enormous infrastructural needs that lie ahead.
Investor comfort in taking on long term credit risk is also associated with their ability to comfortably hedge other risks, such as interest rate risk and exchange risk. A pre-condition for a vibrant bond market is a vibrant interest rate futures and exchange rate futures market, where, again, free entry should be allowed.

A second lesson from the crisis is that the incentives and abilities of players matter enormously. Our regulations assume that management has financial knowledge, control over the financial institution’s operations, and cares about the long run. Yet, the growing revelations, for example from UBS, suggest that none of these assumptions need be true. Traders ran amuck building large positions, with management seemingly unable to restrain them.

In this context, a major source of concern in in India are the state-owned public sector banks. While some of the finest bankers in India are to be found in public sector banks, their inability to pay market salaries to top managers has eroded their strength. The chairman of the State Bank of India, India’s largest bank, makes less than $1000 a month in basic salary. The worry mounts as generations that were recruited in good times, when the public sector had a monopoly, retire.

Equally of concern is the fact that public sector banks are slowly but surely falling behind the new private and foreign banks. While public sector banks are still profitable because of their considerable reach, this advantage is likely to erode over time. The reasons are manifold. Investment in technology in public sector banks has not kept pace and this is illustrated by the fact that the newer breed of banks have a much greater share of ATMs than they do of traditional branches. Also, because they are much better interconnected, they can centralise processing, leaving branches to sell. Thus, not only do they incur lower costs, but can also target
the more affluent segments better through active marketing. Further, public sector banks are woefully underequipped for the businesses of the future. Those who argue that the public sector banks are in good health simply do not understand that they are condemning them to oblivion.

Indeed, it seems to me that there are interest groups that want public sector banks to remain the way they are only because they then continue to be a cash cow, to be milked dry. An analogy may make the point. Air India (and to a lesser extent, Indian Airlines) were good airlines, with monopoly positions in certain markets. But instead of privatizing them, or at the very least, freeing them to compete by allowing them to buy new planes, for a long time the government did neither. Some of the staff, especially among the lower tiers who were overpaid and underworked relative to the private sector, naturally preferred the status quo, concluding that the airlines would survive till their own retirement. Politicians and bureaucrats liked the ability to commandeer seats or upgrade themselves and their families without paying for it. And private sector competitors liked the ability to poach talent from the public sector, and grab market share at its expense, even while prices were kept high and foreign competitors kept out, ostensibly in order to protect the public sector. The end result is a crippled public sector airline, which is making enormous losses, and is sustained only by public largesse. As the courageous chairman of SBI, Mr. Om Bhatt has argued, this is not a fate we should wish on the public sector banks, yet the same cast of characters is playing a similar role.

There is another concern arising from a shackled public sector. Much of the Reserve Bank’s hesitation in opening markets or freeing up competition has to do with its concerns that the public sector banks will not be able to cope, and will render the system unstable. This again underlines the need for freeing the public sector banks, through some mix of governance and compensation reform and privatization, from the stifling burdens imposed by the government...
and special interests. This will allow a faster pace of reform in other essential areas, and enhance growth and stability.

Specifically, many of the infirmities of public sector banks are a result of their strong links to the government. For example, their technological backwardness has to do, in part, with the difficulty of procurement in a bureaucratic organisation, especially when any attempt to speed up procedures or bypass rules results in a vigilance inquiry. Their poor track record on NPAs (with the exception of the recent benign economic period) has partly to do with political interference with the lending and recovery process. Therefore, reforms have to look at ways of weakening that link.

For small and underperforming public sector banks, a variety of options, including privatisation or consolidation with a well-managed public sector bank, need to be considered. For the largest public sector banks, a first step might be governance reform–expanding the boards’ responsibilities to include the appointment and compensation packages of the top officers of the bank, bringing in strategic investors such as a large private or foreign entity, and allowing minority shareholders a greater say in the appointment of directors.

More generally, though, India needs to free up the banking sector. It needs to allow banks the freedom to open branches or ATMs anywhere, a process that is still controlled. It needs to allow bank mergers. And, it should treat domestically incorporated foreign banks on par with domestic banks. These steps will improve overall system efficiency as well as the quality of management. Clearly, the regulatory system needs to be upgraded to keep pace.

The next lesson from the crisis is that having a variety of markets and institutions helps the system regain equilibrium more quickly. That the US banking system has been able to
recapitalise at all has been because it has been able to tap into a variety of sources including sovereign wealth funds. Similarly, some asset sales have been possible because private equity and hedge funds specializing in distressed assets were willing to take up the impaired assets that banks wanted to offload. Indeed, a corollary lesson is that risks are never really where regulators think they are. Most regulators were preoccupied with the risks posed by hedge funds, while assuming investment banks and sub-prime mortgages as being boring and safe. Many had never heard of the term ‘conduit’.

India’s financial system is still overly bank focused. Private equity is growing, but substantially more is needed. We need stronger investment banks. Here again, foreign capital could prove useful, both in bringing skills as well as capital. We also need to steadily expand the range of investments of pension funds and insurance companies, and improve their ability to evaluate and take on risks. Rather than compelling these institutions to be overly invested in government securities, India needs to allow them greater flexibility by moving to a prudent man rule, where fund management is evaluated on the consistency of investments with the objectives, rather than on the basis of realised outcomes. Indeed, the growth of private equity in the US was spurred by a greater emphasis on the prudent man rule.

Another lesson from the crisis is the crucial importance of credit infrastructure. The breakdown of mortgage broker incentives as they originated NINJA (loans to borrowers with No Income, No Jobs, and no Assets) loans, the failure of rating agencies to police the ratings they issued or of the investment banks who packaged the securities to scrutinise the underlying collateral, all contributed to the crisis.
In India, the problem is the lack of basic infrastructure. Even though a strong credit infrastructure seems to enhance creditor rights only, research shows that it also significantly enhances the capacity of individuals to borrow, since creditors are now confident they will be repaid. Conversely, weakening the infrastructure, which seems politically appealing, while seemingly letting borrowers off the hook, also hurts their future access to credit. Despite progress on a number of fronts, India still has weak credit infrastructure, a major factor in limiting financial inclusion.

For example, we do not collect adequate information on potential borrowers, and their payment histories. If we were to track this information better, we could offer households and firms that do not possess collateral a way to borrow. In effect, a better tracking system would give them something to lose if they defaulted – their good credit rating – and thus give them an incentive to repay.

Any system of tracking individual information requires a unique national identifier, and our credit information system is hampered by the lack of one. Furthermore, in a country where so many people are excluded from the formal financial system, credit information alone may not aid inclusion much because so many have never had credit. More sources of information, such as payments of rent or of utilities/cell-phone bills, need to be tapped into to build individual records of payment, which can then open doors to credit and expand access. This means that India has to move from a system where credit information is shared on the basis of reciprocity between financial institutions only, to one where information is collected from more sources and a subscriber gets access to data subject to the credit bureau verifying his 'need to know and authorisation to use'.
Turning to collateral, it can be pledged if the potential borrower has clear title to assets. Land is probably the single most valuable physical asset in the country today. Unfortunately, the murky state of property rights to land make it less effective as collateral than it could be. The current state of land rights has many other adverse effects, including preventing agricultural land from migrating to its best use, slowing land acquisition for industrial and infrastructure projects, clogging courts with disputed cases, and elevating the level of political conflict. While making land rights clear and transparent is expensive, it is probably one of the most pressing needs of the country today.

More generally, India needs to improve its land and collateral registries, and integrate them electronically so that they can be accessed remotely and at low cost. Finally, to deal with distressed bank loans, India has allowed for asset reconstruction companies (ARCs) with special powers. There is really no sensible case for keeping foreign direct investment out of ARCs. The kind of risk capital as well as the kind of expertise foreign investors bring is useful in the economy, and can help provide a valuable buffer. From an economic perspective, capital that comes into the country when the banking sector is distressed and a flood of assets are sold to ARCs, is particularly valuable, and foreign investors, not domestic financial institutions, are most likely to be flush with capital at those times.

Finally, it is important to strengthen the infrastructure to deal with financial crises because these will, in all probability, occur at some point. India urgently needs to strengthen the system of prompt corrective action for financial institutions, so that risks can be contained. Moreover, it needs to improve coordination amongst regulators, so that they can act more effectively when large systemically important institutions are imperiled.
Finally, the crucial issue of inclusion. For India’s continued political stability, it needs to draw more of the poor into the growth process, and this implies greater financial inclusion. Nearly 75 per cent of the credit obtained by households at or below median income is from informal sources. It turns out that most of these loans, including those from friends and family, are at rates that exceed 36 per cent a year.

India is failing on two grounds. Despite the myriad schemes to expand credit, it is simply not reaching the poor. Second, the poor are paying high interest rates even though interest rate ceilings are in place to protect them. Indeed, economists would argue that the ceilings drive them into the hands of the moneylenders because they prevent the formal banking system from charging a rate that would enable it to recover its costs.

Another factor pushing the poor to borrow from informal sources is the nature of their financing needs: they generally require emergency (financial and medical) financing rather than financing for starting long-planned businesses. If a poor landless labourer needs money to buy medicines because his daughter has fallen ill, he simply cannot wait for a bank to make its decision, even if it were willing to give him unsecured credit. He therefore goes to the local moneylender, who can make decisions on the spot, needs little paperwork, and often can lend without.

Moreover, the historical Indian focus on expanding credit also puts the cart before the horse. We need to refocus first on expanding access to financial services, such as payments services, savings products, insurance products and inflation-protected pensions. If, for example, the enormous transfers to the poor through various government programmes can be channeled into savings accounts that the poor open, not only will leakage be reduced, but the poor will be
able to build savings histories with their bank which can then open the door to credit. Moreover, the financial experience dealing with the account and the bank will help build a greater business capacity, a critical need in making better use of credit.

What can we do? Start with a national programme to open no-frills accounts for every household that desires it. Make cash transfers to the poor directly through these accounts. This, of course, requires identification of the truly poor. The government is currently involved in pilot projects on this, and is following the path taken by successful experiments in other countries. Second, charter small banks and allow well-managed microfinance institutions to convert to bank charters. These institutions will have the flexibility and local information that large banks do not have. Third, allow large banks to traverse the last mile through banking correspondents (e.g., the post office, local shops) and technology. And remove interest rate ceilings so that the poor can borrow from formal financial institutions.

I have deliberately picked the issue of inclusion because it embodies all that the Indian financial system needs: more entry, more competition, more innovation, and more use of technology. It is also the issue where the popular consensus is that competition does not matter; where, instead, we need more targets, subsidies and government intervention. I think this consensus is terribly wrong. But it is what allows the government to intervene extensively in the financial sector.

Indeed, some forms of intervention are getting alarming. Increasingly, politicians are taking it upon themselves to control inflation, banning a market here because it sends inconvenient price signals, and threatening price controls there. Indeed, there is increasing concern that such intervention is prompted by a desire to extort money from the threatened
sectors rather than misguided public concern. These tendencies should be combated. Before these interventions, India seemed to be developing a consensus that price controls do not work. We should strengthen such a consensus and leave the task of fighting inflation to the Reserve Bank.

It is therefore a source of some concern that the RBI, one of India’s most reputed institutions, seems to have convinced some sensible commentators like Swaminathan Iyer that it can achieve none of its multiple objectives, leaving the terrain open for politicians. We need to strengthen the consensus that fighting inflation is not only the job of the central bank, but it should be its primary job, and the central bank should have both the necessary tools and the experience to do it effectively.

I should note that many of the concerns I have raised are not India specific. There is a growing tide against free markets around the world, which is reflected in increasingly heated political rhetoric. If economic conditions continue on the downturn, we should be prepared for much of the progress we have made over the last thirty years to be challenged.

India is at a turning point in its financial sector. There are many successes–the relatively low inflation (certainly compared to the triple digits reached in some emerging market countries) over the years indicates sensible macroeconomic management, while the rapidity of settlement at the NSE or the mobile phone banking being implemented around the country indicates that much of our system is at the internet age and beyond. Yet much still needs to be done. Some parts of our system have not yet reached the electronic age and, unfortunately, this is the part that our poor typically face. There is an opportunity here. In the process of gaining the productivity and innovativeness to serve the masses, the financial sector will get the unique edge
and scale to be competitive internationally—indeed, the road to making Mumbai an international financial centre runs through every village and slum in India.