The Other Side August 2, 2012

Public Sector Banks and the MoF

Recent press reports have quoted a spate of instructions of an operational nature from the MoF to public sector banks. (The central bank and a previous Governor have protested against the interference.) Before coming to the issues, keeping one perspective is important: during the Raj era, the theory was that a gifted amateur can do any job equally well. Perhaps this was a reasonable proposition when the principle objectives of government were law and order and revenue. Is it equally valid in today's far more complex world and responsibilities of the government? (In their own home country, the British abandoned this theory more than 40 years back based on the Redcliffe–Maud Report on administrative reforms.)

After the sacking of the late Raj Kumar Talwar, then Chairman of SBI, during the emergency, because he refused to grant a loan to a company which the powerful wanted to oblige, a culture of unquestioned deference to Delhi has become more pronounced in public sector banks in India. Therefore, it is all the more necessary for the ministry to be cautious about the kind of instructions it issues, howsoever desirable and unexceptionable the objectives may be. Recent press reports suggest that these include restrictions on short term loans to companies; curbs on bidding for deposits by quoting special rates in auctions; etc. It can be argued that there is nothing wrong with the latter if the bid interest rate and maturity compare favourably with other sources of wholesale finance (like reducing the holdings of excess SLR bonds, or swapping foreign currency resources for rupees within the limits permitted by the central bank), and if the resources can be profitability employed in funding assets of a parallel maturity.

One other issue is that the ministry has directed the bank boards to concentrate only on the major issues, leaving routine matters to the management. One question is what kind of issues can be considered as major, but surely these would include:

⇒ Asset: liability management;

⇒ The issue of risk management and risk based pricing; and

⇒ Optimizing the return on shareholders' funds.

As it happens, most of these issues have today become highly mathematics oriented. While obviously top management or boards need not have the mathematical knowledge, surely they need a very good conceptual understanding of the issues and their importance, the models used for measuring risks and their limitations. One example is the VaR (Value at Risk) model for measuring risk; the central bank generally insists that VaR limits be approved by the bank boards. After having done consulting work for many public and private sector banks, I have often wondered how many, particularly among the former, understand the implications of the confidence levels, the holding periods, etc. used for calculating the VaR. A connected issue is that of the volatility model used – a simple historical standard deviation of price changes, or other models to mitigate the effects of the reality that price changes in financial markets are not really random, or independent of each other. I repeat that while the boards and top management does not need to have a mathematical knowledge of issues and models used, they surely need to have enough conceptual knowledge to meaningfully apply their minds to the fixation of the limits. How many do you think have this?

Consider once again the issue of asset: liability management. The accompanying table gives data about three private sector and public sector banks each about the net interest margin, by far the largest source of earnings for the public sector banks. I think the numbers in the table speak for themselves, and what difference a more efficient asset: liability management can do for the bottom lines.

The fact is that finance has become more complex and there are questions whether the central banks themselves do not need to improve their skill levels in terms of domain knowledge and the methods of quantitative finance to be able to perform their supervisory function properly. Even the Federal Reserve in the U.S. had no idea what was happening in the mortgage securities market until 2007-08. Partly this was because of the then chairman's ideological faith in market efficiency, but also shows a lack of understanding of the quantitative techniques being used by the originators and the rating agencies. The global economy paid a heavy price in terms of lost output as a result of the crisis.

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Category	Bank	Net Interest Income	Investment (net of equity investments)+advances	Ratio	Change in income if Ratio is improved by 0.25%
Private Sector	1	12,300	292,100	4.21	700
	2	8,000	239,500	3.34	600
	3	2,500	80,000	3.13	200
Public Sector	1	8,300	334,300	2.48	800
	2	2,100	79,600	2.64	200
	3	4,200	163,400	2.57	400

Note: None of the banks is the largest bank in the category

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