Regulating banks: the number fixation

One does not readily recall a period when our banking regulator has been as active as in the last fortnight. Some of the more important steps include:

- Regulations for issuance of long term bonds by commercial banks for financing infrastructure and affordable housing projects;
- Release of the final report of the internal working group on counter-cyclical capital buffer framework;
- A framework for identifying and dealing with domestic systematically important banks (D-SIBs);
- Release of draft guidelines for establishing "small banks".

And in midst of all this, the regulator found time to fine a dozen banks for the way they had lent money to Deccan Chronicle. In the absence of a suspected conspiracy amongst so many banks in a particular case, should not the punitive action be in relation to the weaknesses of the general lending standards of a specific bank? And, in that case, should the prime accused not be the Kolkata based nationalised bank which had reported a huge increase in NPAs some time back?

There are two common features to the various pronouncements (other than the fines):

- Re-inventing the banking structure; and
- Everything reduced to numbers, in pursuance of the Basle approach.

As for the first, at one time it was believed that commercial banks were not the appropriate vehicle for giving project loans. Therefore, specialized term lending institutions, namely ICICI, the Industrial Development Bank of India (which started life as a subsidiary of the Reserve Bank), and the Industrial Finance Corporation of India, came into being. The experiment did not work very well and ICICI and IDBI merged with their respective commercial banking subsidiaries: of the two, IDBI needed a significant infusion of government money to make it viable. (IFCI is now, for all practical purposes, defunct.) And, the Infrastructure Development Finance Company (IDFC) is well on the way to becoming a commercial bank. With the permission to issue long term bonds by commercial banks, with no reserve requirements, we are back to the old model of commercial banks doing long term financing for infrastructure and other projects.

Consider also the issue of establishing special purpose banks. In many ways, payment banks may not be too different from the good old money order facility provided by the post office system – except that, with technological advances, the system would work much faster. As for small banks, just consider the number of innovations in the banking structure tried in the last few decades, none of which seems to have worked too well: regional rural banks, local area banks, micro-finance institutions. Add to this the NBFCs, the RNBFCs, the rural and urban co-operative banks. Can we be more optimistic about the fate of small and local limited purpose banks, now proposed to be licensed? In any case, would it not have been better to limit the bank categories by integrating some of the older models in the new one? Or, as Mark Tulley titled one of his books, are there *“no full stops in India*”? There has been one positive development in the whole scenario: the new government’s attitude may well revive the Aadhar card for payment of governmental subsidies.

Let me now turn to the number fixation so evident in all the Basle capital charges, which we are following perhaps even more faithfully than the Anglo-Saxons: I sometimes wonder whether the financial crisis of 2008, which led to the largest drop in global output since the depression era 1930s, started in Mumbai, not in London and New York! But before coming to Basle III, let me give one example of our original contribution to the number fixation. The long term bonds eligible for concessions on reserve requirements depends on the amount outstanding: the ceiling, as a proportion of the outstanding standard (i.e. “performing”) loans to the infrastructure and affordable housing sectors, has been specified, year by year, until 2020 – and even further! Surely, it would have been better to wait for the response of the system to the relaxations, gather some empirical evidence, and then if necessary limit the amounts?

Coming back to Basle III, the Turner Report issued by UK's Financial Supervisory Authority after the crisis commented that "*The financial crisis has revealed…..severe problems with these* (quantitative finance models)*. They suggest at very least the need for significant changes in the way that VAR-based methodologies have been applied: some, however, pose more fundamental questions about our ability in principle to infer future risk from past observed patterns."* As for VaR, the crisis witnessed 25 standard deviation events several days in a row – even an 8 SD event is statistically expected only once in the history of the universe! Merrill Lynch and Bear Sterns, both of which had very low VaR numbers a week before they had to be rescued by forced mergers, facing huge losses. And yet, banking regulators continue to put their faith in ever more complicated models and higher capital charges. This approach has one major convenience: it renders thinking and exercise of judgement superfluous!

The whole culture reminds me of Keynes' disbelief in mathematical models in economics. And, he once described banking as an illusion: everything works well so long as the depositor is confident that he will get his money back. The moment that illusion/confidence is shaken, no amount of capital would avoid a run on a bank, as Northern Rock, the best capitalized bank in UK, experienced in 2007.

A.V.Rajwade

Email: avrajwade@gmail.com