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Global banking after the GFC: lessons for India

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Abstract

Purpose – This paper is based on a keynote presentation at the 2nd Pan IIM World Management Conference hosted by the Indian Institute of Management (IIM) in Kozhikode (IIMK) in November 2014.

Design/methodology/approach – This paper draws lessons from the "Global" Financial Crisis for the governance, regulation and structural reform of banking, as well as monetary policy in a globalising financial system. Lessons are also drawn from the Eurozone Crisis, the Asian Financial Crisis and China.

Findings – This paper concludes that the appropriate extent of state ownership of banks and the process for reducing it, while also recapitalising banks, along with the development of capital markets, should be an integral part of India's wider structural reform programme.

Originality/value – The paper provides lessons for India with regard to banking and economic growth, financial sector development and addressing market failures in small- and medium-sized enterprises and infrastructural finance.

Keywords India, Global financial crisis

Paper type Viewpoint

1. Lessons from the "Global" Financial Crisis for banking systems everywhere

The Global Financial Crisis (GFC) was not truly, "Global" but was "Great" in magnitude, particularly so in the USA, and the UK and the European Union (EU). Emerging market economies were affected largely due to capital market aftershocks and the "Great Recession" that followed the financial crisis (Ozkan and Unsal, 2012), but their financial systems largely remained crisis-free (Moreno, 2010), as did those of Canada and Australia. In the case of India, deposits of private sector banks dropped significantly in 2008-2009 (Eichengreen and Gupta, 2012). For instance, in the case of ICICI Bank – the largest private sector bank, deposits fell by a tenth between June and December 2008. However, the State Bank of India – the largest government-owned bank – experienced a sharp rise in deposits in the same period due to the implicit government guarantee factor.

The GFC itself marked a monumental failure of bank governance in the worst-affected countries; particularly the USA and the UK, but also Germany (Mullineux, 2014a). Four reasons can be identified. First, banks were not adequately managing their risk exposures and external auditors did not seem to be alert to the problem. Second, shareholders and other stakeholders were not ensuring that bank risk management was properly governed and permitted remuneration systems that rewarded risk-seeking behaviour and encouraged short-term profit-seeking by management to be put in place as they sought ever higher returns on equity, rather the assets. Third, regulators and supervisors of banks bought into the idea that the financial

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system as a whole was being rendered stable because financial derivatives, including mortgage-backed securities (MBS) and collateralised debt obligations (CDOs), were spreading not only exchange rate and interest rate risks, but increasingly, also credit risks, more widely, or "diversifying" them. Fourth, the shadow banking system that developed as part of the processes of securitisation and "derivitisation", along with increased reliance on wholesale money market financing from money market mutual funds (MMMFs), was largely unregulated.

Additionally, three reasons may be cited. First, bank leverage (debt liabilities in relation to equity capital) and funding gaps (loans less retail deposits) increased dramatically in the decade prior to the crisis. Shareholders were thus increasingly exposed to both liquidity and solvency crises, despite the evolution of the Basel Committee on Banking Supervision (BCBS, http://www.bis.org/bcbs/) risk-related capital adequacy requirements from the first Basel Accord ("Basel I") in 1988 to "Basel II" in 2004 and beyond. Second, while Basel I concentrated on credit risks and Basel II additionally required capital provisions for "market risks", neither included liquid reserve requirements. Overall, the focus was on regulating individual banks, using internal "Value at Risk" (VaR) models and the opinions of credit rating agencies (CRAs) for guidance in the case of the bigger banks, rather than systemic risks. Finally, supervision was micro-prudential, rather than macro-prudential.

Monetary policy was led by the US Federal Reserve Board (FRB) in an increasingly globalised financial system in which the US dollar remained the main reserve currency under the Chairmanships of Alan Greenspan and Ben Bernanke. The FRB had responded to a series of negative financial "shocks" in the capital markets, including the collapse of the "Dot-Com" bubble and "9/11" (2001), by cutting interest rates. Low short-term interest rates led to a build-up of household debt and seemingly perverse capital inflows into the USA due to "global imbalances", which pushed down long-term interest rates, making mortgage finance ever more attractive. Compounding the low interest rate problem were "global imbalances" that were an echo of the 1997/98 Asian Financial Crisis and the build-up by China, as well as Japan and the oil exporting "Gulf States", of substantial dollar reserves, which were naturally invested in US Treasury Bonds and stocks. "Cheap money" sustained for long periods tends to stoke up asset price inflations as capital gains from holdings of various financial assets, real estate and commodities are sought because real interest rates and associated yields are abnormally suppressed.

Turning to the key lessons from the GFC, the first is that the regulation and supervision of banking systems and wider financial systems, including shadow banking, is now required. Second, given that the globalisation of finance, and thus international multinational banking, is now well-established, substantial international supervisory coordination will be required, as the Financial Stability Board, which was enhanced in the wake of the GFC, has acknowledged. Third, where the "resolution" of failed banks with cross-border operation is required, the governments involved will have to take the unpopular measure of sharing losses at their taxpayers' expense.

Agreements will, thus, be politically contentious and "blame shifting" can be expected, as in the past with the "Banco Ambrosiano affair" (Paoli, 1995) and in the resolution of ABN Amro during the GFC. More generally, taxpayers should be protected from attempts by big banks and their shareholders and other stakeholders from "pocketing" the gains in the good years while "socialising" their losses in the bad ones.

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That having been said, financial stability is a public good that taxpayers should, at least in part, pay for, especially as they enjoy the tax revenue from the profits and the high salaries and bonuses generated in the good times, and also benefit from the jobs created by a growing and thriving banking sector when it allocates capital efficiency. Hence, the appropriate taxation, regulation and supervision of banks is an important public policy issue (Chaudhry *et al.*, 2014).

It is now clear that (micro- and macro-) prudential regulation of the banks and the wider financial system and monetary policy must be coordinated and that, in a globalised financing system, this must be done both domestically and internationally. Domestic balancing may be difficult to achieve with face of free international capital flows, unless the global imbalances are successfully reduced. There was little evidence that major progress had been made in the post-crisis period, although the recent apparent slowdown in Chinese growth and elimination of Japan's trade surplus may help.

Bank remuneration structures have remained stubbornly unreformed. There has been a regulatory response in the EU, with the UK authorities trying to pick a path between voters' distaste of "bankers' bonuses" and the desire to maintain "The City's" competitive edge, while also discouraging "excessive" risk taking. Ultimately, bankers' remuneration should be a corporate governance issue and it is disappointing that the Boards of Directors and shareholders of banks have not got to grips with it, despite government prompting, particularly in the UK, but also in the USA. The concern about "short termism" in banking induced by management remuneration packages also remains unresolved.

In the USA and the UK, new regulatory authorities have been put in place (the Consumer Financial Protection Bureau in the USA under the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, and the Financial Conduct Authority [FCA] in the UK, which took over from the Financial Services Authority in April 2013) to protect its consumers against the miss-selling of financial products and services and inappropriate financial innovation.

The UK's FCA has become increasingly active, so much so that "The City" is now lobbying politicians to restrain it. "Over-regulation" may, however, push some banking activity into the shadows and discourage potentially beneficial financial innovation, so an appropriate balance does need to be struck with a focus on regulating *banking activity*, rather than banks *per se*. Increased regulation also makes it more expensive to provide basic "utility" banking services without the prospect of cross-selling the higher margin financial products and services increasingly sought by middle classes; especially in the context of ageing populations. Access to basic banking services may, thus, be restricted, leading to financial exclusion.

There is growing evidence of "de-leveraging" in response to the tougher capital and liquidity requirements being imposed in the post-crisis period. It is too early to gauge whether this is transitory, as banks adjust to the new regime, or permanent, but it does seem to have resulted in restricted long-term infrastructure lending and small and medium-sized enterprise (SME) financing, or increased "credit rationing", by banks. These developments, especially with regard to SME financing, have been particularly problematic in the EU, including the UK, where capital markets are much less developed than in the USA. There is some evidence that Internet-based debt and equity crowd-funding is beginning to fill the SME debt and equity funding groups, but credit

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rationing remains well above "normal" levels. It should be noted that many countries, including the USA, the UK and Germany, try to curtail the "normal" credit rationing, which results from information asymmetries, by offering state-backed loan guarantees to banks that lend to SMEs.

The 2009-2012 "Eurozone (debt) Crisis" illustrated the risks associated with allowing a "Doom Loop" to develop (Mullineux, 2014b). As EU banks de-leveraged, they replaced loans on their balance sheets with government bonds. Then, as the crisis deepened, banks in the stronger "core" countries reduced their holdings of bonds issued by the troubled periphery governments, and the banks in the periphery countries increased their holdings of bonds issued by their domestic governments, who were liable to bail them out. The risk associated with holding "periphery" government bonds, and thus their premium over German "bunds", increased. This in turn made it more difficult for the "periphery" countries to finance their deficits. The credit ratings of domestic banks and their governments, thus, became highly correlated, and both deteriorated in "the periphery". The implications for countries, such as India, with a high level of state ownership of banks, are clear. Indian banks weathered the crisis well because the markets did not doubt that the Indian Government would underwrite the banks, as did banks in China for a similar reason, but will this always be the case?

Another by-product of the crisis has been the questioning of the alleged benefits of the "universal banking". The model was well-established in Continental Europe and developed in the UK after the 1986 "Big Bang" financial sector reforms and in the USA after the repeal of the 1933 Glass–Steagall Act (which separated commercial banking from securities or investment banking business in the wake of the Great Crash of 1929) in the Gramm–Leach–Bliley Act in 1999. Proponents of the model emphasise beneficial economics of scale and scope, but managerial diseconomies have become evident in the Citibank group and elsewhere. Further, the bigness and interconnectedness that results from the financial "conglomeratisation" seems to have increased global systemic risks and rendered the "resolution" of global universal banks particularly complex.

The EU has consequently been considering structural reform of the banking sector (Liikanen, 2013), and the UK is in the process of implementing proposals emanating from the "Vickers Report" (2011) and the report of the Parliamentary Commission on Banking Standards (PCBS, 2013), and has set in motion full Competition and Markets Authority (CMA) review of the retail banking sector.

Barriers to new entry to the banking industry should be removed and diversity in banking should be encouraged by regulating retail banking as utility and requiring universal service provision, which in this case means access to basic payments and banking services, including credit. Big banks and their shareholders should not be allowed to benefit from economic rents gained from oligopolistic market power.

New entry can be promoted by "levelling the playing field" with regard to deposit insurance. Big banks should be required to contribute to funded and state-backed deposit guarantee schemes with risk-related premiums and coverage should immediately be extended to new entrants, as recently instituted in China. Big banks should not be allowed to gain a funding advantage from implicit state guarantees, ultimately at the taxpayers' expense, and guaranteed retail deposits should not be allowed to fund trading and wider investment banking activity. Ultimately, the increased capital requirements on investment banking activity and the supplementary capital requirements being imposed on the "systemically important" banks may induce

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the voluntary separation of retail and investment banking businesses. Regulating retail banking as a utility and requiring universal service provision, or access to finance, would similarly encourage separation from investment banking, which would require a higher return on equity to compensate for its higher-risk exposures.

Capital market development and increased Internet-based crowd funding may increasingly fill any financial gaps resulting from the necessary de-leveraging of banking. The USA not only has the most highly developed capital markets, but also very well-established regional and local community-oriented banks, in good part due to the requirements of its Community Reinvestment Act, which was introduced in 1977 and enhanced substantially in the mid-1990s, and subsequently further amended.

As a result of ultimately decisive government intervention in the wake of the September 2008 Lehman Brothers failure, the US financial system recovered more quickly than the systems in the UK and the EU. Consequently, SMEs in the USA have been much less credit constrained because of the strong community banking sector, highly developed capital markets, an established venture capital sector and a rapidly emerging crowd-funding capacity.

2. Lessons from "Further-back" and "Close-by"

The 1997/8 Asian Finance Crisis (AFC) illustrated the risks associated with over-reliance on foreign currency (largely USD) denominated capital and international borrowing from foreign banks, as opposed to domestic bond market financing.

The post-1990 reform of the formerly centrally planned economies in Central and Eastern Europe (CEE) involved the privatisation of both state-owned enterprises (SOEs) and state-owned banks (SOBs). In Poland, the interconnectedness of the privatisation process was fully acknowledged. It was not possible to privatise SOEs without resolving the problem of their indebtedness to SOBs, which was incurred under the central planning system, and yet if the debts were to be forgiven prior to SOE privatisation, the SOBs would be exposed to a growing "bad debt" problem because the SOEs were unable to service their debts at the new market (as opposed to planning) prices. Further, banks were severely undercapitalised and had made no loan loss provisions. The problem was, thus, how to privatise SOEs and SOBs while dealing with the bad debt problems and re-capitalising banks?

More generally, past bank failures, such as the 1991 "BCCI affair", have involved banks lending too much, relative to their bad loan provisions and capital, to a small group of borrowers. The banks cannot let these borrowers default for fear of undermining their own solvency and so the large borrowers can dictate loan terms to their banks. If representatives of the large corporate borrowers join the boards of the banks which lend to them, then their oligarchic power is increased. Further, if they are allowed to set up their own banks, then their depositors are likely to be seen as a cheap and stable source of long-term capital or "milch cows".

As in China, India's partially privatised SOBs dominate the banking sector. India may not be Western, and it is certainly not the same as China, but there are lessons to be learnt from banking systems abroad, nevertheless.

China's state-dominated banking system proved useful in mounting a monetary stimulus to complement the fiscal stimulus implemented by the government after the collapse of Lehman Brothers, but the sector has suffered from recurring non-performing loan (NPL) problems and indeed is currently regarded by many analysts to be troubled

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by NPLs. Capital hoarding by the SOB–SOE nexus in China also starves the SME sector of capital, inhibiting job creation, innovation and growth.

3. Lessons for India

3.1 Banks and growth

The banking and the wider financial sector contributes to growth by efficiently allocating capital and in so doing widens access to finance, thereby reducing financial exclusion and poverty. Further, the expansion of the financial service sector will itself contribute to growth through job creation. In the UK, the growth of employment in the financial sector following the 1986 Big Bang liberalisation was dramatic. Better regulated, governed and managed banks are likely to allocate capital more efficiently, thereby promoting innovation and growth, and are themselves responsible for monitoring, and thus effectively the corporate governance of the SMEs that borrow from them.

The effectiveness of the corporate governance of shareholder-owned banks in the EU and the USA was called into question by the GFC, as we have already noted. However, problems also occurred with the governance of public sector banks, particularly the "Landesbanken" in Germany, the local public savings banks ("Casse") in Spain following the GFC and, more recently, the Co-operative bank in the UK. The central institution of the German co-operative banking system also got into difficulties. Hence, governance problems in banking are evident under shareholder, public and mutual ownership. Different solutions are required for each, but nevertheless, diversity of ownership models seems desirable because the better-managed mutual banks did continue to provide retail banking services to households and SMEs in Germany and the USA, and elsewhere. There is a risk that the post-crisis regulatory reforms are focussing too much on resolving the governance problem in large shareholder-owned banks with the unintended consequences of reducing diversity by squeezing out "mutual banks" and potentially reducing access to finance as a result.

3.2 Modern banking

Advanced financial sectors increasingly rely on "big data" as a fourth "factor of production" alongside the traditional three: land, labour and capital. Indeed, modern banking and finance is based as much, if not more, on information as it is on money creation. What exactly is money, and indeed liquidity, has long been debated by financial economists and has clearly changed over time. Money's prime usefulness is in conveying information on credit worthiness and as a standard for valuing or pricing other products, and it is increasingly becoming digital.

The winners will command the best information set, will potentially "take all" or a large chunk of it. Big banks have for some time looked like "dinosaurs" (as they famously did to Bill Gates of Microsoft, circa 1994) awaiting extinction as they struggle to keep their IT systems up to date; and indeed "fit for purpose" in light of payments system failures in major UK retail banking operations in recent years.

But are banks dinosaurs? Mobile phone payment systems, such as the highly successful M-Pesa system in Kenya, and near-field technology have begun to eat the banks' "lunch" by reducing their domination of payment systems. PayPal and other Internet banking systems have also made incursions as Internet shopping increases in popularity; as has Bitcoin, the digital currency. To survive, the big banks will need to

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form alliances with mobile phone and Internet network providers and/or mobile phone producers such as Apple, which concluded a significant deal with big US banks and credit card companies in September 2014. Banks have started experimenting with mobile banking, and the Reserve Bank of India (RBI) is moving towards granting licenses to payments banks which will enable banks to leverage mobile phone technology to offer low cost-saving and transaction services.

We have noted that the big banks are also under attack from Internet-based crowd-funders and invoice discounters. Some banks are responding by forming alliances with crowd-funders to help them to "up-scale" by investing capital in them and facilitating the securitisation of the outstanding receivables on their loans. Others are setting up their own Internet-based crowd-funding operations to complement their Internet and mobile phone banking facilities.

The "net" result (if you will excuse the pun) will be increased competition and a consequent reduction in transaction costs for users, unless the big banks are allowed to re-assert their dominance of payments systems.

3.3 Addressing market failures

Infrastructural financing is naturally addressed through bond and longer-term insurance and pension fund investment, but due to information asymmetry, there will remain a market failure on SME (both urban and rural or agricultural) lending for some time yet, as capital markets and crowd funding seem unlikely to be able to overcome the problem of pricing credit risks accurately without better-quality information, which can never be full information in a world of uncertainty. While some SME loans are covered under priority sector lending restrictions, the RBI has expressed concern with the default among public and private sector banks in meeting the priority sector lending targets (RBI, 2013). Moreover, with the priority sector criteria often being relaxed, credit flow to the smaller enterprises would come under pressure. Medium enterprises (as defined by the Ministry of Small Scale Industries) are not even included in the priority sector. Hence, credit rationing of SMEs will persist and government intervention through targeted SME loan guarantees, as successfully used in the USA through its Small Business Administration (SBA) and in Germany, through its development bank (KfW), will remain necessary.

Many countries have pressed banks to share information on good, as well as bad, credit risks to improve the quality of lending and to increase the opportunities for households and SMEs to switch accounts between banks. The requirement for banks to make provisions against possible future loan impairments will help encourage banks to assess and price credit risks more accurately.

In most countries, SMEs face not only credit rationing, but also an equity finance gap. Indeed, more equity-based finance and less debt would render them less likely to fail. The venture capital industry is most highly developed in the USA, but even there "seed corn" and "early stage" financing for SMEs has become progressively harder to access as venture funding has gravitated towards private equity funding of medium to large companies. Lessons might, however, be drawn from Islamic "profit and loss sharing" financial contracts under which capital providers share in the downside, as well as the upside. Under debt financing, interest has to be paid whether a profit or a loss is made, making SME failures more likely in recessions, especially if the state and larger companies increase late payments.

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4. Concluding remarks

India should consider whether substantial state ownership of banks is the best means of achieving an efficient allocation of capital and, if not, how should state ownership be reduced?

The reduction of state ownership in the formerly centrally planned economies of CEE led to substantial foreign ownership of banks. Without foreign capital injection, the necessary re-capitalisation of the large, partially state-owned, banks will weigh heavily on government finances. Further, privatisation of the big banks, without breaking them into smaller units, risks creating an oligopolistic market structure in which economics rents can be extracted. The alternative to rapid, and potentially costly, privatisation is to stimulate the growth of domestic "challenger" banks, encourage foreign bank entry and to take steps to widen access to finance.

In recent years, numerous reports have suggested various paths towards banking and wider financial sector reform in India and it seems that the current (Modi) government is preparing to act, with the support of Dr Rajan, the Governor of the RBI. Measures to broaden access to finance have already been instigated.

Alongside the restructuring and recapitulation of the banking system, measures should be taken to speed the development of capital markets in India. As in the CEE countries, the "know-how" imported through foreign bank entry is likely to prove invaluable, and partnerships, including "joint ventures", between domestic and foreign financial institutions, would accelerate the information and skills transfer process. Also, as in the CEE countries, the commercialisation of partially state-owned banks may require a parallel reform of their domestic industrial conglomerate clients, which should be encouraged to issue corporate bonds and reduce reliance on bank financing.

The Modi Government is aiming to rebalance the Indian economy through a "Make in India" campaign, but what is the appropriate balance between the industrial and service sectors in a modern economy? In the most advanced economies, the USA, the UK and the EU, the service sector has progressively become by far the largest sector. Attempts in the UK to rebalance its economy towards manufacturing, and to reduce reliance on the financial sector in the wake of the crisis, have had mixed success. It is the largely service-based information technology, or "IT", sector that has thrived in London in recent years and the financial services sector now recovering strongly, while manufacturing resurgence is patchy.

India already has strong IT services and computer software sectors. These will naturally facilitate the rapid development of Internet and mobile phone banking; which is the banking technology of the future. The "new" technology can successfully promote household and SME access to the payments system and credit and other basic financial services without the need for costly to maintain bank branches, as long as the necessary education and access to the Internet, in both rural and urban areas, are assured.

India already has the IT services and software know-how and thus the opportunity to take mobile banking and finance to a level well beyond the successful M-Pesa payments system in Kenya, if its mobile phone and Internet providers can join forces with the banking system.

With the major banks "capital constrained", some foreign bank and/or "C (communication) and IT" firm participation, and foreign direct investment, would accelerate progress towards achieving access to digital finance "for all" citizens and SMEs in India. Foreign investment in private sector banks would become useful for

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meeting the stiffer capital requirements that are expected to kick in with the implementation of Basel III norms.

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