BRIEFING PAPER

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Financial Regulation in India after the Crisis

After around half a decade of the financial crisis, economies across the world have started implementing reforms in financial sector regulation, on the basis of experiences and lessons learnt from the crisis. It is thus necessary to examine if India's financial regulators have learned any lessons from the crisis, and if any reforms have been introduced to avoid such crisis in the future. This Briefing Paper attempts to find an answer to this question, while analysing select policies pertaining to competition and consumer protection in areas of banking, non-banking financial companies (NBFCs) and insurance.

Uneven Playing Field Remains

A noteworthy incident during the financial crisis that remains itched to one's memory is deposit flight from private sector banks to public sector banks (PSBs).[1] This indicates to the skewed nature of financial regulation in the country, wherein PSBs are considered much safer than private sector banks. A related point to note is that PSBs have been consistently posting higher levels of non-performing assets, and lower returns on investments, when compared with their private sector counterparts.

While no statutory government guarantee has been provided in relation to deposits with PSBs, the government, being largest shareholder, has repeatedly announced its intention to capitalise PSBs, i.e. using taxpayers' money to salvage PSBs. This remains true even after the crisis.[2] In addition, certain special statutory benefits have been conferred upon the public sector financial institutions, from which their private sector counterparts are deprived of. The State Bank of India (SBI) Act exempts SBI from the applicability of laws governing winding-up of companies and provides for its liquidation only by an order of the government.[3]

Consequently, such entities cannot be wound up even if they go bankrupt, contrary to the law applicable to private sector financial institutions. In addition, 60 percent of the funds under the control of government departments/ministries are required to be placed with PSBs.[4]

Box 1: Implicit Government Guarantee to PSBs

PSBs enjoy a perception of implicit deposit guarantee from the government. Between June and December 2008 (financial crisis), deposits in ICICI Bank dropped by a tenth and PSBs posted significantly faster deposit growth.[5] Experts argue that the principal reason for this was implicit guarantee by the government.[6] Such deposit flee is likely to destabilise private sector banks. They will have to hold more capital and maintain more liquidity to reassure depositors, which will work to their competitive disadvantage. In addition, the perception that PSBs enjoy an implicit guarantee is a moral hazard that limits the incentive to enhance efficiency and may encourage complacency or excessive risk taking by PSBs.[7]

The government has gone a step further in the insurance sector. An explicit government guarantee has been provided for all sums assured under policies of Life Insurance Corporation of India (LIC).[8] Laws governing winding-up of companies and liquidation are applicable to LIC only by an order of the government.[9] Government also has the power to modify applicability of certain provisions of the Insurance Act for their applicability to LIC.[10]

Further, any interest or dividend payable to LIC in respect of any securities/ shares owned by it or in which it has full beneficial interest is not subject to deduction of income tax.[11]

There has been no amendment to such competition distortionary policies, even after the crisis, resulting in persistence with the uneven playing field between public and private sector players. Such competition distortionary policies hurt market efficiency and prevent private sector financial institutions to efficiently compete with the public sector counterparts. As a result of low competition, public sector institutions have the tendency to get complacent, adversely impacting consumer interests, in the process.

CUTS research report on Competition and Regulation in India, 2013,[12] recommends doing away with such competition distortionary benefits provided to the public sector. Such recommendations are echoed by financial sector experts as well. The International Monetary Fund (IMF) has recommended providing the government with administrative scope to phase out LIC's government guarantee, or requiring LIC to price the guarantee into its products.[13]

Inefficiency and High Non-Performing Assets

The evidence of sub-optimal performance of complacent PSBs, as a result of lack of competition, and arbitrarily favourable regulatory regime, is evident in form of high non-performing assets in PSBs. The combined NPAs of 21 public sector banks aggregated to ₹1,37,586 crore in the fourth quarter of the financial year 2014, as compared with ₹91,737 crore during the same period of the financial year 2013, an increase of almost 50 percent. This is a matter of serious concern.

Outgoing Deputy Governor of RBI, K C Chakrabarty, has stated that the problem of PSBs, in general, was a result of poor leadership and management of banks. He termed this as 'non performing administration' and was of the opinion that there was a lot of room for improvement in the internal management of the PSBs.[14]

It has been noted that the verification process of loan application in PSBs is not robust and neither is the recovery; and after the loan is dispensed there is no follow-up and no recovery mechanism. Unlike the private sector, PSBs are reluctant to possess the property, often for political reasons.[15]

Interestingly, private sector banks have not seen much deterioration in asset quality and have managed to maintain their NPAs at low levels, owing to deployment of flexible repayment terms, effective monitoring and working together with the borrowers.[16]

Whilst the RBI has been pushing the PSBs to improve their performance, it is expected that the new government may pitch for stricter norms on NPAs.[17] It is being realised that government control, coupled with vested interest, has been a major hindrance in efficient operations of the PSBs. As RBI officers are nominated as directors on the boards of PSBs, this also leads to conflict of interest. Experts have suggested appointment of well qualified, independent board members that are not from the RBI.[18]

Box 2: Inverse correlation between PSB capitalisation and efficiency

In 2012-13, the government had provided capital funds to PSBs to the tune of ₹12,517 crore to enable them to maintain Tier-I CRAR at a comfortable level.[19] This was repeated in 2013-14 wherein a capital infusion of ₹14,000 crore in 2013-14 was made in PSBs.[20]

While the government has been recapitalising the PSBs, their gross NPAs (as a percentage of gross advances) increased from 3.17 percent to 3.84 percent during 2012-13. Similarly, net NPAs to net advances ratio of state-run lenders slipped to 2.02 percent at end-March 2013 from 1.47 percent a year earlier.[21] The NPAs for PSBs further deteriorated and hovered near 5 percent during the financial year 2013-14.

In addition, the return on assets (ROA) of PSBs reduced from 0.88 percent in 2011-12 to 0.78 percent in 2012-13 while ROA of private sector banks increased from 1.53 percent to 1.63 percent during this period. During the same period, PSBs posted a decrease in return on equity (ROE) from 15.33 percent to 13.24 percent while ROE for private sector banks increased from 15.25 percent to 16.46 percent.[22]

A recent review by the Committee on Governance of Boards of Banks in India suggested privatisation of PSBs or designing a radically new governance structure which could ensure their ability to compete successfully, in order that repeated claims for capital support from the government, unconnected with market returns, are avoided.[23]

Welcome Steps on Bank Licencing, but More Needs to be Done

After a decade of drought in granting of bank licenses, in April this year, the Reserve Bank of India (RBI) granted in-principle licenses to two entities, infrastructure financier IDFC and micro lender Bandhan. The RBI also stated that guidelines on differentiated banks as well as 'on-tap' licenses are likely to be announced by the end of 2014. The new rules are expected to provide opportunities for companies who have failed to get into the RBI's final list as well as for new entrants. It will also set out categories of differentiated bank licenses that will allow a wider pool of entrants into banking. This decision to make the licensing process continuous is a departure from the current practice of stop-and-go licensing.[24]

This is welcome step from the regulator; as high entry barriers provide unfair advantage to the incumbents, who, due to lack of competition, settle for sub-optimal performance, adversely affection consumers' interest.

While banking sector has been lucky and couple of in-principle licences have been granted after a decade, the NBFC sector has not been that lucky with RBI virtually stopped granting any registrations to NBFCs. Licences create important economic opportunities but lack of transparency and wide discretionary powers to the regulators act as entry barriers for market participants.

Inadequate Focus on Consumer Protection Persists

The Banking Codes and Standards Board of India (BCSBI) monitors and assesses the compliance of member banks with codes and standards framed to achieve high levels of consumer protection. A 2012-13 review of compliance with such codes and standards brought into focus the flagrant violations and shortcomings in code implementation. Around 38 percent of banks in 2012-13 earned average/below average ratings. This clearly shows the long path banks must tread to fulfill their commitments to their customers. The review found that majority of complaints was regarding credit/debit cards followed by non-observance of the fair practices code. In addition, complaints related to unauthorised fund transfers, fraudulent withdrawals from ATMs using duplicate cards, phishing e-mails aimed at extracting personal information have registered significant increase in recent times. Going forward, there is a need for building up a robust mechanism to prevent incidents of fraud in areas of mobile/net banking and electronic fund transfer.[25]

Financial service provides must ensure simplicity of the product sold and should observe their duty to inform the customer about the features of the product. They must help customers fully understand the features, benefits, risks and costs of the financial products, minimise sale of unsuitable products by encouraging best practice before, during and after the sale. A culture of customer-centricity and sensitivity to the needs of the customers especially those belonging to the vulnerable sections of the society, must be developed. In addition, financial institutions must ensure that there is a clear specification of liability, if things go wrong.[26] The report on Competition and Regulation in India, 2013 has also made similar recommendations.

It is understood that RBI proposes to frame comprehensive consumer protection regulations based on domestic experience and global best practices.[27] The Nachiket Mor Committee[28] has also pointed out that given that imbalances in information, expertise and power between the buyer and seller of financial products will only be exacerbated in the future, it becomes clear that existing approaches to customer protection have severe limitations. It has suggested departure from the principle of "caveat emptor" i.e. let the buyer beware, to the principle 'caveat venditor', i.e. let the seller beware. This will force the seller to take responsibility for the product and discourage sellers from purveying products of inferior quality.[29]

To ensure consumer protection in the insurance sector, the Insurance Regulatory and Development Authority has also recently issued standard format for life and non-life insurance policy for improving transparency and enabling policyholders/beneficiaries to take informed decisions.[30]

Conclusion: Few Steps but Much More Efforts Required

The financial crisis prompted economies to formulate various expert groups to suggest appropriate reforms for financial regulation. These committees include Goodhart Committee, Kay Review, Parliamentary Commission on Banking Standards, UK (PCBS), Sergeant Review, and, Geneva Reports on World Economy, amongst others.

The Goodhart review pointed out that risk management concerns of individual banks are quite different from those of regulators. It should not be for the government/regulators, to try to determine how much risk market participants take on board, nor to set out the particular way that they assess such risks.[31] The Kay Review identified short-termism of market participants as principal problem in financial regulation. The PCBS recommended increase in the level of consumer protection to regain trust of customers. The Sergeant review of simple financial products in the UK revealed that simple processes and products must be available to the consumers that allow them to make straight forward purchasing decisions.[32]

The Geneva Reports opined that financial regulation must focus on,[33] *"(i) constraining the use of monopoly power and the prevention of serious distortions to competition and the maintenance of market integrity; (ii) protecting the essential needs of ordinary people in cases where information is hard or costly to obtain, and mistakes could devastate welfare; and (iii) [managing situations] where there are sufficient externalities that the social, and overall, costs of market failure exceed both the private costs of failure and the extra costs of regulation."*

As a result of recommendations of such expert groups, the UK moved to twin peaks model, with consumer protection and prudential regulation as focus of financial regulation and the US enacted the Dodd–Frank Wall Street Reform and Consumer Protection Act, to enhance consumer protection standards.

India also embarked upon review of financial sector regulation and the Financial Sector Legislative Reforms Commission (2013) recommended wholesale reform of the financial sector regulation. The Report of Committee on Customer Service in Banks (2011) recommended higher standards of consumer protection in banking industry, and the Report of Working Group of Resolution (2014) recommended establishment of a Financial Resolution Authority.

Key Recommendations

While brilliant reforms have been suggested, government interest to implement such recommendations has been found wanting. This is specifically true with respect to leveling the field amongst public and private sector financial institutions, and removing of the competition distortionary provisions under the primary laws. A recent research report indicated that nations adopting free banking laws experienced an increase in output per capita compared to the states that retained state bank chartering policies.[34]

The government must realise that facilitating competition will improve market efficiency and reduce burden on government and ultimately the taxpayers. Civil society will need to play a significant role in convincing the government in introducing pro-competition and consumer protection changes in regulation, by demonstrating that benefits of such changes will outweigh the costs. This could be undertaken with assistance from internationally recognised tools such as regulatory impact assessment, business regulatory impact assessment, including cost-benefit analysis.

In addition, financial firms must improve their efficiency. There is growing need for banks to strengthen their internal credit appraisal system i.e. their credit assessment and risk management mechanisms. At the same time, banks should also consider using external credit appraisals in conjunction with their own assessment.[35] Independent research and evaluation organisations must play an effective role in providing such services.

Endnotes

1 Barry Eichengreen and Poonam Gupta, *The global financial crisis and Indian banks: survival of the fittest?*, MPRA Paper No. 43365, December 2012. The authors note, '*It seems that depositors were confident for other reasons that their deposits were safer with the SBI due to the government's implicit guarantee of its liabilities, and that this dominated other considerations.*'

2 In January 2013, the government decided to provide capital funds to public sector banks during 2012-13 to the tune of ₹12,517 cr. In October 2013, the government confirmed capital infusion of ₹12,517 cr. in financial year 2012-13, and approved infusion of ₹14,000 crores during financial year 2013-14. *http://pib.nic.in/newsite/PrintRelease.aspx?relid=100196*

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7 Barry Eichengreen and Poonam Gupta, *The global financial crisis and Indian banks: survival of the fittest?*, MPRA Paper No. 43365, December 2012. The authors note, *'It seems that depositors were confident for other reasons that their deposits were safer with the SBI due to the government's implicit guarantee of its liabilities, and that this dominated other considerations.'*

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