Preparing Indian Banks for Global Competitiveness: Strategic and Policy Perspectives

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Introduction

It would be no exaggeration to say that the financial world is a vastly different place after the crisis. Many propositions that might have been taken for granted until it precipitated are being questioned in its wake. One set of these surely has to be about the things that go into making banks globally competitive. The increasing visibility and dominance of multinational financial corporations in the years before the crisis contributed to the perception that the formula for success in this sector had been discovered and mastered. Massive size, wide diversification across the entire spectrum of financial activities, - intermediation, investment and insurance – and global presence, combined with large pecuniary incentives were, apparently, the most effective way to achieve and sustain competitive advantage.

The crisis has clearly raised serious questions about the sustainability of this model, both at the micro and macro levels. As business models go, the combination of rapid growth and widespread diversification appears to have contributed quite centrally to both the crisis itself and the way in which governments were constrained in dealing with it. On the first consideration, it does appear that the accumulation of risks – on or off the

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balance sheet – that accompanied the growth and diversification of the largest US and European banks were not accompanied by matching capabilities in risk identification and mitigation. On the second, the term “Too Big to Fail” says it all. When financial institutions grow beyond a certain size, their collapse can have serious consequences for the rest of the financial system as well as for the real economy, both domestically and globally. No government can afford this kind of fall-out and will, therefore, be forced to save an institution, thereby going against the basic grain of market discipline.

Clearly, the crisis and its ongoing resolution hold many lessons for the combination of factors that make banks competitive. They also illustrate the inherent trade-offs between the “private” or strategic dimensions of competitiveness and its “public” or policy dimensions. In this talk, I propose to lay out a simple framework for bank competitiveness and explore their strategic and policy implications. I hope this will provide a useful input into the panel discussion that follows.

The Determinants of Competitiveness

Scale has generally been viewed as the most important, if not the dominant, determinant of bank competitiveness. In the Indian context, no discussion about banking sector reform is complete without reference to consolidation, which is generally taken to mean a merger between two relatively small banks or between a large, supposedly strong one and a smaller, supposedly weak one. While it is perhaps tempting to see the achievement of scale as the silver bullet for competitiveness, both domestic and global evidence do not make an unambiguous case for it. To go back to my introductory comments, large banks can become extremely vulnerable if their

expansion strategies have been based on taking on a complex array of risks. In the Indian context, there is substantial evidence, some if it produced by my colleagues in their research activity, that there is no unambiguous relationship between scale and efficiency or performance. Comparing across countries, a simple comparison of the five largest banks in China and India suggests that while the former are many times the size of the latter in terms of their balance sheets, this does not apparently lead to a significant difference in efficiency and performance indicators.

I don't have the time to go into the details of all the evidence, but it seems to me that it does raise questions about a uni-dimensional approach to competitiveness. Scale may matter, but is not by itself enough to guarantee the desired outcome. Let me, therefore, explore other factors that may matter and, in doing so, assemble the components of a competitiveness strategy.

I will postulate three other factors. First, there is the issue of "scope". The crisis has re-activated a long-standing debate on the merits of narrow banking vs. the recent trend towards universal banking. The question is: how wide and encompassing is the "universe"? Virtually all large banks, both at home and outside, have diversified well beyond the traditional boundaries of banking. There is a clear merit to this strategy from the viewpoint of what I would call a "Life-Cycle" approach to meeting customer needs. As the requirements of a given customer segment become more complex, there is value to be realized for both parties by expanding the range of services provided. This argument clearly justifies moving beyond the boundaries of conventional banking, which would otherwise drive customers away as their needs expanded beyond these limits.

However, as the crisis demonstrated, things can possibly go too far. As the range of activities that banks engaged in moved into the realm of investment banking, in which they combined their traditional assumption of credit or default risk with the new animal of market risk, internal and external mechanisms designed to monitor and protect against risk clearly fell short. This issue will also provoke substantial debate, so let me make a couple of assertions and move on. The first implication I would draw is that the achievement of scale in a way that substantially increases the riskiness of the asset base may prove to be counter-productive. This may well be Banking 101, but seemed to have been forgotten somewhere. The second is that the drivers of scale must be accompanied by a proportionate expansion in risk management capabilities. If this is scrupulously followed, it might make specific expansion strategies more costly and, therefore, unattractive, which, from the perspective of prudential regulation, would be a good thing.

This leads me to the second factor, which, I would term “prudence”. Very clearly, the ability of banks to identify, measure and provide against risks of all kinds should now be seen as a critical contributor to survival. Of course, there is little point in having a competitive strategy of you do not first have a survival strategy! This dimension needs to be addressed in two ways. First, there could be restrictions, either self-imposed or mandated by regulation, on the kinds of exposures that banks can take on. Second, going back to the earlier point about risk management capabilities, these need to be seen as an unavoidable component and, therefore, a cost element in any business strategy. Properly evaluated, this input will reduce the distortion in IRR calculations

when the management is evaluating alternative business and expansion strategies. If this distortion is sizeable, the crisis tells us that it can threaten survival.

Third, there is the issue of “knowledge”. Various interpretations can be put on this encompassing concept and perhaps all of them are relevant when we look at knowledge as a source of competitive advantage in banking. One aspect is clearly related to the application of technology; another would be the achievement of best practices in credit assessment, risk management and other activities, particularly with reference to the quality of information and judgment that is brought to bear on the allocation of funds.

An important dimension of knowledge relates to the debate on scale. In the early 1990s, the first Narasimham Committee visualized a three-tier structure of the domestic banking sector, with the bottom tier comprising relatively small, regionally focused banks. The underlying rationale was that such banks could compensate for their absence of scale with their intimate knowledge and insights into local conditions. This would help them meet the needs of their client base as well as manage risks more efficiently. More recently, the Committee on Financial Sector Reforms chaired by Prof. Raghuram Rajan, made a case for the encouragement of local area banks on much the same grounds, i.e., that a better understanding of the local context would offset the cost disadvantages of operating on relatively small scales. Of course, both blueprints saw these smaller banks as being fully plugged into the financial system, which would help them both raise funds and pass on risk. However, the importance of “local” knowledge as a determinant of competitiveness was emphasized.

If we interpret this argument more broadly as relating to a balance between understanding client needs and understanding the business environment, the increasing globalization of Indian business clearly provides a vehicle for the increasing globalization of Indian banks – keeping in mind, of course, cross-border regulatory barriers. Following their clients abroad was the basic strategy of banks in the developed economies; once a presence was established, they would obviously look for ways to expand business by serving new sets of clients. In the current global context, there are obviously more restrictions in place than before, which makes replication of this strategy difficult, but the basic principle is still valid. Knowledge about the client's requirements has to be quickly and credibly supplemented with knowledge about the operating environment.

In short, I would look at a competitiveness strategy as consisting of these four components: scale, scope, prudence and knowledge. The relative importance and balance between them will obviously be influenced by the objectives and resource constraints of each organization. But, I think that this provides a useful way to think strategically, which is rooted in both concept and evidence.

Policy Considerations

Given the significance of the externalities that the financial system as a whole and the banking system in particular generate, we cannot talk about competitiveness strategies without considering their policy implications. Let me briefly address three sets of issues.

The first is the traditional regulatory concern with prudence. I have already referred to the private or strategic compulsion for prudence in any viable competitiveness strategy.

But, this is clearly not enough in a situation in which inter-linkages between institutions, each of which has a small and contained quantity of risk, can cause a snowballing, which threatens the system. Macro-prudential or Systemic risk is a real threat and, because of inherent non-linearities – the whole is greater than the sum of the parts – cannot be addressed only by private or institution-specific measures. Just as internal capabilities for risk management need to be developed and sustained, capacities to understand these inter-linkages, monitor them and buffer the economy against the materialization of their threats must also expand proportionately. In this sense, the space for the pursuit of specific competitive strategies will possibly be constrained by the mechanisms available to identify, measure and mitigate the inherent systemic risks.

The second issue relates to competition and the possible trade-off between the objective of scale and the need to maintain a competitive industry structure. Perhaps, in an environment in which the full potential of the market is yet to be tapped, the two forces are not in serious conflict with each other. Competition may work as a positive force, which drives individual banks to focus on their areas of competence and, in the process, achieve efficient scales of operation in all of them. But, this is an idealized description of market conditions. The reality is that the market is highly segmented, which raises the prospect of scale-deterring competition in some segments, while leaving others under-serviced. From a policy perspective, this is not a particularly desirable outcome. An argument could be made for introducing incentives and disincentives, which will of course have a bearing on strategic choices, to steer the system towards that more favourable linkage between competition and scale.

The third issue is closely related to the second, but has some distinct aspects as well. Financial inclusion is a central part of the policy agenda. The perspective on this issue is largely driven by the circumstances described above, viz., that there is an inherent reluctance on the part of banks to service certain client segments because they are not commercially viable. A combination of regulatory mandates, implicit and explicit subsidies and moral suasion has been brought to bear on the financial system in pursuit of this objective. However, more recent thinking and evidence on this issue suggests that commercial viability is not unachievable, given an appropriate mix of organizational structure, human resources and technology. This is still an evolving landscape, but as the differentiators between good and bad models become clearer, policy instruments can potentially be brought to bear on aligning strategic choices with policy objectives.

Concluding Comments

Let me conclude by summarizing the simple competitiveness framework that I attempted to lay out. From a strategic perspective, competitiveness can be achieved by balancing four factors – scale, scope, prudence and knowledge. All are important in a generic sense, but each institution will have to decide what weights to give to them, depending on its particular strategic objectives.

From a policy perspective, three factors are likely to influence policy interventions that will steer strategic choices in order to align them with policy objectives. First, there is the issue of macro-prudential risk. Second, there is the potential trade-off between competition and scale. Third, there is the issue of finding the right mix of ingredients to achieve financial inclusion in a commercially viable way.

I trust this will be a useful input into both the panel discussion that follows and the strategic thinking in the banking system as it charts its future course. I thank the organizers for giving me the opportunity to share my thoughts.