Business Standard

Options on the future of banking

Book review of 'Towards a Safer World of Banking'

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Towards a Safer World of Banking
Bank Regulations after the Subprime Crisis
T T Ram Mohan
Business Expert Press
149 pages; Rs 2,396

Towards a Safer World of Banking by T T Ram Mohan, who is a professor of finance and economics at the Indian Institute of Management, Ahmedabad, is a nifty little book aimed at students of business management and bank executives. It makes sense to take a relook at the world of banking since it is almost a decade since some of the biggest banks in the financial world such as the Bank of America, the Royal Bank of Scotland, the Citigroup as well investments banks such as Bear Stearns and Lehman Brothers either failed or nearly did. Since then, governments and taxpayers have been bailing out the troubled banks in the hope that doing so would be, in the long run, cheaper than the cost of letting such entities sink. But this process has been arduous, with massive and unsavoury political and social repercussions. Not surprisingly, there is considerable interest in ensuring that such a contagion does not recur. This book, then, is an appropriate read for anyone wanting to understand whether we have done enough to ensure that.

The book is divided into five chapters. In the first two, the author discusses the financial and banking crisis that started in 2007 and the causes for the subprime crisis. Now, there is no dearth of reasons advanced for the meltdown. In fact, depending on who you might have read and what you do for a living, you could choose from the long list of causes and not be entirely wrong. This is known as the “Murder-on-the-Orient-Express” theory of the crisis. But therein lies a problem. Unless one can zero in on the exact problem you cannot even begin to provide a lasting policy solution. So the author helps the reader tussle with questions such as: Does an economic contraction cause a banking crisis or the other way round?

Similarly, the author analyses each of the 12 broad reasons given for the subprime crisis, such as the existence of a housing bubble in the US and elsewhere, loose monetary policies, greedy consumers, excessive financialisation or the global macroeconomic imbalances, to name a few. But many of these factors existed in the past and in other places without causing a global crisis. For instance, there have been periods of low and falling interest rates or instances of housing bubbles in several other countries. In the end, though, the author settles for “regulatory failure” as the principal culprit. According to him, there were “serious failures in relation to banks” such as lowering of loan writing standards, a focus on trading income by holding securitised assets and low amount of equity capital in relation to assets and so on. The author takes into account the analysis by Atif Mian and Amir Sufi in their book, *A House of Debt*, which gives primacy to the excessive buildup of private debt. But Professor Mohan Ram argues that this, too, only shows that the ambit of regulation should have been much broader.

The third chapter focusses on regulatory reforms since the crisis. Much has been done, from increased capital requirements and far more stringent norms for liquidity to tighter norms for securitisation and macro-prudential regulations. This has yielded results. As of 2015, in the US, for instance, the top five banks had a common equity Tier 1 ratio that was higher than that specified by Basel III and all but one bank surpassed higher requirements imposed by the US Federal Reserve. There have been similar improvements in the Europe as well. And yet, chapter four argues, not enough has been done to deal with the key problem that still exists: Banks being too big to fail. There is growing concentration in the banking sector, which, in turn, makes the whole sector more vulnerable.

Chapter five is about solutions. The author is among those who thinks that radical and out-of-the-box ideas are needed to disaster-proof the banking system. Some of the ideas discussed include the "shared-responsibility mortgages" proposed by Messrs Mian and Sufi. In such a mortgage, the lender offers downside protection to the borrower while the borrower agrees to give 5 per cent capital gain to the lender on the upside. Also discussed is the chairman of the Institute for New Economic Thinking Adair Turner's even more radical suggestion to limit the amount of debt creation itself.

But perhaps the most unusual solution is the one proposed by the author: India's experience with public sector banks (PSBs). These last 10 pages of the book are likely to elicit far more interest among the Indian readers who are at present witnessing an embarrassing bloodletting in India's PSBs. The author argues that the Indian experience, where PSBs account for 70 per cent of the banking system, as well as the Chinese set-up, where similar entities account for 90 per cent of the system, are responsible for these countries being the world's fastest growing economies.

But it is all too clear that Indian PSBs are holding back growth instead of delivering it. The author offers a spirited defence for the PSB functioning — but stops at 2013-14. That is exactly the point at which the problems starting showing up. The author's argument that PSBs' troubles in the past two or three years are the result of structural failings of a developing country (such as the lack of a well-developed bond market) is not entirely convincing. The truth is that the deep rot in Indian PSBs highlights the risks associated with government ownership of banks.