Harun R Khan: Taking on risk – the sensible way

Keynote address by Mr Harun R Khan, Deputy Governor of the Reserve Bank of India, at the CII "Confederation of Indian Industry" National Risk Management Summit 2015 on "De-risking the Future of India Inc.", Mumbai, 10 February 2015.

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Shri Suresh Senapaty, Shri Richard Rekhy, Shri Deepak Parekh, Smt. Greeta Varughese other distinguished guests & invitees on and across the dais. This invitation to give an address at this important CII event gives me a great pleasure. CII seems to have chosen a very interesting theme for this national risk summit – "*De-risking the future of India Inc.*" – I am, of course, wondering why CII is thinking of de-risking the future of India Inc. though the participants here would appreciate the fact that de-risking would also mean that they have no business to be in "business".

Risk-return-retribution in a VUCAP world

All human enterprise, more so business activities essentially involve risk taking, in a bid to earn the "reward" or "return" according to the risk-return trade-off. This relationship is, however, far from simple as the reckless chasing of returns may result in unimaginable levels of risks not only for the individual enterprise but also for the whole system. The risks posing a threat to the financial and economic balance of the world today are far from being properly managed and controlled. I understand that the prevailing evidence of continuing, if not increasing, appetite, for fast returns is one of the major motivations behind the broad theme for this seminar.

While developing my thoughts on the much used idea of the risk-return trade-off, I was led to think of a missing "R" – Requital – in the risk-return conundrum. The tremendously forceful human fascination for reward and the almost irresistible tendency to take or overlook risks in that pursuit has, more often than not, resulted in inevitable retribution or requital, in the long term.

In the present context, probably it is the zeitgeist that drives us crazy. Having seen the massive impact of the global financial crisis, we may want to take a pledge to de-risk the future. Peter Bernstein, the American financial historian, had an interesting perspective; according to him, "Risk and time are opposite sides of the same coin, for if there were no tomorrow there would be no risk. Time transforms risk, and the nature of risk is shaped by the time horizon: the future is the playing field".[1] Hence, our approach should be to ensure risk compatibility over time rather than trying to de-risk the future. In fact, a fanatic commitment to risk aversion could itself be a risk that businesses might face in any post-crisis period.

May be that we need to strategize to meet the challenges of a VUCA world. Part of the military vocabulary, it is an acronym for volatility, uncertainty, complexity and ambiguity, now widely used to explain the vagaries of global economy and the financial markets. I would like to add a P to this, which stands for perversity, making it VUCAP. That wouldn't be a misfit given the nature of the contemporary global economy, financial markets and the army interventions across the globe!!

We used to scorn high volatility in the past, but are now wary of low volatilities. We do worry about uncertainties, but certainty brings complacency and makes us vulnerable. Are we all

[1] *Against the Gods.*

really uncomfortable with complexity? Not sure. For some, complexity pays. And there is this ambiguity in all these. The latest financial stability report released by the Reserve Bank of India (December 2014) talked about “an ambience wherein weak growth prospects are still considered benign for financial markets” for that would lend strength to the expectations that ultra-easy monetary policies would continue; that, in a way is perversity. But then, that’s the world that we have to deal with.

I think it might be in Nature. Let’s for instance take a look at the ancient Egyptian religious thought, where the themes – viz., *order, chaos and renewal* – appear repeatedly. Every year the Nile flooded, but then it renewed the fertility of the soil and helped a highly productive farming industry that sustained the Egyptian civilisation. The global financial crisis, like every other crisis, has provided us new lessons as also opportunities.

Having added a P here and an R there to put the broad theme of this seminar in perspective, let me now turn to some specifics.

Business risk and regulatory dialectics

Being a regulator, I will start with the business community’s concerns over legal and regulatory risks. As I could see from your flyer, there is a slot to discuss this and a brief is given thereunder. While it talked about increasing risks faced by companies arising from complex regulatory enforcement and new legislation, it also pointed out, rightly, that, these were brought upon due to the corporate scandals and breakdowns in the past few years. This is also because organizations have been doing more business across boundaries than ever; thus, adding global regulatory concerns to their local regulatory risks. So, we all understand and appreciate the concerns here – both of the law enforcers and of those who are subjected to these laws and regulations.

Oftentimes, we get to hear how difficult it is to do business in India. But multinationals, at various points of time, have had similar concerns over doing business elsewhere too. At the DLD technology conference in Munich recently, Nicolas Brusson, the co-founder of BlaBlaCar, the French ride-sharing start-up, when questioned about the rationale in starting his venture out of France with its 28 sets of laws and regulations, replied: “when you start from France, everything looks simple”. I am sure Indian companies that ventured overseas in the last one decade or so may now vouch for these sentiments. In the current context, it may make immense sense to seriously look at the “Make in India” pitch with the government trying to do what it can.

We must understand that most of the times regulatory stance follows, rather than precede, the excesses committed by the regulated entities or the overreach of the so called self-regulatory mechanism. Their actions in fact emanate from the very nature of the wider mandate that the regulators carry on their shoulders. In what is called as “regulatory dialectics”, financial market regulation is an endless process with both the regulator and the regulated making alternative moves in terms of regulation, avoidance and re-regulation.[2] This must be true of other markets, too.

What guides the actions of regulators is the need to ensure smooth functioning and stability of the markets that they regulate and not populism. In other words, as John Kay, the Financial Times columnist, often says, crowd-pleasing is no substitute for wise judgement. “That’s why we prefer to entrust the navigation of a plane to a skilled pilot instead of using the average of the opinions of the passengers”, were his words of wisdom.

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2 Edward Kane – “Loose Ends in Capital Regulation: Facing Up to the Regulatory Dialectic”, presentation at International Banking Conference Federal Reserve Bank of Chicago, November 11, 2011, Chicago.

Use and misuse of credit

That brings me to a widespread concern of the regulators like the Reserve Bank of India (RBI) over corporate leverage and the prevailing credit culture. One challenge that some corporates might face, going ahead, is in terms of raising resources – not because of non-availability of resources, nor for lack of creditworthy business opportunities but because of how the debtors respect their commitments as also an evolving thinking on "efficiency imperative" in credit dispensation. It is very likely that the days ahead will experience enhanced scrutiny of credit decisions of banks by depositors and tax payers, besides shareholders. Is it all because of the deteriorating credit culture? We need to examine.

Banks form the backbone of our financial system and carry out an important function, viz. reaching financial savings to those in need of it. Thus, credit is the other end of this intermediation process and we all must understand the etymology of the word "credit" and respect the semantics. The only way we address the situation is responsible use of credit.

As Governor Rajan has warned,[3] there is an "uneven sharing of risk and returns in enterprise, against all contractual norms established the world over – where promoters have a class of "super" equity which retains all the upside in good times and very little of the downside in bad times, while creditors, typically public sector banks in our context, hold "junior" debt and get none of the fat returns in good times while absorbing much of the losses in bad times".

Let us now look at the way "leverage" is assuming negative connotations. Leverage per se is a necessary evil for businesses to grow. Why then corporate leverage is being quoted of late as a concern for financial stability? Indian companies, no doubt, have come of age in terms of building world class infrastructure projects, withstanding tough competition from global players, and expanding their wings beyond national borders. While some have succeeded, the ambitions of others have proved to be hubris. Their actions needed enormous resources, which came from domestic and overseas financial markets though the ensued global financial crisis (GFC), demand slump and currency volatility exposed them to unexpected risks. Could they have seen all this ex-ante? Probably going ahead non-financial companies may think of some kind of stress tests to assess their resilience to emerging risks, similar to the approach adopted by financial sector industry, subsequent to the GFC.

Risks of unhedged forex exposures

Large scale unhedged foreign currency exposures are not only a threat for individual entities but also a concern to the economic and financial system stability. While regulators certainly will not like to micro manage what otherwise is a commercial decision, corporates need to take care of the potential risks embedded in their unhedged currency exposures since they might incur significant costs due to unexpected and sudden exchange rate movements. You all might be aware of the recent decision of the Swiss National Bank that claimed a few scalps while the victims cried foul.

On the other hand, as Governor Rajan had indicated some time back,[4] borrowers get into a trap at times of exchange rate appreciation which gives them a false sense of complacency in terms of having higher equity due to rising asset prices. While we do have comfortable foreign exchange reserves, there is a strong view that no amount of such reserves can cushion extreme external shocks. That too here we are talking about nations. You can

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3 Saving Credit – Talk by Dr. Raghuram G. Rajan at the Third Dr. Verghese Kurien Memorial Lecture at IRMA, Anand on November 25, 2004.

4 Competitive Monetary Easing: Is it yesterday once more? – Remarks by Dr. Raghuram G. Rajan at the Brookings Institution, April 10, 2014.

imagine how vulnerable corporates can become if they have too much of foreign currency exposures.

For those business entities that do not have a natural hedge, mere cost advantage in terms of pure interest rate differential (without the hedge costs) should not be the guiding factor for overseas borrowing. On the other hand, we also had this unpleasant experience, in the aftermath of the financial crisis of 2008, when many Indian exporters who had entered into complex derivative structures with banks suffering severe losses arising out of marking to market of their derivative positions. This is why I said earlier that complexity benefits some and hurts others. Hence corporates need to understand not only the risks they are assuming but also the risks arising out of faulty "risk mitigation" processes. People in business should therefore realise that adoption of risk management strategies is not meant for generating additional earnings but is needed for protection of the projected income flows.

Last year when the US Fed indicated its intentions of tapering of quantitative easing (QE), India, like many emerging market economies, particularly those with current account deficit (CAD) came under severe pressure due to capital outflows. Several measures were taken to address volatility in the foreign exchange market that included, among others, reduction in limit for overseas direct investment (ODI) under automatic route from 400 per cent to 100 per cent of the net-worth of an Indian entity as a macro-prudential measure though in genuine cases requirements above the revised limits were considered under the approval route besides many administrative measures aimed at curbing the opportunities for excessive financial market activities. The Reserve Bank and the Government had to take a number of measures to de-risk the national balance sheet; just to illustrate , the curbs imposed on gold imports and opening of concessional swap windows for mopping up longer term foreign currency resources through foreign currency deposits and borrowings by the banks.

With return of stability in the Rupee-Dollar exchange rate, restrictions with respect to remittances under ODIs were largely withdrawn on July 01, 2014 and the limits under automatic route for overseas investment were restored to 400 per cent of the net worth of the Indian entity. In other words, the job of de-risking the corporate world sometimes is upon macro prudential regulators like the RBI for the larger concerns that I had explained to you earlier. Yet, I must also tell you that the dividing line between prudential regulation and micro management is often thin.

Dealing with disruptive ideas and technologies

Let me now turn to another theme of discussion in this summit. This relates to the threats posed by disruptive ideas and technologies and the risks in not being able to swiftly appreciate the emerging challenges posed by the digital world. There is a perceptible discomfort amongst a section of the business community with the rapidity with which the world is changing as a result of disruptive ideas and technologies.

As per a PwC survey,[5] 60 per cent of the firms surveyed indicated "the speed of technological change" as a threat to their growth prospects. On the other hand, the manufacturing industry may be particularly worried about the fact that more and more talent and resources are shifting their preferences to virtual platforms than to brick and mortar manufacturing. The valuations seem skewed towards such initiatives, but let's not for a while forget the fact that these disruptive initiatives do face their own set of risks and challenges, what is more important, however, is that they are inevitable.

The attitude of de-risking doesn't go well with disruptive ideas and this gets clearer by looking at the start-up culture that the US is known for and why that country stands apart and enjoys leadership position amidst fast changing economic cycles and consumer preferences.

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5 PwC 2014 Annual Global CEO Survey.

The recipe for success lies in transforming the businesses to be relevant in a post-industrial digital world. For countries like ours we need to reassure that technologies would ultimately improve job opportunities by augmenting inclusive growth – both quantitatively and qualitatively – rather than taking them away and that they enhance the standard of living rather than destroy it.

Coping with cyber threats

For the financial sector specifically, there is a need to look into the extant IT environment, since there is a feeling that the IT infrastructure at most financial firms is fragmented and inconsistent.[6] The financial sector industry rests on trust and credibility, and increasing cybercrime is threatening this basic premise. According to a report[7] released by the British Bankers' Association (BBA) in association with PwC, "defending and countering cyber-attacks whilst keeping up-to-date with evolving regulations and policy is a complex challenge".

As you know, cybercrimes are getting sophisticated and nuanced. Their perpetrators could be broadly categorised as "organised cyber criminals" and "enemy state agents". Motives could be anything ranging from corporate espionage to intellectual property rights to siphoning off funds. In all these, if we look at it seriously, the primary weapon is exploiting vulnerabilities. While they cannot be easily wished away, the only way corporates can tackle this is to be "proactive" about their "cyber resilience".

In the case of a data theft last year at one of the global investment bank, what was disturbing was not the security breach per se but the fact that the hackers were inside their systems for close to two months before being noticed! Corporates need to put in place a robust business continuity management (BCM) plan (which is the broad theme of the last session of this summit) and perform business impact analysis. No corporate can afford to brush these off as trivial non-operating activities since the potential risks involve not only monetary loss but also reputation and legal risk which can simply demolish established businesses.

A survey[8] indicates that 41% of economic crime was committed by employees within an organisation. How do we address this? Can we seriously think of examining the incentive-compatibility structures at our companies? Since risk is inherent in every business, in the absence of appropriate incentive compatibility structures, we may encounter behavioural patterns leading to decision making processes that de-risk the individual rather than taking the optimal decisions that would benefit the organisation. Such behavioural patterns may lead to functional paralysis and at times, to explosive business disruptions within the organisation.

We can even think of gender balance in decision making, the mostly ignored aspect of the "inclusiveness" discussions. I am reminded of the famous response of Christine Lagarde to a journalists' question. She said "had Lehman Brothers been Lehman Sisters today's economic crisis would look quite different". That might be a quip, but we have seen the success of Mohammed Younus who turned to women to make "micro finance" what it is today. According to some research in behavioural finance, excessive risk taking in men has to do with their body chemistry.

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6 Managing complexity – the state of the financial services industry 2015, Oliver Wyman.

7 The Cyber Threat to Banking – A Global Industry Challenge.

8 PwC 2014 Global Economic Crime Survey.

Optimism with caution

India is on the cusp of a great upsurge and business entities must ride the wave but they should be mindful of the risks that they are assuming for themselves and for the system as a whole. Macro-economic vulnerabilities facing our economy have significantly receded, thanks to improvement in growth outlook, fall in inflation, sharp reduction in oil prices, recovery in the external sector coupled with a bigger war chest of forex reserves, and a strong commitment from the Government to contain fiscal deficit. This implies we are much better positioned among our peer countries to cope with future uncertainties and vulnerabilities. Having said that, we cannot afford to be complacent and that is why we want to be cautious in our approach and want to be more certain than everyone else that our economy and financial system do not have to repeatedly face many of these vulnerabilities.

In other words, at this juncture, India cannot afford to lose the greatest opportunity that it possibly got over the last so many years, given its relatively strong position amongst emerging market economies. On the other hand, with a political set up so attuned to the concerns of the industry, the "Make in India" perspective offers a paradigm shift in terms of Government-industry interaction.

Yet, a successful implementation of this paradigm requires asking some basic but fundamental questions for each industry in terms of *"What do I offer?", "What are my key competencies?" and "What are my weaknesses?"* Is it the cost control centric rather than value addition centric approach of Indian industry that is to be addressed first? The term "de-risking" should mean finding one's own moorings, *i.e.*, the sustainable *USPs*. A manufacturing industry driven by cost minimization philosophy compromising on quality can only be fleeting source of comfort.

Conclusion

Let me conclude with a few thoughts. The sustainable solution for risk mitigation lies, to a great extent, in knowledge leadership. To progress from "me too" business models which are all too vulnerable to disruptive onslaught from ever nimbler start-ups to "knowledge leadership" is a significant leap. But India as a country has to make that leap in order to develop sustainable source of leadership. And such leaps will have to be enabled at our educational institutions, vocational or otherwise. More and more institutions of excellence must be encouraged to serve as incubators for legions of technology breakthroughs.

The question we require to pose is what stops us from replicating such innovation centric knowledge hubs. Knowledge leadership doesn't imply that Indian industry as a whole will be insulated from churning. After all there is only one company common between the Dow Jones index of the early twentieth century and twenty first century. It rather means that such leadership will entail that for every loser in such an enterprise, there are multiple winners.

I wish you all the very best and hope you will have fruitful discussions on a broad range of themes starting from "risk analytics" to "regulatory risks" to "digital forensics" to "risks from work place of the future" and finally to "climate change and sustainability risks". I am sure that at the end of the summit you will all arrive at a few workable strategies to manage your business risks more efficiently.

Thank you all.