S S Mundra: Strong financial services sector – imperative for sustainable growth

Keynote address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the ICAI International Conference "Accountancy Profession: Spearheading Excellence", Indore, 9 August 2015.

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Good Morning to you all!

1. I am pleased to be here this morning to speak to the delegates of this International Conference and I thank ICAI for providing me this opportunity. As you all know, the theme of this morning's session is "Financial Services Sector- Agenda for Sustainable Growth" and as somebody who has spent his entire professional life in the banking sector – first as a commercial banker and now as a Central banker, I would speak with a particular emphasis on banking sector.

Introduction

2. Let me begin by taking you back to South Korea of the year 1997. The "grey-haired" amongst you would recall that in the period leading up to 1997, the Korean economy as also the other "tiger" economies in the South East Asian Region had expanded by 6% to 10% on an annual basis. Buoyed by expectations of rapid growth and expansion, the chaebols (family-owned business conglomerates) in Korea had raised significant amounts of foreign funds for investment in building industrial capacity. However, as the economic growth slowed down, the debt problem started to accentuate and one of the chaebols, Hanbo collapsed under a $6 billion debt load. The company had decided in 1993 to build the world's fifth largest steel plant and there was cost escalation of the project from Won 2,700 bn to Won 5,700 bn while the steel demand had turned sluggish. The situation deteriorated further in July 1997 when Kia, Korea's third largest car company asked for an emergency bank loan to avoid bankruptcy. These events prompted international credit agencies to downgrade the ratings of Korean banks with heavy exposure to the chaebols and thus, began the financial meltdown in Korea.

3. Of course what is widely known as the "Asian Financial Crisis" had begun earlier on February 5th, 1997 in Thailand when a Thai property developer failed to make a scheduled interest payment on its eurobond loan. The business model of financial institutions in Thailand was built around issuing eurobonds denominated in US dollars to benefit from the interest rate differential between dollar denominated debt and Thai debt and using the proceeds to fund property development. By January 1998, the stock markets in many of these economies had lost over 70% of their value, currencies also depreciated by a similar extent and many had to seek IMF assistance.

4. My purpose in beginning the address by narrating these events is to highlight typically how problems unfold in a crisis. The problem often begins with banks taking excessive exposure (concentration) to a particular sector or sectors, the corporate increasing their leverage manifold and investing in creating excess capacities. Unraveling of the risks could perhaps still be managed if the banks' capital positions were strong, but if that is not the case, risk manifests itself in all its dimensions. Leveraged positions created out of borrowed money from abroad for funding growth in domestic markets add another twist to the tale. Once home currency depreciates, debt servicing becomes a challenge for corporates holding large unhedged positions. If there are large scale borrowings by various corporates, this debt crisis could easily degenerate into a full-blown currency crisis.

5. The Financial Crises typically take the form of currency, debt or banking crisis and have severe consequences for the economy. A question that begs an answer at this stage is why financial crises happen? There are, of course, many reasons – some economic, some social and some political. While we would leave a detailed discussion on this issue for another day, suffice to say at this stage that the origin of all crises can be traced to a weakness in the underlying structure and an all-round failure to exercise self-restraint and lack of adherence to the established framework. In fact, the ground for the 2008 Financial Crisis was created by a prolonged period of easy monetary policy, consequent mispricing of risks, a search for yield by the market intermediaries and an inadequate supervision over market behavior.

India today

6. Looking at the Indian scenario today, one can't avoid some comparison with the events in the South East Asian economies of 1997–98, though the degree of severity differs widely. Let me take the example of the steel sector. Bank loan to the steel sector in India has witnessed a 21% CAGR over the past five years and broadly ranges between 4 to 9 % of individual bank's loan book. Banks' total exposure to the steel sector stands at Rs. 3 lakh crore while the net sales for the companies within the sector also stands at around Rs. 3 lakh crore with an EBIDTA of Rs. 37000 crore. The level of stressed assets in the sector exceeds 27%. Large capacities are lying idle as global/domestic demand conditions have weakened. Further the capacity expansion has been done using excessive leverage. These pointers definitely raise concerns.

7. Excessive leverage by the borrowing corporates is not limited to the steel sector alone. The Global Financial Stability Report released by IMF recently has noted that 36.9 per cent of India's total debt is at risk, which is among the highest in the emerging economies, while India's banks have only 7.9 per cent loss absorbing buffer, which is among the lowest. An analysis of a sample of 3,700 companies by Credit Suisse has highlighted that 37% of the debt held by these companies is with companies having Interest Coverage less than 1.There may be valid questions around the assumptions made in deriving these conclusions, but the underlying direction cannot be ignored.

What are the consequences of a weak financial sector?

8. Let me answer it differently. Financial sector facilitates risk-sharing by reducing information and transactions costs. A strong financial sectors characterized by strong financial intermediaries and wider and deeper financial markets. In a strong financial sector, the liquidity and maturity transformation amongst the borrowers and savers happens in the most efficient manner. In such a market, savers are confident in handing over their surplus funds to the financial intermediaries which can then be borrowed and invested for creation of productive assets at the least cost. This can create multiplier effect and generate wealth and prosperity for both savers and borrowers and for the economy as a whole. Particularly in case of EMEs, where credit market is typically bank-led, an efficient resource allocation framework is central to Governments' efforts towards employment generation and poverty eradication. On the contrary, a weak financial sector consisting of weaker intermediaries and shallow financial markets would invariably be prone to crisis resulting from inefficient resource allocation and disproportionate risk-taking behavior. So, typically, a weak financial sector would have highly leveraged corporates and/or over indebted individuals. Absence of a strong financial sector also drives individuals towards dissaving or moving into physical assets which retards investment and consequently growth besides building up asset price bubbles.

9. A weak financial system can have deleterious consequences for the economy and the country. Dallas Federal Reserve researchers Tyler Atkinson, David Luttrell and Harvey Rosenblum in their paper "How Bad Was It? The Costs and Consequences of the 2007–09

Financial Crisis" observe that the crisis was associated with a huge loss of economic output and financial wealth, psychological consequences and skill atrophy from extended unemployment, an increase in government intervention, and other significant costs. Their estimate of total loss for the US economy alone is nearly $ 14 trillion, which is nearly 7 times India's GDP.

10. The quarterly report of March 2012 of the Special Inspector General for Troubled Assets Relief Program (TARP) in the US puts the cost of Gross US Government Bailout Outlays from the 2008 Financial Crisis at $4.6 trillion, while the guarantees from US Treasury, Federal Reserve and other US government agencies totalled $16.9 trillion. Likewise figures released by the National Audit Office in the UK, put the cost of bailouts for the UK taxpayer due to the 2008 Financial Crisis alone at a peak of £955bn.

11. The above numbers, thus, give a sense of the economic loss arising out of financial crisis. These numbers are staggering and hence, scary. As the old adage goes, "prevention is better than cure" and hence, it is the endeavor of the regulatory reform process to strengthen the financial system and prepare it to withstand the force of any impending crisis.

12. So, what all is being done to make the financial sector and the banking sector healthy? Before I get into the steps taken to strengthen the banking sector post crisis, I must highlight the monetary stimulus infused by various Governments/ Central banks across the developed world. The monetary policy makers in the US, Europe, UK and Japan have all followed an expansionary monetary policy to wriggle their way out of recession. But the efforts have not quite borne fruit as many of these countries have not yet reached anywhere close to pre-crisis growth rate. Japan has, in fact, entered its third "lost decade" and is still stuttering to find growth. Moreover, as is being proven now, loose monetary policy is like "Chakravyuha", the famous battle formation in the epic "Mahabharata" where it was easy to enter, but difficult to exit.

13. Let me now turn to the reforms aimed at the banking sector.

Global reforms

14. The banks in Europe and the USA entered the financial crisis with highly –leveraged balance sheets. They were too thin on equity and the balance sheet was too precariously placed to withstand write-down on their investments in complex derivate instruments. The situation was somewhat better in the developing world, but even the banks in these markets got impacted as the pains of the real economy slowly started to inflict the financial economy. It was in this background that the regulatory reform process was set in motion by the multilateral Standard Setting Bodies to undo the excesses of the pre-crisis era. The major elements of the reform process that have been implemented/ currently under negotiation are as under:

- Basel-III capital prescriptions including capital conservation and countercyclical buffers
- Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)
- Leverage Ratio
- Total Loss Absorbing Capacity (TLAC), a work-in-progress, which aims at a higherloss absorbency requirements and resolution framework for G-SIBs/G-SIIIs/G-NBNIs
- Regulation of the shadow banking sector
- Reforms of the OTC derivatives market and resolution of CCPs
- A standardized, non-modeled approach for calculating regulatory capital to resolve the problem of excessive variability in banks' regulatory capital ratios (A thought)

- Compensation– Alignment with prudent risk taking, Claw back provisions
- Transparency in benchmark setting

15. The underlying objective of these reform measures is to avoid the dependence on taxpayers' money to bailout financial institutions in the event of stress.

Indian position

16. Being a bank dominated economy, a healthy banking sector is imperative for India's economic growth. RBI has been proactively working towards development of a strong and efficient banking system through its regulations. As member of the international Standard Setting Bodies, we are not only implementing the globally agreed regulatory reforms now, but have also been proactive in introducing macro-prudential measures like higher risk weights for real estate exposures of banks, measures for dealing with risks emanating from derivatives and securitization transactions and spiraling unhedged forex exposure of corporates, much before the global attention was drawn to such risks. At RBI, we have always been conscious of the need for the regulation to evolve quickly for addressing incipient risks and it is in this spirit that many of the recent reform measures have been set in motion.

Recent measures taken by RBI

17. An important pre-condition for banks to be able to meet their lending obligations to current and prospective borrowers is that they remain profitable and solvent. It is in this context that following regulatory actions have been launched in recent past which are a fair mix of both, prudent regulation and right incentives to support growth with proper risk management:

- Guidelines on "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy covering formation of Joint Lenders' Forum (JLF), Corrective Action Plan (CAP), "Refinancing of Project Loans", "Sale of NPAs by Banks" to facilitate early recognition/resolution of financial distress
- Banks permitted to grant an extended debt repayment period to their borrowers in long-gestation projects ("5/25" scheme)
- Enabled banks to take steps for Strategic Debt Conversion (SDR) giving them right to convert their outstanding loans into a majority equity stake if the borrower fails to meet conditions stipulated under the restructuring package
- Enhanced fraud monitoring framework
- Issuance of long term infrastructure bonds to facilitate financing of long term infra projects
- Revoking forbearance on restructuring

Certain other regulatory measures like revision of the single/group borrower exposure limits and identification of D-SIBs, etc. have also been initiated.

Role of the auditor community in promoting sustainable growth

18. Let me now turn to some messages that I would like to give the auditor community present here. First of all let me compliment you for the very critical role that you play in keeping the banking sector healthy by auditing the balance sheets of banks and that of the borrowers to whom the banks lend. I would, however, begin on a light-hearted note. I quote former AIG Vice Chairman ***Jacob Frenkel***, who, in the aftermath of the Financial Crisis, once

quipped, ***"The left side of the balance sheet has nothing right and the right side of the balance sheet has nothing left. But they are equal to each other. So accounting-wise, we are fine."*** I am sure we don't want our accounting system to be fine like this.

19. External auditors play a vital role in maintaining market confidence in audited financial statements. In the case of the banking industry, this role is particularly relevant to financial stability given banks' financial intermediation function within the economy as a whole. Core Principle 27 of the Basel Committee's Core Principles for Effective Banking Supervision (September 2012) states that "the supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion".

20. Over the years, we have observed several accounting scandals unfold, latest in line being the one at Toshiba. It is understood that Toshiba would have to revise its pre-tax profit figures by ¥152bn ($1.2bn) over a seven-year period dating back to 2008. The amount involved accounts for nearly 30 per cent of the total pre-tax profit during the period. The initial findings have showed top executives' involvement in accounting malpractices where the inflated figures were made possible by delaying the reporting of losses and underestimating project costs. A sustained failure of this kind most definitely points to gaps in the audit process.

21. Another piece of accounting manipulation was observed in case of Rosneft, the Russian state controlled energy group, which, in a bid to mitigate the effects of the rouble's fall on its results, changed the way it accounted for foreign currency swings. The company shifted to recording the impact of such fluctuations when they materialized, rather than calculating the temporary effect every quarter. I am not sure how the audit community views this but analysts would definitely find it intriguing and not presenting a true and fair picture of the company's financials.

22. Auditors are expected to maintain highest standards of professional ethics and ensure that the financial statements of the enterprises they audit, present a true and fair picture of the prevailing state of affairs on an ongoing basis. As professionals, you must remain rather vigilant when auditing areas that: (a) involve significant management estimates and judgments, especially those measurements involving a wide range of measurement uncertainty; (b) involve significant non-recurring or unusual transactions; or (c) are more susceptible to fraud and errors being perpetuated due to weak internal controls[1].

23. As I said earlier, the lending business and the loan appraisals depend almost entirely on the balance sheets submitted by the borrowers and hence, fabricated account statements can lead to erroneous conclusions and unwarranted financing of enterprises. Banks increasingly lean on the auditors for undertaking stock and asset audit, concurrent audit and forensic audit. While looking at corporate balance sheet and to understand the level of leverage, it is important to look through the corporate structure and gearing of capital in downstream subsidiaries.If these tasks are accomplished proficiently, that would not only strengthen the banks' financials but also help create a stronger financial sector.

24. Many contend that accounting rules fueled the recent global financial crisis. While there is broad consensus that accounting rules are an important determinant of bank behavior, it would be imprudent to blame a single factor for the crisis as the specific mechanisms and their interaction with regulatory requirements are less well understood. The implications of the use of fair value accounting and the incurred loss approach of loss provisioning under International Financial Reporting Standards (IFRS) are cases in point.

[1] BCBS Paper : External audits of banks (March 2014).

Both have been criticized as contributing to a pro-cyclical behavior in banks' decision making, i.e. adding exuberance and fueling investments in the up-turn and triggering downward spirals and throttling investments in the down-turn of the credit cycle[2]. Regulation, on the contrary, are framed to last "through the cycle." I am, however, not going to delve deeper into this debate and would only focus on some of the imponderables which implementation of IFRS would throw up, especially in the Indian context.

IFRS Implementation and the imponderables

25. What IFRS implementation would entail for the banking system? The question is how prudential regulation would exist alongside IFRS? Proposed impairment calculations under IFRS, accounting for interest income on Effective Interest Rate basis and presence of multiple systems for operation and accounting of different portfolios would mean that IT systems would have to be upgraded/realigned for IFRS migration. Banks would also need to overcome challenges around converging policies for financial accounting and tax accounting for preparation of financial statements.

26. As the IFRS implementation date draws near, there are several pressing questions for which answers would need to be found.

i) How would the consolidation of accounts happen in situations where the parent entity is covered under Ind AS but the downstream subsidiaries are not?

ii) What would be the position when an account of one of the subsidiaries has to be drawn up under Ind AS but that is not the case for the parent entity (say an NBFC holding company)?

iii) How do you deal with equity with a "put" option?

iv) How the firms' account can be made comparable across periods?

27. It is quite possible that initially adoption of fair value accounting may lead to negative implications for the revenue of firms and consequently, could impact the balance sheet of both – firms as well as that of the banks.

Conclusion

28. I am reminded of a quote by Jim Peterson, a former lawyer for Arthur Andersen, the now-defunct accounting firm that audited Enron. He said "***An auditor's opinion really says, "This financial information is more or less OK, in general, so far as we can tell, most of the time***"," I trust the accounting community present here does a much more meaningful and methodical job than what Mr. Peterson suggests.

29. Let me conclude by reiterating that a strong financial sector is a sine qua non for sustainable growth. Financial Sector and in specific, the banking sector, derives its strength from a healthy credit portfolio, both corporate and retail as well as a healthy investment portfolio. Accounting standards and the auditors have a pivotal role in enabling the banks to develop such portfolios. There are, of course, complex but essential interplay between regulations, accounting standards and credit ratings.

30. I am sure that the Conference would be able to guide the various stakeholders in finding appropriate answers to many of the issues which I have just referred to. I once again thank ICAI for inviting me to share my thoughts on this occasion and wish the Conference all success.

[2] BCBS Working paper : The interplay of accounting and regulation and its impact on bank behaviour: Literature review (January 2015)