RISK MANAGEMENT AS CATALYST FOR SUSTAINABLE BANKING

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Introduction

I intend to analyse the topic of risk management as a catalyst for sustainable banking, under two broad headings. The first relates to financial system stability, which is the foundation on which sustainability is built. I will review this firstly from a global perspective, as the implications of the banking crisis of 2008 affect us all, and then discuss stability issues relating to Sri Lanka. Next, I will review the challenges of risk management in facilitating growth in our post conflict economy.

Financial system stability – a global perspective

The fragility of banks

The first issue I would like to highlight is the inherent fragility of banking systems. The sustainability of banking is of particular relevance today after the catastrophic banking collapse in the US in 2008, the financial and economic impacts of which reverberate globally even today. Economic growth has suffered while banks reduce loan portfolios In order to rebuild shattered capital. Regular booms and busts of banks have characterized their historic evolution over centuries. While the problems of the mega-banks continue to hit the headlines, it is not so well known that some 250 smaller US banks have been liquidated after the crisis, at the rate of two a week. The existence of efficient resolution laws and institutions (particularly the FDIC), have prevented the spectre of zombie banks prolonging and deepening the US economic recession, in contrast with the experience of Japan in the 1990s. Reinhart and Rogoff in a seminal study of banking crises, analyse the causes and consequences of what they describe as an equal opportunities menace, striking at frequent intervals both developed and developing nations alike. They are conclude that banks are inherently fragile institutions, which need constant and vigilant nurturing.

What causes banking crises?

Two of many causes are analysed in the above study.

1. Financial repression and bank runs

Based on exhaustive empirical analysis, the study concludes that bank crises are mainly caused by financial repression and by bank runs resulting from the erosion of public confidence. These factors are amplified by foreign exchange crises, volatile capital flows based on inappropriate economic policies and over aggressive lending by banks. Poor governance adds fuel to the flames.

Financial repression and erosion of confidence as causes of bank collapse were well illustrated in Argentina a decade ago. Governments forced residents to save in banks by providing them with few options in stunted capital markets. The government stuffed debt into banks via reserve and other requirements, allowing them to finance themselves at artificially low cost. They also directed or influenced banks to lend to preferred borrowers or projects at low rates, thereby distorting risk management checks and balances. Local currency debt expanded to a level that it became unserviceable, banks lacked the liquidity to repay depositors, confidence eroded, panic set in and banks collapsed.

2. The leverage problem

The second cause is the problem of leverage.

The rapid scaling up of Western bank balance sheets based on unprecedented levels of borrowings, was also a cause of catastrophe. As an example, the assets of the three largest UK banks was 7% of GDP at the start of the 20th century, but increased to 200% of GDP by 2007 based on a massive rise in borrowings. Leverage of banks in Europe and the US, increased in a decade from modest levels to 30 times on average by 2007. Returns on equity increased from single digits to 30% during a period when inflation was negligible. Arithmetically, virtually all of the ROE increase came from increased leverage. Why did shareholders permit such large increases in debt and the heightened risk of bankruptcy that goes with it?

The preference for debt over equity

There are at least five reasons why banks preferred to issue debt over equity in order to grow their businesses.

1) The tax subsidy which favours the issuance of debt over equity

2) Deposit guarantee schemes which effectively subsidize borrowings from retail customers

3) The moral hazard expectation that governments will bail out bond holders but not shareholders in a crisis. The AIG collapse, where shareholders were wiped out and bank lenders were bailed out, vindicated this belief

4) While bond issuance attracts subsidies, equity issuance has grown more expensive. An example illustrates:

   In the case of a non-financial company like Coca Cola, its shares sell for 17 times next years expected earnings or to restate the arithmetic, equity shareholders expect a return of 5.8% when they buy the shares. Since Coke can issue long term debt at 4.2% pa, the premium of equity over debt is a modest 1.6%, so the funding decision of the Treasurer is fairly balanced. In the case of US banks, the equity premium is much higher averaging 10%, and incentivises the issuance of debt rather than equity.

5) The fifth reason relates to the ownership and governance of banks

   A governance fault line also lies at the heart of the leverage problem and the resulting banking crisis. Ownership and control of banks are exercised by shareholders, but equity is only a tiny fraction of their balance sheets, thereby driving risk taking incentives of shareholders out of line with the interests of other stakeholders including depositors, bond holders, minority shareholders and of society in general. This governance asymmetry is amplified by the limited liability that shareholders enjoy and by their relationship with management.

   As share ownership became more diversified, there was until comparatively recently, what is aptly described as an amicable divorce between shareholders and managers. However in the 1990's, in order to realign shareholder goals with those of management, remuneration was defined in terms of maximization of returns on equity. Princely bonus schemes distorted broader objectives, risk management principles and commonsense. Boards and management responded by increasing borrowings in order to boost short terms returns, but at enormous long terms cost to their institutions. With hindsight, setting return on equity as a target directly incentivized the scaling up of borrowings. Return on assets, which omits the leverage effect, would have been a more appropriate management target from a risk mitigation perspective.

De-risking "too big to fail" banks

Regulators are rightly determined to de-risk overleveraged banks. The dilemma is whether this should be done by increasing capital requirements or by breaking up banks which are regarded as too big to fail and too complex to manage. The recent unexpected USD 5 billion trading loss at J. P. Morgan, previously regarded as the safest of the big banks, has further fanned the flames of debate. Basel 1 set an arbitrary target of 8%, which just happened to be the prevailing capital ratio of most US banks at that time. The Basel Committee analyzed the issues in 2010 and recommended a ratio of around 14%, although 10% is the compromise target set under the Basel 3 regime. Even when Basel 3 is in place, based on average risk weightages, it is estimated that a loss of 4% of the value of assets will render a bank insolvent. Basel 3 is therefore regarded as a good starting point, but is unlikely to be the finishing line for capital adequacy. Capital requirements are on a constantly rising trend line, at a time when the banking profit paradigm is changing to a low cost, low risk, low return, commoditized model. Mckinsey's in a recent analysis of banking sector prospects conclude that return on equity on standard retail and corporate banking will settle at around 7% p.a., hardly a return which will excite shareholders sufficiently to infuse new capital.

The dilemma on capital is therefore this. For many equity investors, increasing the capital of banks is anathema, unthinkable. To quote an analyst at CLSA on Wall Street. "Banks are increasingly regarded as unanalysable and uninvestable". The market preference seems to be to derisk the banks by breaking them up, so that they can no longer be regarded as "too big to fail", thereby attracting massive new levels of protective capital. Sandy Weill, the former Chairman of Citigroup, the architect of the complex conglomerate which exists today and who lobbied strongly to repeal the Glass Steagal Act which separated investment activities from conventional retail banking, is an epic convert to the cause of breaking up the big banks. He now agrees that if a bank is too big to fail, it is too big to exist.

Investor scepticism is reflected in share prices, where most US banks trade at a hefty discount to book value. Sale of the parts is likely to fetch a much higher value than the sale of the whole, but breaking up is hard to do. Whichever way this tussle is resolved, it is clear that bank capital and bank sustainability are two sides of the same coin. Whether banks meet new capital norms by slashing assets or by increasing reserves by cutting costs or dividends or by equity issuance or a combination thereof, remains is to be seen. The focus of risk managers is now on the management of the liability side of balance sheets. Simultaneously, loan books are being downsized to preserve capital, to the detriment of the global economy.

How different or similar are the challenges for Sri Lankan banks?

Banks in Sri Lanka-stability and growth sustainability

As the economy strives for high and sustainable growth, Sri Lankan banks are expected to play a catalytic role. They will face two broad challenges in doing so, firstly to maintain financial sector stability, and secondly, to align their own business strategies with the growth trajectory of the economy. Keeping these twin objectives of stability and growth in sustainable balance, is the challenge of the new era ahead.

1) Financial sector stability in Sri Lanka

The Sri Lankan banking sector has proved to be resilient through the turbulence of the last three decades of conflict. The issues which have so troubled banks globally are far more muted locally. Thus, leverage averaging around ten times, at least for private banks, is moderate and is largely based on stable customer deposits rather than institutional borrowings. Capitalization is strong. The major misalignment between corporate goals and management rewards at western banks, is also not an issue here. Bank investments in Treasury Bills and bonds of around Rs. 400bn. is around 10% of total banking assets, and by itself does not raise concerns of financial repression Regulatory supervision and support for the financial system is also regarded as strong. This benign view of stability is reflected in the Central Bank's Financial Systems Stability Review for 2011 where the banking system is described as stable and resilient, sustained by strong economic growth and growth in assets, higher capitalization, adequate liquidity buffers, low risk levels and healthy earnings. The financial system was also stress tested by the Central Bank, with no material concerns reported.

That risks to these scenarios can arise was highlighted recently by Standard & Poors, using a different methodology, which ranked the Sri Lankan financial sector relatively high on the risk scale in comparison with our peers overseas.

Details on which these conclusions are based have not been fully provided. However, their findings have been strongly contested by the Central Bank and Bankers Association based on the systemic strengths listed above.

Nevertheless, it is useful to consider some aspects of the methodology used by Standard & Poors in making their risk assessment. Firstly, the economy and banking sectors are assessed together under a single measure. This reflects the reality that bank performance and economic policies and cycles are closely linked. Banks performance is procyclical and rides the economic waves. There is however a time lag between cause and effect, reflected in the old banking maxim that good loans are made in bad times, and bad loans in good times. For risk managers, it emphasizes the point that credit decisions cannot be taken at the level of individual borrowers alone, but should be viewed in the context of economic and portfolio risks, and that the quality of loans can only be assessed over time and economic cycles. Other risk factors considered by them include the range and stability of funding options available banks. They also reviewed the supervision of finance companies. The hard lessons of contagion have been well learned in the recent global crises as well as recently in Sri Lanka. They also assess the relative competitiveness of the banking industry, but state that Individual bank risk ratings will included assessment of factors such as business positioning, capital and returns, risk strategy, funding and liquidity. A specific point they considered was the potential for conflict of interest arising out of the investments by the EPF in commercial banks, highlighting the dual role of the Central Bank as regulator of banks and supervisor of a major investor in banks. While they acknowledge that the Central Bank has mechanisms to manage the risk, they state that "we assess systems without such potential conflicts as relatively less risky than those with".

Aligning economic and banking goals for sustainable growth.

The opportunities and risks for banks in the post conflict era, reflect those in the economy. Government policies as set out in the Mahinda Chintanaya, include sustained GDP growth exceeding 8% pa, raising per capita income to USD 4000, rebuilding neglected infrastructure such as highways, power, ports and airports, increasing tourist arrivals to 2.5 Mn. and building specified industry sector hubs. These are extremely ambitious goals, and rightly so for a nation at peace, after decades of debilitating conflict.

These goals need to be supported by structural changes in the economy in at least two respects, which are of relevance for banks (Table 1). Firstly, growth can only be sustained by a high level of investment and the productivity of its use. National savings falls far short of investment targets of 35% of GDP and banks need to facilitate domestic savings and remittance transfers, as well as FDI and capital inflows, to help fill the gap. The gap between savings and investments exceeds USD 5Bn annually. Government investment has increased sharply, but is now capped at around 6 ½% of GDP due to fiscal constraints. The balance of nearly 30% of GDP will have to come from the private sector and overseas. If investment on this scale is to be attracted, the investment climate will need to be regionally competitive and in particular, the rules of engagement between public and private sectors should to be clearly defined and impartially enforced. Secondly, that the economy needs to be rebalanced if it is to sustain growth, away from consumption and imports and into investment and exports. The future direction of bank lending will need to reflect this change.

In the new economic context, regulatory and policy objectives for banks have been redefined to include the following potentially transformative goals.

1. Ensuring financial sector stability

2. Doubling assets to around Rs. 8 Trillion by 2016

3. Refocusing lending to productive sectors including infrastructure and exports

4. Promoting inclusive banking and access to finance particularly for SMEs.

5. Reducing intermediation costs

6. To this ambitious policy list must be added the objectives of the providers of capital i.e. the generation of adequate, predictable, risk adjusted returns on capital.

The risk factors for banks in achieving growth goals

The risks inherent in the new stability and growth targets, can be encapsulated in a single word, capital, for it is though the prism of capital that the many facets of banking risk may be most clearly viewed.

Banking in Sri Lanka is a capital intensive industry in a capital short economy. While capital adequacy levels of the industry are comfortably high at present, there is no doubt that demand and supply side pressures are increasing. Capital requirements are mounting, as Sri Lanka keeps pace with tightening international regulatory and accounting norms. The full implementation of Basel 2 standards, particularly the ICAAP requirement and the move to Basel 3 compliance, combined with, the vigorous present and projected pace of asset expansion, implies that capital formation, its allocation and pricing, will become the central focus for Sri Lankan banks, in common with their global peers, in the coming years. On the supply side, banks are increasingly resorting to raising Tier 2 capital overseas, but this is only a limited answer to the problem and carries its own risks of foreign exchange hedging and rising leverage. The more sustainable answer lies in generating and retaining high profit levels or in issuance of new capital. The challenges relating to these are examined below.

There are three main factors which will be considered by the providers of capital in deciding whether to invest in Sri Lankans banks. Firstly the risks, secondly the prospects for adequate and sustainable returns based on clear business strategies and competitive advantages and thirdly the space for investment.

1) Risks

The risk factors at a systemic level were discussed earlier. At the level of individual banks there is likely to be scrutiny of the implications of recent sustained loan expansion. On average, loan portfolios increased by 24% and 31% over the last two years, with lending growth expanding at 33% in the first five months of 2012. Non-performing loans are at a historic low of 3.8% now, but may be tested by the unseasoned portion of expanded portfolios and a slowing economy. On the liability side of the Balance Sheet, deposit growth has not kept pace with asset growth, while increased borrowings pose their own risks of maturity and pricing gaps and the hedging of foreign exposures. Going forward, banks will be expected to support economic development with enhanced term lending for projects and infrastructure. The nature of these risks differ significantly from the short term business loans which presently dominate the balance sheets of banks. E.g. the market risks associated with the traditional role of maturity transformation of banks will increase, as liquid short terms deposits are lent for longer term illiquid assets, in a market where hedging options are limited. The nature of credit risk will also change, as banks assess long term project cash flows in an environment where economic and industrial assumptions are fluid and dynamic. If these new risks are to be prudently managed, it is a prerequisite that syndicated loan and capital markets, both debt and equity should be developed. As principal players in the financial markets, bigger banks will be expected to play a leading role in capital market development. They will also need to allocate an appropriately higher prudential level of capital against these new risks, and be able to price the risks accordingly. In summary, the processes and skills within each bank on credit, Treasury and capital markets management in particular, will be centre of the plate for investors as will a high level of individual bank capitalisation. Of particular relevance in this context is the existence of robust activity based cost accounting systems, which facilitates allocation of risk, risk based pricing and profit centre accountability. “If you can’t measure it, it doesn’t exist”, is a management reality.

2) Business strategies and competitive advantages

Investors will want to invest in banks with well thought through business strategies and competitive advantages, which are more likely to produce adequate, sustainable risk adjusted returns. Although industry ROES increased to a satisfactory 20% last year, stripped of one-off gains (including revaluation of foreign exchange positions and other assets), this may be a challenging target to sustain in a more difficult economic environment.

An understanding of competitive advantage flows from an assessment of competition and drivers of change.

It is relevant therefore to review the composition of the banking industry. Six banks, including two state banks, the three largest private banks and the largest foreign banks, together are own 2/3rd of assets and generate 2/3rds of profits. In Sri Lanka as elsewhere in financial services, scale is a critical determinant of success. Eighteen banks, namely three mid sized and 15 smaller banks therefore compete for 1/3rd market share or have to find competitive advantages to erode the shares of their larger peers. The challenge here is not just "too big to fail", but "too small to succeed".

The profit paradigm of the industry is reliant on net interest income, which contributes 70% of revenues and is based on a relatively high net interest margin exceeding 4% on average. NIMs are under pressure both from rising competition for funds, from policy makers and from customers who complain of excessive intermediation costs.

High margins are need to meet the relatively high level of overhead costs, as each bank in a fragmented industry invests in its own expanding distribution network of conventional and costly branches and ATMs, IT systems, product and brand marketing and all the other expensive essentials and extravagances of modern banking.

In Sri Lanka and many overseas markets, the trend is for banks to be caught in a pincer movement of reducing margins and rising costs, resulting in lower shareholder returns at a time when much more capital is needed.

Banks are addressing the dilemma in five possible ways. Firstly everywhere there is pressure to cut costs and improve efficiency. Smaller banks have a disadvantage in doing so, as they invest heavily upfront in distribution and other fixed costs, in the knowledge that the revenue needed to absorb these costs will be generated later rather than sooner. In the interim, they face uncomfortable pressure on profits. Secondly, banks attempt to diversify into other sectors to generate non-interest income. To the extent that transactional banking commissions and foreign exchange incomes are enhanced, this is a healthy development. However, banks need to resist the historic temptations to bet the farm on speculative positions on foreign exchange, bond, share or real estate markets, in order to boost flagging short term profits. Thirdly, by transforming into financial conglomerates. Here, the undoubted attractions of diversification need to be balanced against the complexity of the task, the need for specialist skills and a different set of risks. Fourthly, the use of transformational technology, I quote from a landmark report of July 2011 by KPMG International, "It seems clear that mobile payments are set to transform the banking industry. On offer are a host of benefits and opportunities that have the power to protect existing revenues, drive new revenues and capture market share. For banks that are still standing on the sidelines, this is a critical juncture. Continued delay may risk the loss of market share and revenues to competitors".

The Central Bank has wisely anticipated the trend by publishing regulatory guidelines for mobile phone payments, separately for TELCOs and for banks. It is the former which has seized the initiative so far. It is timely for banks to consider the transformational power of the basic 2Gmobile phone to increase revenue, facilitate domestic and foreign remittances, make inclusiveness a reality and reduce distribution costs. An open system allowing payments by consumers using any Telco or any bank, is more advantageous for the customer than restricted proprietary systems. Fifthly, consolidation. It seems clear that the cost of doing business reduces, and access to capital increases, for larger than for smaller banks, in a more concentrated rather than a fragmented industry. May be these are ideas whose time has come. To quote from the CEOs report for 2011 for a large domestic commercial bank. "The rise of mobile banking, and the promise of forging deeper relationships with customers even when they are on the move, will challenge us to be more innovative than ever." And again, banking industry consolidation is "both necessary and inevitable to control the cost of intermediation by leveraging economies of scale".

Investment space

It is clear that there will be growing demand for Tier 1 capital from domestic banks, beyond the availability of retained earnings. Fortunately, there is also large pool of equity investment available regionally, looking for investment opportunities. It should be a perfect match.

However, constraints do exist. On the supply side, global providers of capital generally have criteria relating to minimum investment size. Supply of global capital on an optimal scale is constrained by demand side limitations.

These include the relatively small market capitalization of our banks, the policy of ownership diversification, which generally limits a single owner to 15% of voting shares and by entrenched ownership positions, which result in a low level of free float of shares. A further complication for investors is the acquisition by different government entities of shares in private banks, which in aggregate represent dominant minority share holdings in those entities. This aggregate holding may provide ownership stability, but also crowds out private investment and raises concerns about strategic priorities and governance checks and balances. The mitigants to these concerns need to be well articulated, if needed capital is to be attracted. In short, if significant capital investment is to come in, there are trade off which need to be recognized and decided at policy level.

SAVINGS/ INVESTMENT % GDP			
	2010	2011	Projected
Domestic savings	19.3	15.4	
National savings (including remittances)	25.4	22.1	
Investment	27.6	29.9	
Investment to sustain 8% GDP growth			33-35
Savings shortfall USD Bn.		4.6	7.0

THE STRUCTURE OF THE ECONOMY % GDP 2011				
Consumption	Investment	Exports	Imports	%
84.6	29.9	23.1	(37.6)	100

Conclusion

In conclusion, I would state that Risk management has evolved from its foundations of commonsense and judgment of individuals, to the highly mathematical approach needed to accomplish complex and predictive objectives in a world beset by unpredictable change. It's objective remains unchanged to provide the strong defenses on which policies of robust expansion can be sustainably anchored. The accomplishment of the economic goals of a resurgent Sri Lanka depend on it's success.