Ideal Banking System

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ABSTRACT

There is need to understand how an idealized banking system should work – a banking system not too different from what may emerge in the fairly near future in several developed countries. The key to understanding the supply of loanable funds (credit availability) is to understand the behavior of banks. Many argue that banks should behave in a risk averse manner. At the heart of the problem lies the approach to banking systems that assumes that focusing on higher standards and uniform regulation to ensure the safety of individual banks would make the banking system safer.

Introduction

Banks in different countries have different sizes and different approaches to function manage and regulate. Among the various types, what is an ideal banking institution which will stand the test of time, approach to meet the unbanked and under banked areas assumes significance. At the heart of the problem lies the approach to banking systems that that focusing on higher standards and uniform regulation to ensure the safety of individual banks would make the banking system safer.

Ideal size of Banks: While there is no ideal size for banks, some of the smallest ones may have excessive exposure to risk and some of the largest ones may contribute excessively to systemic risk. So a move towards a moderate size would be good for the banks and good for the system. Breaking up large banks while desirable may not be politically feasible so penalizing size through greater than proportionate increases in capital requirements may be the right way to encourage the largest institutions to shrink.

Bank capital requirements need to be increased significantly both in quality and quantity to make banks more robust to shocks and losses.

What makes a good banking system?

Up until now we have looked at some of the fundamental problems that afflict banks and the banking system so the next part is dedicated to discussing what policy measures can help us best tackle these problems. Before we do that, it might be useful to define what a good bank and a good banking system should look like.

A good banking system is one which

- And does not depend on regular doses of tax payer subsidy
- Within such a system a good bank is one which
  - Lends to those who others don’t lend to and does not lend to those everyone else lends to
  - Strikes the right balance between efficiency and safety
  - Aligns the incentives of stakeholders to the overall long terms success of the economy
  - Minimizes the risk that it poses on other financial institutions and the economy
  - Performs well at its core functions of maturity transformation and credit allocation

These are the criteria we use to briefly lay out our suggestions for improving the functioning of banks and banking systems.

Anywhere in the world Banks need to grow, not only of balance sheet size, but also in terms of greater penetration of banking services to the unbanked and under banked segments of the population. Banks have contributed to economic progress several nations. They also cater to a whole host of diverse stakeholders who have equally diverse expectations. The success banking system as a whole depends on how well these stakeholder expectations are met.

A. Productivity and Efficiency: Banks play the critical role of financial intermediation by performing the task of maturity and risk transformation, besides providing payment and settlement services. In order to effectively perform these functions, banks need to ensure that they maintain high levels of productivity and efficiency in their operations. Two kinds of efficiency are essential for banks:

- Allocation Efficiency: Banks have to ensure that the precious societal resources are allotted to the most productive activities. Besides, while taking allocation decisions, the interests of the most vulnerable sections of the society should also be taken into account.
• Operational Efficiency: Operational Efficiency requires banks to perform the financial intermediation function in a safe, secure and speedy manner while ensuring that the cost of performing the intermediation function is minimized. While profit margins are important for sustaining banking operations, the cost of operational inefficiencies of banks should not be passed on to customers by way of higher service charges and fees. Banks need to improve both, allocation and operational efficiency, so that the financial intermediation function is effectively performed. This would include reengineering of all critical products and processes by leveraging on innovative technology based solutions, while retaining a strong customer centric focus.

B) Financial Consumer Protection and its Linkage to Risk Management Function; Financial Consumer Protection has emerged recently as a key area. The global financial crisis has highlighted the vulnerability of the consumer class, which has been worst hit in the crisis. The basic fact, that the well being of the consumer is essential for the sustainability and growth of the service provider, has been lost sight of. The principles enjoin upon supervisors and oversight bodies to ensure an equitable and fair treatment of consumers, disclosure and transparency in product and service offerings along with promotion of financial education and awareness amongst the consumers. At a minimum, it must be ensured that poor do not subsidize the provision of banking services to the rich. The business operations of banks should be customer-centric in nature. This should be reflected in all aspects of banking operations including creation of customized products and services, pricing of services, delivery channels, etc. Banks should, inherently, be flexible in their operations so that they have the ability to meet the evolving stakeholder expectations. Banks should be able to appreciate the risk-return trade-off involved in various activities. The basic premise that greater return would invariably come from assumption of higher risk, needs to be appreciated and disseminated, both within the organization and to banks’ customers. Banks need to develop the ability to discern good risk from bad, so that they selectively take on only those risks that are in alignment with the bank’s long-term strategic vision.

A key related issue is the integrity of MIS in banks. Most of the banks do not have a system of working out activity wise costs and returns. Unless banks know the return on each and every product, they cannot arrive at a truly risk based pricing.

C) Impaired Assets; Another issue which is generating considerable concern and is likely to impact banks’ ability to serve its stakeholders is the rising portfolio of non-performing assets (NPAs) and restructured loans. While the downturn in business environment globally and in India has contributed to this rise, there is need to reflect on why risk management practices during boomtime were unable to anticipate future downturns and build up suitable safeguards while giving loans. The rising impaired assets is a ‘governance’ issue as banks have forgotten the art of saying ‘no’, except, may be, to small borrowers. Banks need to significantly improve their risk assessment capability and their ability to price risks, so that they take on only those risks that they understand and can effectively manage. I believe that this need is all the more pronounced in the case of public sector banks, which, at times, end up with assets that have been executed by private sector/foreign banks on account of inherent weaknesses.

The ability to manage NPAs is important in order to preserve the strength of bank balance sheets and to retain the appetite to take on good risks. An attitude of complete risk aversion would not be appropriate as banks are in the business of taking risks, but with adequate safeguards. Another issue that I would like to bring up before you is the element of discrimination practiced by the banks in restructuring of loans. Analysis of available data indicates that the larger borrowers have invariably received the benefit of restructuring of loans, while the restructuring in case of SME/ agriculture loans has remained abysmally low. There is need for lower levels of impaired assets if there is timely care, caution and intervention and support from banks.

D) Financial Inclusion; The extent of exclusion in the financial system continues to be unacceptably high in several underdeveloped countries in the world. The unbanked masses constitute a unique but important stakeholder group for banks, even though they may not be bank customers. Meeting the expectations of this group through financial inclusion efforts presents a huge business opportunity for banks. While there is no ‘one-size-fits-all’ approach to financial inclusion, it is important that banks recognize three important prerequisites for maximizing the benefits of financial inclusion efforts. These are: Holistic approach to provision of financial services, not just credit or deposit alone meeting the needs of small firms; Focusing on segments of population excluded by gender or geographical remoteness.

Banks need to focus on leveraging technology to create new business models and delivery
channelsthat are customized to the needs of the targeted population. Technology has the potential to act as a force multiplier in the financial inclusion efforts, provided it is implemented in a planned manner. There is, however, an increasing realization that mere reliance on technology enabled non-face-to-face channels alone would not be sufficient to meet the goal of creating an inclusive financial system. There is a need for opening more brick and mortar outlets and delivery points, both as a control mechanism for Banking Correspondents (BCs) and to gain the trust and acceptability of the masses. The assessment of the progress in financial inclusion since the introduction of Board approved financial Inclusion Plans is that while there has been considerable progress in the number of accounts opened, the actual number of transactions per account or per BC continues to be extremely low in several countries. This reduces the viability of the financial inclusion efforts and would, ultimately, result in concerned stakeholders losing interest in the exercise. The low transaction levels indicate inadequacies on both the demand and supply sides such as deficiencies in BC operations, nondistribution of smart cards, lack of awareness on the part of the account holders, etc. Banks need to identify the causes for the low transaction rates and urgently address them. In order to be successful, sustainable and scalable, financial inclusion should necessarily be commercially viable for everybody including the bank, the BC and the technology provider. However, the pricing should not result in exploitation of the customers.

The banking system is at a crossroads in several countries with multiple opportunities and challenges before it. They have to make the right choices in order to ensure the future of the banking system as the key pillar upon which the economic prosperity of the country rests. Banks are the lifeline of any economy and it is the collective responsibility of all of us to ensure that we have a strong, resilient and inclusive banking system geared up to face all domestic and global challenges. A better banking system should be simpler, safer, smaller, more diverse and more stable. Further, there is need for (a) Government–insured deposits (b) Government imposed reserve requirements, with reserves held at the central bank in interest–free accounts; and (c) No transactions cost banking. Given the high growth potential of the economy and favourable demographics, banks have immense opportunities to expand their business with traditional as well as innovative products. The banking community played an important part in enabling the Green Revolution. However, the burden of indebtedness is still high in rural India, and the rural masses are exploited in the credit market. Much of the credit intended for farmers goes through indirect channels, and not directly to them.

Problems in the supply of credit to rural families include inadequate supply of formal credit on the whole, imperfect and fragmented rural credit markets, and unequal distribution of credit, particularly with respect to region, class, caste and gender. In spite of the dominant role played by women in both farming, they are denied credit as they lack land titles. Many of the farmer suicides, particularly in the drought-prone areas, are attributed to lack of access to formal credit at reasonable interest rates.

Financial inclusion;

Apart from the initiatives taken by banks, some of which are commendable, the most important instrument to reach the unreached in terms of access to credit is microcredit. A number of non-banking finance companies have entered the rural microcredit market. Many microcredit agencies have been charging interest rates not very dissimilar to those charged by moneylenders. Borrowing then becomes more to meet pressing consumption needs, rather than for farming or small-scale enterprises. There are examples of micro-enterprises organised by women's Self-Help Groups with the help of microcredit. The pervasive nature of malnutrition in India is evident from national and international surveys. International price volatility is high, both due to a continuous rise in petroleum prices, and unfavourable weather conditions. For the poor, including small and marginal farmers, food inflation increases their vulnerability to hunger. There is need for providing finances at reasonable rates of interest by the banks at least to the people below poverty line to mitigate the problem of inflation.

References


[8] (Banking Ordinance, Section 2, Interpretation, Hong Kong) Note that in this case the definition is extended to include accepting any deposits repayable in less than 3 months, companies that accept deposits of greater than HK$100 000 for periods of greater than 3 months are regulated as deposit taking companies rather than as banks in Hong Kong.


[10] RBI, Bombay publications 2010