What Makes a Good Bank?

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Kotak Mahindra Bank is the first (and till now, the only) Non-Banking Finance Company (NBFC) that has been given a banking licence. It was given a licence in 2003 when the second round of banking licences were issued and has grown to be a stable, successful bank.

The NBFC started its journey in 1985 as a bill discounting entity, in response to the limited banking finance available even to sound companies due to the controlled environment. Over the years, it started new divisions and entered new businesses, becoming a respected name in each of them.

Prudence

The concept of prudence has always guided the company's actions, both when it was an NBFC, and when it became a bank. Prudence is, in fact, one of the three major qualities that, according to Mr. Uday Kotak, make a good bank. Prudence, in general, is defined by Mr.Kotak as not taking on excessive leverage. Excessive leveraging by banks and individuals led to the global financial crisis of 2008, whose impact on the financial markets and the real sector is visible even after so many years. The company always took calculated risks, and offered a competitive rate to its customers. As its bills discounting business grew at an exponential rate, the company grew conscious about the possibility of a default and the inadequacy of its capital to bear any resultant losses. This reflects the company's cautiousness, even though it was essentially financing highly-rated companies at that time. The company addressed the issue by starting the concept of co-endorser, getting the discounted bills counter-signed by foreign banks looking for some fee-based income in India. This took the pressure off the company's balance sheet.

When it became a bank, its prudence was reflected in the fact that it did not lend to the infrastructure sector (except for a few sound investments) even when every other bank was doing so, something that is now haunting the banking sector. Its reason for doing so was its evaluation of the risk-reward pattern. While the rewards were in line with other investments, the risks were disproportionately high (Mr.Kotak puts it as "the risks of a private equity investment with the returns of a loan").

It is very important for a bank to keep a tab on the amount and type of risk that it is willing to take on. Risks undertaken by a bank should not only be consistent with its capital levels, but also with its views on the expected future events. Mr.Kotak believes that these views should not be pre-formed (whether due to ego, or a lack of understanding, or any other reason) and should not drive a banker's perception of risk. Rather, it should be an astute perception of risk that should drive a banker's view. The two major risks being faced by Indian banks today are concentration risk and duration risk. Banks need to develop the skill–set required to manage risks in a rising interest rate scenario (which is now possible given the possibility of an intra-day short and the availability of the OIS market).

Simplicity

Simplicity is the second pillar on which a good bank stands. Simplicity refers to a bank offering only those products to its customers whose features and implication can be understood both by the bank and the customer. Complicated forex derivatives were sold to various companies by a number of banks during the first decade of the 21st century. The complexity and financial implications of a number of these products could not even be understood by the banks selling them, despite the availability of complex computer programs to decipher them. The companies buying these products too could not understand the implications, and ended up taking additional exposures instead of covering the existing ones. The subsequent losses that the buyers had to suffer, lead them to file cases against the banks for their recovery, thus spoiling the bank-client relationship and the accompanying trust forever.

Humility

The third factor that makes a good bank is humility. It refers to the understanding by a bank that its role is to serve its customers, and it can exist only as long as its customers continue to patronise it. The huge amounts of money that is available to a bank, can lead to huge egos (Lloyd Blankfein, Chief Executive of Goldman Sachs was once famously quoted as claiming that "bankers were doing 'God's work'"). The humongous power enjoyed by bank executives leads them to sometimes take risks at uncalled-for levels, exposing not only their banks, but even the global financial sector to an utter collapse.

Challenges Ahead

The first major challenge that banks (both in India and around the world) need to recognise is the emerging technology. Technology these days can be both transient and disruptive. Just like it has done in other fields, there is a realistic possibility that technology might, to a certain degree, evolve enough to dis-intermediate banks in a number of low margin – high volume areas, some of which are large sources of income for them. It has already happened to a small extent in the USA and Europe, where banks' securities business is facing a challenge from internet-based exchanges (like E*Trade). At the same time, developments like bitcoin should serve as a wakeup call for the financial services industry as a whole. While bitcoin may never emerge, or might not be allowed to emerge as a major threat to any currency, it serves as a reminder that the environment can suddenly change even at the most basic levels, and that banks need to be prepared to embrace the emerging technology, or face challenges at currently unimaginable levels. Another emerging trend where emerging technology changes the whole scene in an industry is that of the "winner takes all". With technology being proprietary in nature, the changes result in one player emerging as an undisputed market leader with a major chunk of the market, at the cost of all other established players. It could even be that this winner could be a non-bank entity that changes the whole banking scene. The possibility of this scenario being played out in the banking industry should serve as a warning to all banks to anticipate/prepare themselves for emerging technology.

The second challenge for banks as we look ahead, is that of managing the conflict between customer needs and bank profitability. As a bank goes about its routine business, it faces an

ever-present conflict between what is good for its customers and what is good for its own profits (or for the level of incentives received by the employee dealing with the client). This happens in the case of retail as well as wholesale customers. This conflict needs to be handled in an unbiased, objective manner that would help the bank prosper in the medium and long term. Too much emphasis on the short-term profitability can have quite a negative long-term impact on the bank. Kotak Mahindra Bank uses the concept of "Dharma" to guide it through these decisions, whereby each employee is expected to focus only on the area of his own responsibility. So the employee responsible for customer service focuses on what is good for the customer, irrespective of the earnings implication of the various products. The employee responsible for credit recovery would focus on that, without needing to bother about the impact of his actions on the fee-based income to be generated from the defaulting customer. On the whole a medium and long-term view of profitability overrides the short-term factors. There is also an interplay between technological advancements and conflict management in a transparent manner, as newer technological changes are likely to force banks to be more transparent and honest in their dealings with their customers. Being transparent and having a culture of compliance is no longer a choice, but a compulsion.

Another extremely important challenge is that of managing the effects of volatility. Volatility is not only here to stay, its amplitude is on an increasing trend. An unstable and ever-changing environment can have devastating effects on a bank's profits and balance sheet, unless the leadership is agile in managing the change.

Appropriate pricing of risk is exceedingly important for the long-term survival of a bank. A bank's Return on Assets (ROA) and Net Interest Margin (NIM) should be correlated to the level of risk the bank is taking on its balance sheet. Hence, while deciding on the pricing of any product or loan, it is necessary to look at its Risk Adjusted Return (RAR) rather than Return on Equity (ROE). The spread on any asset should always be commensurate with the risk attached to the asset. The challenge is not to yield to either competitive pressures, or to analysts' or investor community's short-term outlooks.

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