Prevention is better than a cure: Let’s apply this adage to banking

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SUMMARY
Ghalib’s wonderful risk-taking advice for entrepreneurs, ‘Manzil toh milege bhatak ke hee sahi, Ghumrah toh woh hain jo ghar se hee nahin nikle (destinations are reached by wandering, lost are those who stayed home)’ feels like bad advice for bankers

Ghalib’s wonderful risk-taking advice for entrepreneurs, “*Manzil toh milege bhatak ke hee sahi, Ghumrah toh woh hain jo ghar se hee nahin nikle* (destinations are reached by wandering, lost are those who stayed home)" feels like bad advice for bankers. Stupidity or unrealistic ambition is not illegal because a society’s progress depends on equity financed entrepreneurs overestimating their probability of success. But banks are hardly entrepreneurs and highly accident-prone because of high debt-to-equity ratios, theoretical liquidity birth defects, financial statements sensitive in real-time to external events, employee compensation outflows that often don’t match later losses, and small saver ‘safe haven’ branding that legitimizes bailouts. We make the case that no bank regulatory regime can eliminate failures, regulation cannot replace culture and governance, and prevention is cheaper than any cure.

First, the objective of bank regulation is to avoid depositor losses and contagion, not stop all failures; handling drunk driving by banning cars would be effective but silly. This objective has become harder with mobile banking and social media (US-based Silicon Valley Bank lost $43 billion or a quarter of deposits within three hours). Recent failures forced bank regulators to orchestrate bailouts that create precedents (however unavoidable) that their successors will regret. In the US, non-eligible deposits were guaranteed and its central bank created a lending programme for government securities that pretends interest rate rises haven't happened. In Switzerland, where Credit Suisse run into a a crisis, the Swiss central bank extended a credit line of $54 billion and the Swiss government committed to a backstop of $13,500 per citizen (this now faces parliamentary pushback)

Second, regulation cannot substitute culture or governance because some risk and supervision models are useful but are all incomplete; every regulatory tweak creates an industry of consultants and accountants that 'teaches to the test'. Leo Tolstoy's opening line of *Anna Karenina*, "All happy families are alike, but every unhappy family is unhappy in its own way" is often invoked by banks not involved in a 'current' crisis. This may not be true because every crisis reveals how the bank's management, risk managers, auditors and board directors 'set the tone from the top' on longevity, moderation and trusteeship through decisions on compensation, growth and leverage. Credit Suisse had capital and liquidity, but its annual report describes many litigations and acknowledges poor risk controls, a lead indicator of bad ancestors in management and governance. SVB's board was negligent in not understanding that bank balance sheets are more important than their profit and loss statements; it lamented deposit growth but didn't lower deposit interest rates, failed to mandate a lowering of its uninsured deposit share, and didn't strategize to raise more stable retail deposits. Indian bank governance has two mirror-image challenges; in public sector banks, the principal shareholder has been more powerful than the board or chief executive, while in private sector banks, the CEO has been more powerful than the board or shareholders. These are sought to be addressed with 'judgement' based interventions on board member approvals, shareholding caps, non-licensing of industrial groups and CEO approval, tenure and compensation caps. Much future upside lies in the art and science of improving the effectiveness of bank boards.

Third, prevention is much better than a cure. Even the most aggressive allopathic doctors recognize the evidence from *National Geographic*'s 'Blue Zones'—the impact of walking, relationships, nature and vegetarianism on longevity and health—but every doctor knows that most lifestyle advice doesn't get respect until it's unavoidable. Regulators must perform chemotherapy (bailouts) when needed, but must start choosing invasive prevention to prevent surgery. India's regulations around liquidity buffers (CRR, SLR) were criticized till global liquidity coverage ratios were introduced. Our informal deadline for diversification of banks with highly concentrated deposits was considered micromanagement. Our investment fluctuation reserve from bank treasury profits was meant to serve a countercyclical purpose but was said to lower returns. Our restrictions on small and cooperative banks were said to hold back financial inclusion. Our prudence over domestic bank holding companies and ring fenced subsidiaries was supposed to hold back innovation. These prescriptions are invasive, but made with the humility of doctors who know that post-mortems have a certainty that prescriptions don't and the confidence that we don't have to be Western to be modern.

It would be churlish to not acknowledge two points. First, Indian bank supervision and regulation was easier with the large share of deposits held by government-owned banks independent of performance; their bad loan write-offs were routinely covered by equity recapitalizations that diverted public money needed for healthcare, education and skills. Second, Indian banking is underdeveloped; our credit-to-GDP ratio needs to rise from 58% to 100% and MSME credit must break its multi-decade stagnation of around ₹12 trillion.

Paracelsus, a Renaissance physician, suggested that the dose makes the poison; anything powerful enough to help also has the power to hurt. Bank regulation aims to balance safety and growth. But this balance must recognize that banks are never 'only' business. In calm waters, bankers gift wrap themselves up in the language of financial inclusion and market their business plans to investors as if they sell washing machines, shampoo or computers. But in storms, even advanced financial markets with high consumer financial literacy have to bail out banks. Bailout inevitability (Stephen Cohen's description of Pakistan as a country that negotiates with a gun to its own head comes to mind when dealing with failing banks), ever-bigger bailout bills and the rising frequency of financial storms make bank regulation both hard and special.

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