MTM losses: RBI deputy governor terms regulatory dispensations akin to steroids

Interest rate risk of banks cannot be managed over and over again by their regulator, says RBI deputy governor Viral Acharya

Last Published: Mon, Jan 15 2018. 10 08 PM IST

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RBI deputy governor Viral Acharya exhorted banks to build "its own immunity and strength" by putting in place processes for efficient management of interest rate risks. Photo: Reuters

Mumbai: As lenders stare at a huge dent in profits due to spike in bond yields, Reserve Bank of India (RBI) deputy governor Viral Acharya on Monday said banks have approached the central bank for a special dispensation, but the regulator is reluctant to accede to such requests.

The banks need to manage the interest rate risks in a better way, he said. "Interest rate risk of banks cannot be managed over and over again by their regulator. The regulator, in interest of financial stability, is caught in such situations between a rock and a hard place, and often obliges," Acharya said, citing three recent episodes of acceding to such requests.

He, however, added that resorting to such help from the RBI is "not desirable" for better price discovery in the government security market and effective market discipline. "Recourse to such asymmetric options—heads I win, tails the regulator dispenses—is akin to the use of steroids. They get addictive and have long-term adverse effects in the form of frequent relapse even though their use may be justified to relieve occasional intense pain," Acharya said, in a rather blunt message.

Speaking at the annual Fixed Income Money Market and Derivatives Association of India (Fimmda) dinner in Mumbai, Acharya exhorted banks to build "its own immunity and strength" by putting in place processes for

efficient management of interest rate risks.

The benchmark 10-year government bond yield has surged 0.67% in the December quarter alone on fears like fiscal slippage and surge in inflation. Domestic ratings agency Icra had pegged the mark-to-market (MTM) losses for the Indian banking system due to the rising yields at Rs15,500 crore for the quarter, with the state-run lenders taking 80 per cent of the total impact.

Recent media reports had said the banks, which are already reeling under the non performing assets (NPA) problem, have approached the RBI for special dispensations like recognising the losses over two quarters in order to minimise the impact on their botttomline.

Acharya confirmed that the lenders have indeed approached the RBI. “Market liberalisation does not just involve the regulator easing business processes, introducing new products and creating new markets; it also requires participants to take initiative to re-skill themselves for constantly evolving market conditions and products,” he said.

He said perhaps banks do understand the risks of sharp rise in bond yields, but pointed out that the issue is that of “incentives” that lead to such risks being ignored. The academic-turned-central banker also suggested a slew of measures which can be adopted by the lenders to prepare themselves better for such risks, stating that risks on sovereign bond investments “materialise from seemingly calm initial states”.

The suggestions include the board, head of treasury and the chief risk officer approving the risk limit for the portfolio in terms of the capital that can be put at risk, which can transform into a risk strategy and be guarded in a manner that adjusts for changing risks rather than merely serving as an easy-to-game compliance limit.

Acharya also called for erring officials to be taken to task. “Those who swing bank investment portfolio for the fences and put bank capital at excessive limits relative to the approved levels should be held accountable when their bets go bad due to poor or no risk management. Not all volatility is due to ‘black swan’ events that deserve risk-takers being carried through,” he said.

Stating that such measures are not “rocket science”, Acharya said managing the interest rate risks better requires governance mechanisms at the highest levels, an incentive to manage it, and a top-down organisational strategy to implement.

“The treasury functions at banks need to be modernised with urgency, subjected to careful scrutiny by boards, overlaid with prudent risk management practises, and trained to employ hedging instruments specifically targeted at managing interest rate risk,” he said.

First Published: Mon, Jan 15 2018. 10 08 PM IST

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