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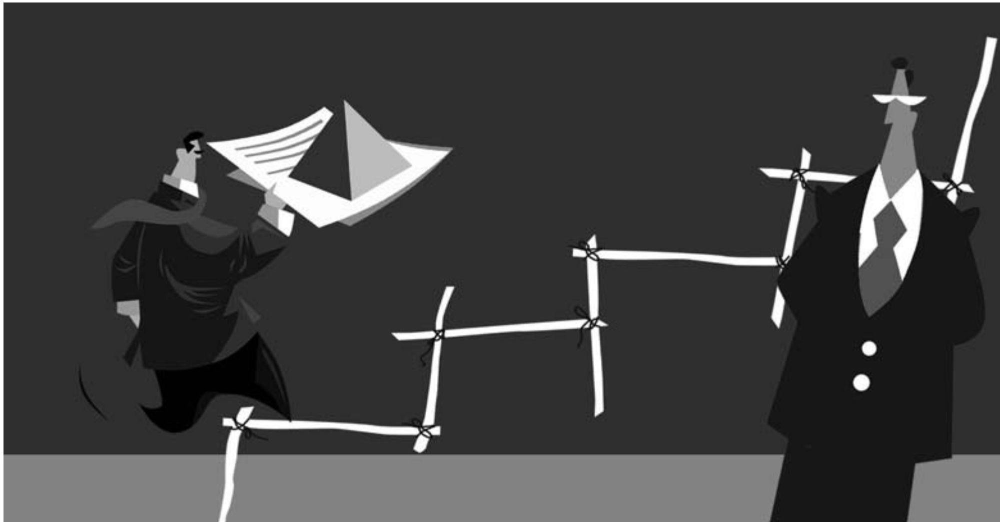

In the mind of a stressed borrower

A game of signals and asymmetric information

When a firm faces stress, the story turns on whether it is insolvent or merely illiquid. In this article, we put ourselves in the shoes of a firm facing difficulties in debt servicing. Liquidity stress, with a weak financial system, can potentially generate insolvency.

When a firm faces stress, the heart of the question is: Illiquidity versus insolvency. Illiquid is a firm that has payments to make, but lacks cash to make them. This could happen because the firm has good assets which are illiquid. Insolvent is a firm which is not able to pay off the liabilities even if all the assets were carefully and slowly liquidated.

When a firm has a lot of borrowing, and particularly when the borrowing is short-dated, old borrowings are maturing all the time. The firm needs cash all the time to meet these repayments. This process of refinancing can go on smoothly as long as lenders have confidence in the firm. The oxygen supply is in the hands of lenders. Every month, perhaps every week, the firm has to go back to lenders and make them feel comfortable to lend again. Keeping lenders happy is even more important than keeping customers happy.

For firm-specific reasons or system-reasons, when the flow of new debt coming into such firms is interrupted, this induces a crisis for the firm. It is useful to peer into the mind of the company when facing such a crisis.

At the heart of a lending contract is asymmetric information. Lenders do not know if the borrower is sound. Credit ratings are not a useful information signal. We are seeing some firms say "X is a standard asset on my book as no default has taken place". This inspires fear in the eyes of the market. The only notion of value is fair market value: What price would we get if the asset were sold in the market tomorrow? Our old notions of asset classification — X is valued at book as he has not defaulted on me — should not be used.

SNAKES & LADDERS

AJAY SHAH

An equity raise communicates information. If the company were insolvent, shareholders would not throw good money after bad. Lenders are much more comfortable in supplying additional debt once 10 or 20 per cent of the balance sheet is brought in as fresh equity capital. A small equity raise reduces leverage and signals solvency. Conversely, if shareholders do not bring in equity capital when a firm has a liquidity crisis, this heightens the fear among the lenders.

The normal market process — greater need gives a higher interest rate — does not work as we lack a functioning bond market. There is extreme discomfort with high interest rates in India as they signal desperation. It is a bad signal if a firm borrows at an unduly high interest rate. Borrowers are in a bind where they badly need cash, which is not available at the prevailing rate, but paying much higher rates will send a bad signal.

The stock price is a valuable signal. If there had been a panic, or a comprehensive collapse, then all stock prices would have been down, but this is not the case. What we are going through is a stress test, and the stock market is discriminating. It is awarding large price drops to some firms where it sees trouble and small price drops to others. Every day, speculators on the market are judging the difficulties of each firm, and putting their money where their mouth is. Credit will return to healthy firms which have passed the stock market's filter. Healthy unlisted firms wish they were listed, as they lack this independent information signal, which carries more trust than a credit rating.

The existing lenders receive pleas for help. An existing lender is given a choice: Either you refinance me or I will default on your watch. Borrowers are in the odd position of threatening default but simultaneously asking for credit. In the typical bureaucracy of a lender, agreeing to refinance postpones the problem for some time, ideally beyond the retirement date of the decision maker.

Indian finance is now in the grip of investigative agencies. Committee members worry about future questioning: "How did you decide to give a loan to X when the newspapers and the stock market knew there was distress?" The pathway of refinancing through existing lenders also breaks down when the lender firm is itself in the scramble for liquidity.

If spurned by existing financiers, a next lever is to sell assets and pay down debt. The trouble is, everyone knows this is a distress sale. Only the best assets can be sold (as buyers don't trust anything else), and they would be sold at a discount to fair value. After the transaction is completed, the seller would have less equity capital (equity pays for selling below book value) and reduced credit quality (as the best assets have been sold off). In addition, news of the sale of good assets at a discount spreads rapidly, and constitutes a negative signal. Such transactions push an illiquid seller closer to insolvency.

All these issues turn on the problem of market liquidity. Deep and liquid financial markets are a valuable thing, and have not been prioritised adequately. Deep and liquid markets are a public good. Nobody has an incentive to build, protect and maintain public goods. Narrow vested interests seek to harm market liquidity, and a stream of policy actions tends to come out, which pollutes the commons.

Design work in India's financial sector reform was done from 2007 to 2013. Some pieces of this got done (e.g. inflation targeting, the merger of the Securities and Exchange Board of India and the Forward Markets Commission, the Insolvency and Bankruptcy Code). The Bond-Currency-Derivatives Nexus was not built, and micro-prudential regulation remained faulty. The resolution corporation (RC), the systemic risk database (FDMC) and systemic risk regulation (FSDC) have not been put into place. We have a fledgling IBC machinery that can deal with non-financial firms such as real estate or infrastructure companies, but not financial firms. We are being reminded of the salience of this reform agenda.

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