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The bird's eye view in finance

Micro prudential regulation of finance is essential

SNAKES & LADDERS

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We are seeing difficulties in banks, mutual funds, non-banking financial companies (NBFCs), the bond market, and real estate. There are interconnections between these difficulties: The components are not siloed. It is difficult for a siloed financial regulatory architecture to obtain information, engage in root cause analysis, and solve problems. There is a natural bias for micro-prudential regulators to postpone the recognition of a problem. System thinking diverges from the view of one firm at a time. We require the Fiscal Resolution and Deposit Insurance (FRDI) Bill, the Financial Data Management Centre (FDMC) and a technical secretariat at the Financial Stability and Development Council (FSDC). Absent these three components, we need an informal team which will self-consciously mimic the working of these institutions.

There is a perennial tension between the worm's eye view and the bird's eye view. The worm sees things that the bird does not, and vice versa. In recent months, we have been freshly reminded of the need to see the wood for the trees in Indian finance.

Micro-prudential regulation is the job of pushing financial firms to cap their failure probability. As an example, we may have an objective that no more than 2 per cent of banks should fail per decade. Roughly speaking, this corresponds to about two significant bank failures in India per decade. Micro-prudential regulation involves writing rules that prevent excessive risk taking by banks, so that the failure probability of any one bank does not exceed 2 per cent over a 10-year horizon.

With mutual funds, there is no possibility of firm failure. The Securities and Exchange Board of India's (Sebi's) concern in micro-prudential regulation is to ensure that net asset value (NAV) is always reported correctly, and promises of redemption are always met.

To achieve these objectives, micro-prudential regulation thinks deeply about one financial firm at a time. The regulator requires a deep understanding of the business and identifies a minimal set of interventions which achieve its narrow objective, while avoiding central planning of products and processes.

Micro prudential regulation of finance is essential. But it is different from system thinking. Let us look at events of recent years, at the interactions of components of the financial system.

Credit stress in non-financial firms (e.g. infrastructure and real estate) surfaced in 2008. Early bankruptcy solves the problem, but when this is not done, the amount of debt balloons. With stressed borrowers, new debt is required to pay off old debt. The balance sheet grows and increasingly leverages, as default is staved off by paying old lenders using money borrowed from new lenders. This raises the question: Where is the new debt going to come from?

For many years, banks and the RBI tried to grow out of the problem. Weak borrowers were given more debt by banks. When the banks got conscious about their over-leveraging, at first, a new funding channel was opened up through mutual funds, NBFCs and the bond market. This channel has run into difficulties in the last one year. Now we have a group of stressed borrowers running out of ways to roll over, and we have four stressed components of the financial system. There are feedback loops at work where the problems of borrowers, real estate prices, bond market, mutual funds, NBFCs and banks are reinforcing each other.

These two paragraphs constitute system thinking. We have to see the financial system from a high-level perspective, and see these pressures and relationships. This cannot be done by micro-prudential staff for two reasons. First, the day-job of micro-prudential regulators is to look at the failure probability of one firm at a time. Second, the failure of firms beyond the targeted rate (e.g. about two bank failures per decade for banks, about zero errors in NAV or redemption for mutual funds) is a failure of micro-prudential regulation. Micro-prudential regulators thus have a bias in favour of glossing over problems.

This question was examined by Justice Srikrishna's Financial Sector Legislative Reforms Commission (2011-13). System thinking in finance does not fit well with monetary policy, as this is primarily about macroeconomics, about delivering low and stable inflation. System thinking in finance does not fit well with sectoral micro-prudential regulators, as their orientation is to look one firm at a time, as their knowledge is siloed within one sub-sector of finance at a time, and as micro-prudential regulators have a bias in favour of not recognising difficulties.

This led to the design of a council, the Financial Stability and Development Council (FSDC), made up of chairmen of financial regulators and the finance minister. This would be backed by a technical secretariat, which would have expertise in system thinking, and a system-wide database that was named the Financial Data Management Centre (FDMC). Alongside this was the thought process about the bankruptcy of financial firms (to be done by the Resolution Corporation, and encoded into the FRDI Bill) and non-financial firms (Insolvency and Bankruptcy Code, IBC). We now have one out of these four components of the destination financial regulatory architecture (the IBC). The recent years would have worked out better if we had the other three tools also.

When we look back at the financial stress of 2000-01, the key actors were UTI, the BSE, and Calcutta Stock Exchange. There was no FSDC or FDMC in the picture. The resolution of financial firms requires the FRDI Bill (which constructs the financial Resolution Corporation), but this was deep in the future. Hence, that crisis was dealt with by putting together an informal team at the Ministry of Finance, which bundled together certain elements of the FSDC, FDMC and RC.

Such an approach may be useful in the present context, as about three years are required to build the FSDC, FDMC and RC. For such a team, there is one important lever that is now in hand, which was not available in 2000-01: For stressed real sector firms, we have the IBC. The ability to put firms through the IBC as soon as possible, and let creditors choose between resolution and liquidation, is an important arrow in the quiver, which is now available.

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