Spillovers in a Deepening Financial Sector

Dr.Ashima Goyal
Emeritus professor
IGIDR

As financial markets deepen segmentation reduces. This has mostly positive but also some negative effects. Risk sharing and efficiency rises as risks and tasks can be distributed to those most able to bear them. But interconnectedness implies spillovers in one section can affect others.

Bank runs are well understood and their widespread systemic effects have led to many regulatory responses, but large spillovers can force regulatory rescue (the too big to fail effect) creating moral hazard. In markets net stress selling can overwhelm a specific segment of a market. Regulatory tightening interacting with credit downgrades and margin calls can spark further asset sales reducing liquidity in other markets also.

Another source of spillovers is cross border flows from non-bank financial intermediaries (NBFIs) that are lightly regulated in advanced economies (AEs). Global risk-on and off and search for yields create contagion for emerging markets (EMs).

Then does risk rise or fall with more diverse financial entities?

Domestic Diversity

Financial markets are subject to herd behaviour. Market participants tend to hold similar views and follow similar strategies, resulting in too much of one-way positions and volatility. This is mitigated somewhat when there are entities of different types, origin and ownership, without domination of one type. Indian markets have a good balance of types unlike many in many AEs that are too homogeneous. For example, banks shrank after the global financial crisis (GFC) as regulations targeted them, leading to market dominance.

Indian markets have also seen non-bank entities grow but banks remain important. Over April-Dec 2023 the stock of bonds had risen to 34% of non-food credit. Sources of funds for manufacturing now include private credit alternate credit funds (AIFs) and venture capital funds. Funds structures make equity type features possible in debt and can reach credit to high-risk, lower rated and new firms.

If banks now account for a lower loan share, it reduces possible asset liability mismatch and future stress for them. A mixture of public, private and foreign ownership leads to diverse strategies. This is also required for heterogeneous Indian customers. Sophisticated investors co-exist with illiterate first time deposit openers.

New entities enable specialization according to comparative advantage. For example, in co-lending agreements between banks and non-bank financial companies (NBFCs) banks bring cheaper funds and NBFCs their strengths in distribution. Fintechs can analyse cash flows and reduce risks in unsecured bank loans. As costs fall and efficiency rises, interest rate spreads decrease.

But even as new types of interconnectedness mitigate old risks they may create new ones, for example funds do not have deposit runs but are subject to firesale risks when they are forced to sell assets even as prices crash.

Regulation

Because of the many temptations in finance supervision will always be required along with a strong layer of compliance functions. But regulation can be most effective if designed to enhance resilience, with self-insurance against shocks and incentives to mitigate excess volatility.

Macro-prudential (MaP) type regulations such as loan to value ratios, margins, exposure limits and caps moderate risk-taking. Higher capital adequacy provides self-insurance and reduces moral hazard by creating more skin in the game. Simple MaP regulations can be applied universally also to shadow banks reducing arbitrage possibilities.

MaP regulations are examples of principle-based rules that give operational freedom. They are less subject to arbitrage than principle based regulation, while avoiding the detailed multiple compliance requirements of rule-based regulation. Pre GFC, for example, entities took advantage of principle based regulation and created excessive risk. The own-assessment-of-risk-based capital buffers of the pre-crisis banking regulations, Basel II, allowed strategic use of number of years' data in VAR models so that capital required varied widely for similar exposures.

India moved towards principles after the liberalizing reforms, but when a large number of frauds occurred it reverted towards rules. Delegating more monitoring to Boards is consistent with the first, since Boards are well-suited to interpret principles and policies. But, as regulators moved towards the second, Boards became compliance checkers. Principle-based rules are a via media, where a few rules with good incentive properties can remove the necessity for detailed rules.

Since individuals do not take into account spillovers from their decisions they create systemic risks that tend to vary with the cycle. Trend following behaviour further aggravates the cycle. Countercyclical prudential regulations that increase the long-term cost of activity during booms and reduce these costs during busts have useful preventive features.

India was a pioneer in using counter-cyclical macro-prudential regulation before the GFC. A counter-cyclical rise in provisioning for bank housing and commercial real estate loans proved effective when real estate prices rising. Provisioning directly affects the profit and loss account of banks. In 2023 risk-weights were raised for unsecured retail credit and damped sharp growth.

While they should be countercyclical, loss-absorbing capital buffers are often built in bad times, hurting recovery and neglected in good times. Other types of countercyclical macro-prudential regulations reduce the need for large capital buffers. Trade-offs are possible in prudential measures.

Prudential regulations tend to be used more by EMs, although they work best when applied uniformly across jurisdictions and institutions. AEs use has increased post GFC but is largely on banks and borrowers. The arbitrage that followed led to NBFIs accounting for around half of global financial system assets and the majority of cross border portfolio flows.

Reducing risk premiums

In response to repeated external shocks if EM central banks (CBs) actively reduce risk premiums, it can reduce borrowing costs. For example, interest rate differentials in EMs tend to exceed actual depreciation building in excess returns. Premia rise with excess exchange rate volatility, even though the latter is often due to global and not domestic factors. There is a case, therefore, for intervention.

Most EM CBs use strategic intervention, signals, prudential regulation and capital flow management in order to reduce excess nominal volatility and prevent persistent misalignment from real equilibrium rates. A larger tool box is an essential defence against continuing global fragilities. Markets tend to have more confidence in countries with self-insurance through large buffers, such as FX reserves. Indian FX risk premiums fell sharply in 2023 as these measures helped reduce exchange rate volatility.

While EM CBs intervene largely in FX markets, after the GFC AE CBs have expanded their balance sheets and injected massive amounts of liquidity through broadened lender of last resort (LOLR) facilities backing all kinds of market instruments. Repeated interventions, as banks retreated from market-making roles post GFC, habituated markets to unconditional CB support. Post pandemic wobbles in AE banks and markets settled down partly since CBs responded with fast liquidity injections. They were careful, this time however, to label them as temporary market support distinct from the ongoing tightening and balance sheet contraction to fight inflation.

But prudential regulation as well market microstructure has to be improved with different types of liquidity pools, market makers, transparent data on risks, to mitigate the moral hazard from expectations of CB bailouts. Since technology is constantly increasing the speed and interconnection of markets the absence/inadequacy of such features increases market dependence on CB LOLR.

In India the CB liquidity window is restricted only to banks. In 2018 extreme pro-cyclicality in financial regulations, liquidity and in macroeconomic policy, led to NBFC distress and a sharp fall in output and credit.

As the Indian financial system diversifies the lender of LOLR has to be more widely available. But since the NBFC universe servicing the informal sector is large and varied universal LOLR is not feasible. Therefore the focus is on preventive prudential regulation, self-insurance through higher capital adequacy and on market liquidity. For example, a debt backstop has been created for mutual funds. There are suggestions to create a 24 hours platform for the money market to mitigate banks hoarding of liquidity to cover money transfers that are now 24*7.

Indian markets also have a technology advantage. Although post GFC moves to shift OTC to exchanges increased concentration risk on exchanges, in India since margins are imposed on Individuals through their electronic IDs there is a depth of information and ability to identify potential risks. For example, the dominance of short term trade in transactions is not so worrying since 90% of the volume is from institutions with risk absorption capability.

The answers to interconnection risks, therefore, lie in complex, context-relevant regulatory responses that close gaps, not in stopping market integration where it may be improving market efficiency. Regulatory sandboxes are available to encourage innovation, but regulators are concerned about arbitrage-seeking products that may go against the spirit of regulation.

In complex structured products, dialogue with regulated entities may help clarify whether a product is risk sharing and enhances financial stability or escapes regulation and increase risk and close loopholes. For example, private credit AIFs are making credit available from HNIs who understand the risks to lower rated firms. Since there are risk-sharing arrangements there is no repayment burden in bad times. But regulations have been tightened to ensure AIFs are not onlending to entities in which investor are already invested, thus escaping regulations against evergreening.