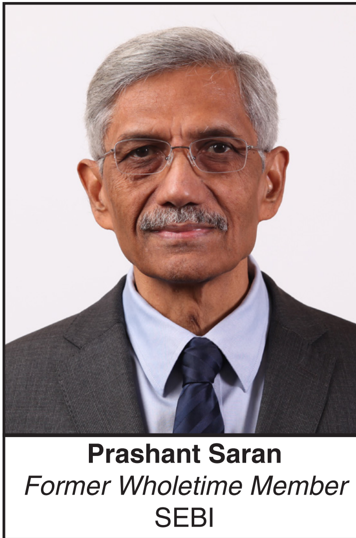
Limits of Standardisation



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Instinctively, we understand the advantages of standardising products, services and regulations. When we shop for our breakfast cereal, we are at mental ease because we know whatever we might pick up from a supermarket shelf has a certain taste, nutrition, and wholesomeness. We also want to be at ease when we go to another city and feel confident that our electronic devices will work because we know that the electric outlets have the same size and the electricity will flow at the same voltage. We go to any hotel and almost blindfolded we know where to find the bathroom toiletries, slippers and master switch (though the same does not hold for the shower fittings which are difficult to fathom most of the times). A good hospital in Mexico looks and works almost the same as another good hospital in New Delhi. All this is very reassuring. The advantage of standardisation were clear to even to earliest civilisation as they , almost invariably, standardised the measures of weight, length and time. The progress of standardisation is seen as a progress of a civilisation. A civilised country is one where everyone is treated alike, whether she is the poorest person or the royalty. In this article, we intend to illustrate the limits of standardisation using example of regulations around the Indian bond markets.

This ideal is also sought and implemented in financial areas. Generally Accepted Accounting Principles ensure that financial statements across financial entities are reliable and comparable. Now almost all countries have the same or similar accounting practices. International standards are framed and implemented whether it is capital requirement for banks or corporate governance for companies. The governments and regulators make an extra effort that uniform regulations are enforced and take considerable pride when regulations and laws are applied uniformly across the whole population. Policies are made and sought to be implemented strictly across the whole population. Standardisation of regulation helps the consumers and producers of financial instruments to have certainty and is in consonance with the idea of equality before law. From the point of view of governments, it is useful in helping them to monitor their subjects.

Is the all consuming quest for uniformity and standardisation good for our civilisation? Is it a mark of progress or we should take a breath and find out where standardisation may not be the ideal solution? Through standardisation of modes of travel, shelter and food, the hospitality industry has made tourism easy but has robbed the very reason why people may like to travel. We yearn for the serendipity of discovering a good local food joint rather than opting for ease of walking into a McDonald outlet.

Matters turn to be more serious and unpredictable when uniformity is adopted unthinkingly in making and implementing policies, financial or otherwise. There is an oft repeated story or the US Department of Agriculture adopting zero tolerance policies towards forest fires in the early twentieth century in the hope of increasing the forest cover. Any fire had to be put out before the next day morning. The policy was implemented with all the rigour and the forest fires came down drastically. After a couple of decades a survey was done for measuring forest cover. Surprisingly, the forest cover had decreased despite the forest fires coming down drastically. Research showed that forest fires mainly burn the undergrowth and the leaves, letting the trees revive themselves in a few years. In absence of forest fires, the undergrowth putrefied and permanently killed trees in many tracts of forests.

Introduction of high yielding varieties of wheat and rice has indeed solved food problem to a great extent but has made the scenario of a large scale viral or fungal attack on crops scary beyond imagination. That is why environmentalists are most concerned about maintaining bio-diversity.

The International organisations of regulators like the Basle Committee on Bank Regulation or International Organisation of Securities Commissions (IOSCO) and even OECD have issued standards that have been adopted almost verbatim in almost every jurisdiction. It is argued that uniform adoption of these standards will make the financial system resilient to shocks.

Yet, there are many who have started speaking in favour of merits of diversity in regulations. Professor Lawrence J White of Stern School of Business while acknowledging the good points of a uniform and centralised regulatory system argues why diversity can be a good thing. There is no doubt that the regulatory landscape in the US is one of maddening complexity with several federal regulators of deposit taking institutions, in every market and one must add 50 state regulators as well. A large financial institution faces unbelievable complexity. Yet there are merits in the system that have allowed the system to survive without denting the USA's financial supremacy. One obvious advantage Prof. White quotes is the fact that no single regulator can stop an innovation, as it can be incubated by some other regulator and in the past it has happened many a time. Diversity of regulatory views prevented the Global Financial Crisis from becoming worse because some of the regulators desisted reducing bank capital in deference to Basle II.

To sum up Prof. White says:

> *The idea that diversity can have substantial value for financial regulation is not just an artefact of abstract theorizing. There are a number of important, real-world instances where the presence of multiple financial regulatory agencies allowed good ideas to flourish (and where the presence of only a single regulator would have squelched--or at least significantly delayed--the implementation of the idea)*

and/or helped hasten the demise of bad ideas.

There is lesson to be learnt from Prof. White's ideas to understand the challenges faced in development of Indian corporate bond markets. Indian financial Sector Regulators have been articulating the need of a vibrant corporate debt market for various reasons, including additional resources for raising capital and de-risking of banking sector. Though in absolute terms, corporate bond market has increased in size substantially, yet it pales into comparison with equity market. Further, the liquidity in corporate debt market is observed to be much less. Various reasons have been attributed to this situation. Unlike equities markets, corporate debt market is mainly an institutional market with large ticket size. The retail is generally outside the market for privately placed bonds because the minimum face value, till recently, was Rs. 1 lac. The retail investor is not excited about the yield difference of a couple of percentage points as he is conditioned to believe that securities markets are for windfall gains where people get rich quick. Even among the corporates, investment in bonds is mainly in Held To Maturity category and the secondary trades are not many. Liquidity in bond markets is generally low as compared to equities. Even among hundreds of Government Bonds only a handful bonds are liquid and are called 'on the run securities'. It is a tall order for a corporate bond to be liquid for the reason that the issue sizes are modest the number of investors limited. Corporates issue bonds in several tranches to avoid a lumpy payment schedule, hence the liquidity is limited. Government often re-issues older bonds where as a corporate has no incentive to bunch its payment obligations.

It can be argued that the laundry list of problems cited above are also prevalent in the developed markets where there is a much more liquid market in corporate bonds. We have to look for a deeper reason why despite best efforts, corporate bond market is not thriving.

One of the reasons could be that the investors in corporate bonds are Instutional investors. They are obliged by virtue of either the applicable laws or by their investment policies to invest only in highest rated bonds as largely they cater to small man. The intention of protecting the interests of retail stakeholders is good. However rating being the main or only criterion regarding investment gives rise to unintended consequences. The regulator also provides that the valuation ought to be done by external valuation agencies who simply apply spreads applicable to the given rating over the risk free interest rates and value the bond with minimal scope for subjective judgement.

Market for any instrument exists because the buyers and sellers value that instrument differently. When any trade takes place the buyer thinks that the instrument has better valuation, i.e., present value of future cash-flows is higher than what the market price indicates and therefore buys the instrument. On the other hand, the seller must have opposite views. This happens invariably in the case of equity shares. Almost everyone has her own views about the future cashflows as well as the applicable discount rates. No standards have been or can be laid down when a share may be considered under-valued or over-valued. Every investor, whether it is the retail investor or an institutional investor forms her own views and is completely justified in holding it against everyone else's views. However, in the case corporate bonds the entire decision is primarily dependent upon the ratings given by a Credit Rating Agency. It is unlikely that two investors would have substantially different views on the valuation. Of course, they would have minor difference in opinions as to the exact value or different needs of cash flow and thus some trades are still possible.

Recently, it has been proposed with view to developing CDS market that Mutual Funds may be allowed to buy as well as sell protection and even buy below investment grade bonds.

It will be useful to recall the environment in which CDS market developed. In the late 1970s markets for Residential Mortgage Back Securities (RMBS) and Collateralised Borrowing and Lending Obligation (CBLO) started developing. These were risky securities and a decade later market for Credit Default Swap (CDS) started developing. CDS was a great idea. Admittedly, there were excesses that allegedly led to Global Financial Crisis(GFC). CDS was a great idea and despite its getting the blot of being a contributor to GFC, was not banned but the regulators put corrective mechanisms and currently it is much safer. Is it a good idea to have a CDS market in India at this stage? Is it like putting the cart before the horse? There should be a market in risky securities first and only then a market for hedging in these risky securities is likely to develop.

An attempt was made in 2012 by way of promoting Alternative Investment Funds, especially the Category III Funds. These regulations were extremely light touch. The investors were supposed to read the Information Memorandum and invest and if the issuers were untruthful drag them to court or banish them from market. But trained on the ethos of protecting bank depositors and small investors, these regulations have had scores of amendments and now look almost like Mutual Fund Regulations. The basic idea of AIF Regulations, ostensibly, was to develop equivalents of PE Funds and Hedge Funds. These institutions, especially Hedge Funds would have appetite for risky securities and as a defence mechanism would automatically take to developing CDS markets.

However progressively, these look and behave more like Mutual Funds and also have no sizeable portfolio of risky securities. The bulk of corporate bonds lie with Mutual Funds. It is doubtful whether funds with a mandate to serve the smallest investor would have any appetite for risky securities and CDS.

There are deeper structural problems holding back development of the CDS market in India. A trade in any instrument takes place only when the buyer and seller have substantially different views on the future cash flows from that instrument. For example, no two people have the same view on the future cash flows of an equity share of a company. Regulators do not provide any uniform method of valuation of equity shares. Each Investment Manager takes her own call and decides to buy or sell the equity share.

In contrast, in India bond investors' own decisions become secondary to the ratings given by the Credit Rating Agencies. Even when valuing the portfolio, an external

valuation agency takes over, which applies a spread over the risk-free return for the given rating. In such a scenario, it is more likely than not that everyone in the market has more or less the same view on the future cash flows of a bond, reducing the scope for developing a CDS market on such bond. Unless and until the viewpoints of the buyers and sellers of protection differ directionally, the likelihood of trades in the CDS market is minimal. In view of the above, there is need for both the market players and the regulators to go beyond applying spreads over risk free rates for a given rating for valuation purposes. Unless the buyers and sellers have different views no market is likely to develop, be it risky securities or CDS. It should not be thought that existence of risky securities, per-se, is bad for an economy. Many investments, like those in infrastructure sector are risky by nature. These can be financed only when someone is ready to be the risk taker. It is another matter that as custodians of common man's savings Banks and Mutual Funds should be exposed to risky securities only to a limited extent. Other players who have capacity to understand and to absorb risks, such a Hedge Funds, are the ideal candidates as consumers of risky securities.

To sum up, standardisation of regulatory practices such as valuation is a useful tool in the development of financial markets, as it leads to transparency and certainty to the producers as well as consumers of financial instruments. However when it is carried to an extreme, forced uniformity in views on prices kills the basic buying and selling functions of markets become defunct. While protecting the interests of the small investors, the regulator should not become an instrument in blocking the development of markets. Extreme standardisation even in other areas are likely to lead to anomalous situations.