Need for System Thinking in Finance

What is the issue?

- Defaults and stresses are being witnessed across banks, mutual funds, non-banking financial companies (NBFCs), the bond market, and real estate.
- It is high time that the government understands the importance of system approach than the current micro-prudential regulation.

How does micro-prudential regulation work?

- Micro-prudential regulation is the job of pushing financial firms to cap their failure probability.
- It involves writing rules that prevent excessive risk taking by banks.
- E.g. there may be an objective that no more than 2% of banks should fail per decade
- It ensures that the failure probability of any one bank does not exceed 2% over a 10-year horizon.
- With mutual funds, there is no possibility of firm failure.
- So 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 the objectives, micro-prudential regulation thinks deeply about one financial firm at a time.
- It identifies a minimal set of interventions which achieve its narrow objective.
- However, this approach avoids central planning of products and processes.

How did the recent crisis evolve?

- 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 increases significantly.
- With stressed borrowers, new debt is required to pay off old debt.
- The balance sheet grows, as default is staved off by paying old lenders using money borrowed from new lenders.
- For many years, 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.

- Thereby, the mutual funds, NBFCs and the bond market came in.
- But these too have run into difficulties in the last one year.
- Now India has a group of stressed borrowers running out of ways to recover, and four stressed components of the financial system.
- The problems of borrowers, real estate prices, bond market, mutual funds, NBFCs and banks are reinforcing each other now.

What lies ahead?

- The components of the recent problems are not to be seen in isolation.
- It is difficult for a fragmented financial regulatory architecture to obtain information, make root cause analysis, and solve problems.
- Also, there is a natural bias for micro-prudential regulators to postpone the recognition of a problem.
- What is needed is a system thinking that diverges from the view of one firm at a time i.e. micro-prudential regulation.
- There is a need to see the financial system from a high-level perspective, and see the pressures and relationships.
- Such an approach could significantly acknowledge the interconnections among the shortfalls and address the problem in a better way.
- An informal team that looks into the various components of the financial system holistically may work.

Source: Business Standard

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