Micro-prudential regulation

Macro/Finance Team, NIPFP

July 22, 2013

What is micro-prudential regulation?

- Regulation to maintain the safety and soundness of financial institutions

Why is micro-prudential regulation required?

1. Financial service providers have an interest in their own financial health, but this interest is sometimes diluted by:
   - *Governance failures* within firms, because of misalignment of incentives
   - *Moral hazard* induced by the implicit promise of government bail-out
2. Consumers have an interest in the financial service provider's financial health, but are often not able to do much because:
   - There is *information asymmetry* between the consumer and the provider
   - *Coordination problems* among consumers prevent collective influence
   - *Market power* of a provider is usually much greater than that of its average consumer

Why non-sector-specific micro-prudential regulation?

The FSLRC report points at the following reasons for a non-sector-specific approach to micro-prudential regulation

1. There is underlying similarity in all financial contracts, and there are common principles that underpin micro-prudential regulation in different sectors;
2. It will minimise the potential for regulatory gaps;
3. It will minimise regulatory arbitrage;
4. It will help curtail regulatory race to the bottom; and
5. Multiple regulators interpreting a single set of non-sector-specific provisions, can generate healthy public debates.

Where will micro-prudential regulation apply?

The Indian Financial Code lays down the following tests for the regulator to determine which activities should be subject to micro-prudential regulation, and to what extent:

1. The nature of the relationship between the financial service provider and its consumers, including:
    1. the detriment caused to consumers if obligations are not fulfilled by the provider,
    2. the ability of consumers to access and process information relating to the provider's safety and soundness, and
    3. the ability of consumers to coordinate among themselves to monitor the provider's safety and soundness.
2. Inherent difficulties in fulfilling the obligations owed by a financial service provider to its consumers.

Instruments of micro-prudential regulation I

The Indian Financial Code provides a range of instruments to be used by the regulator to pursue micro-prudential objectives. The regulator can:

1. Impose conditions for authorisation to carry on the business of financial services
2. Vary, suspend or cancel an authorisation;
3. Impose capital resource requirements and liquidity requirements;
4. Impose investment restrictions;
5. Mandate certain systems of governance and internal controls;
6. Mandate certain risk management systems and processes;

Instruments of micro-prudential regulation II

7. Place due restrictions on outsourcing;
8. Regulated certain types of transactions by regulated persons, such as mergers, acquisitions, related party transactions, etc.;
9. Impose requirements around auditing and actuarial services availed by regulated persons; and
10. Take various supervisory actions to monitor compliance and assess safety and soundness of the regulated persons.

Principles to guide micro-prudential regulation I

The regulator must consider the following principles in discharging its functions and exercising its powers:

1. Any obligation imposed on regulated persons should be proportionate to
    - the nature, scale and complexity of the risks in the regulated activity being carried out; and
    - the manner in which the regulated activity ranks on the following factors:
        - the nature and extent of detriment that may be caused to consumers in case of non-fulfilment of obligations;
        - the ability of consumers to access and process information relating to safety and soundness; and
        - the ability of consumers to coordinate among themselves to monitor the safety and soundness.
    - in case of regulated persons that are Systemically Important Financial Institutions, the relevance of the regulated person for the stability and resilience of the financial system;

Principles to guide micro-prudential regulation II

2. Regulatory approach needs to take into account the feasibility of implementation by regulated persons and supervision by the Regulator;
3. The need to minimise inconsistencies in the regulatory approach towards regulated activities that are similar in nature or pose similar risks to the fulfilment of the Regulators objectives;
4. Any obligation imposed on regulated persons should be consistent with the benefits, considered in general terms, which are expected to result from the imposition of that obligation;

Principles to guide micro-prudential regulation III

5. The desirability of facilitating competition in the markets for financial products and financial services and minimising the adverse effects of regulatory actions on competition in the financial sector;
6. The desirability of facilitating access to financial products and financial services;
7. The desirability of facilitating innovation in financial products and financial services;
8. The need to ensure that regulatory actions are carried out in a manner that is least detrimental to competitiveness of Indias financial system;

Principles to guide micro-prudential regulation IV

9. The need to take into account the long-term implications of regulatory actions, which will include a period of at least five years following a regulatory action;
10. The need to minimise the pro-cyclical effects of regulatory actions; and
11. The requirement that persons who control and manage the affairs of regulated persons must share the responsibility of ensuring the safety and soundness of the regulated persons.