Create a Crisis and make it Worse*

C.P. Chandrasekhar

On August 10, the government tabled a new bill in Parliament, with the aim of using its majority to push through a desperate policy initiative in the form of the Financial Resolution and Deposit Insurance (FRDI) Act. The Act seeks to create an ostensibly 'independent' FRDI Corporation, which would take over the task of resolution of failing financial firms from the Reserve Bank of India and other regulators. To that end, it is to be armed with special and near draconian powers to implement its mandate, and given control of the deposit insurance framework currently managed by the Deposit Insurance and Credit Guarantee Corporation of India.

The context in which the bill is being introduced needs noting. Financial liberalization over the last twenty-five years provided greater freedom for financial firms and reduced oversight by the central bank. The government in turn encouraged public sector banks to use their freedoms and hugely expand their credit volumes so as to spur a private, debt-financed consumption and investment boom. As part of that 'strategy', a significant share of incremental lending went to large corporate players investing in risky projects in capital intensive areas like steel and infrastructure.

This was a major departure from the more conservative banking practices of the pre-liberalization era. As a result of the change in behaviour, which exposed the public sector banks to liquidity and maturity mismatches, banks have accumulated large non-performing assets, which in many cases are well in excess of 10 per cent of the advances made by them. Since a disproportionate share of the NPAs are with public banks, the government as owner and the central bank as regulator are culpable, especially since they had the right to appoint and monitor bank chief executives and keep them pliant. This culpability was true of NDA and UPA governments, both of which backed and implemented measures of financial liberalization and relied on bank credit as a stimulus for growth, thereby contributing to the increase in the volume of bad debts.

This places on the government the responsibility of helping the banks to deal with defaults on large loans. Initially, this evinced two kinds of responses from the government. The first was to help restructure large problem loans through the Corporate Debt Restructuring mechanism, which allowed for longer repayment schedules, reduced interest rates and provided additional credit to tide over the difficult times. Restructured debts could be treated as "standard assets", absolving banks of the need to provide for these loans and technically write them off. However, in many cases, this merely postponed the bad debt problem at a cost. The second response was to provide budgetary resources for recapitalizing these banks, to ensure capital adequacy as and when provisioning became unavoidable.

The first of these was resorted to so liberally that the magnitude of the NPA problem remained hidden, with a rising volume of "restructured standard assets" in the books of the banks. When the RBI finally decided to do away with this practice of concealing NPAs, by issues strict guidelines on recognition of bad assets, the volume of NPAs in the banking system rose rapidly. The increase meant that the sums that had been allocated and were planned to be allocated by the government for the recapitalisation of public sector banks turned out to be grossly inadequate to cover losses. But because the government wanted to meet self-imposed fiscal deficit targets, it was unwilling to suitably increase allocations for recapitalization.

This meant that other ways had to be found to address the problem of large and debilitating NPAs. As a first new step to address the problem, the government recently promulgated the Banking Regulation Amendment (Ordinance) 2017, which introduced new clauses into the Banking Regulation Act (BRA). These clauses meant that the government could authorize the RBI to take special action to resolve the bad debt problem. This would involve forcing banks to launch proceedings against identified borrowers to recover their unpaid dues. If no agreement for restructuring could be arrived at between the borrower and its lenders, liquidation proceedings against the borrower were to be launched to recover as much of the loan as possible.

Initially, 12 large borrowers accounting for around a quarter of total NPAs were identified for action. Since then, an additional set of more than 25 borrowers have reportedly been identified. But proceedings at the National Company Law Tribunal suggest that this effort can at best be a partial solution, since, among other things, finding assets that can cover the defaulted loans is not easy. Large write offs are inevitable. That raises the possibility of bank insolvency, necessitating measures of resolution.

The FRDI Act defines the resolution mechanisms being pushed by the government, as an alternative to recapitalization. At the centre of the new scheme is the creation of a new independent corporation that would take over the task of resolution of bankruptcy in banks, insurance companies and identified “systemically important financial institutions” (SIFIs). The FRDIC will also take over the task of insuring bank deposits, compensating depositors up to a specified maximum amount (at present Rs. 1 lakh), in case of bank failure.

As part of its responsibilities, the corporation is to be mandated to classifying the financial institutions under its jurisdiction under different categories based on risk of failure, varying from ‘low’ and ‘moderate’ (or in whose case the probability of failure is marginally or well below acceptable levels), to ‘material’ or ‘imminent’ (implying failure probabilities that are above or substantially above acceptable levels) and, finally critical (or being on the verge of failure).

In cases of financial firms placed under the material or imminent category, the Resolution Corporation is to be given the power to: (i) inspect the books to obtain information on assets and liabilities; (ii) restrict the activities of the firm concerned; (iii) prohibit or limit payments of different kinds; and (iii) require submission of a restoration plan to the regulator and a resolution plan to the FRDIC, if necessary involving a merger or amalgamation. In cases identified as critical, the FRDIC will take over their administration, and proceed to transfer their assets and liabilities through merger or acquisition or to liquidate the firm with permission from the National Company Law Tribunal (NCLT). To leave no choices open, the law prohibits recourse to the courts to stay the proceedings at the NCLT or seek alternative routes to resolution. Since liquidation involves compensating stakeholders according to their designated seniority, depending on the net assets available, any stakeholder can be called upon to accept a “haircut”, including holders of deposits in excess of the maximum specified as insured against loss.

The implications of this Act are many. To start with, while the independent FRDIC and the concerned regulator will determine whether a financial firm is to be placed in the material or imminent category, the task of working out an acceptable restoration or renewal plan rests with the firm under scrutiny. That is, the responsibility of restoring viability is that of the bank, insurance company or SIFI, with the regulation and resolution authority retaining the right to determine whether this has managed to reduce the probability of failure.

Second, since mere categorisation in the ‘material’ or ‘imminent’ category will send out a signal, banks so designated can become the target of a run, as depositors fearing failure would want to move out their deposits. That is, instead of resolving the problem of vulnerability to failure, the mechanism may precipitate failure.

Third, the restoration and/or resolution plan, to be acceptable, may ‘force’ the financial firm to accept amalgamation or merger. This would have implications for parties that are not responsible for the state of the firm, including officers, employees, creditors and small shareholders. For example, retrenchment or downgrading of the status of employees may follow merger and amalgamation. And where resolution requires the preferred strategy of “bail-in” of the firm, shareholders, creditors and, if need be, depositors, would be forced to accept a “haircut” or loss. The unstated objective of the exercise is to save the government and the regulator from carrying the costs of a “bail-out” of the failing firm.

Thus, the tabling of the FRDI bill is a clear declaration by the government that it sees painful resolution or liquidation as an unavoidable cost of addressing the bad debt problem that currently afflicts the banking sector in particular. It also makes clear that the finance ministry, the central bank and the government sponsored regulators will not carry any of the financial burden associated with resolution, but rather would transfer financial and other costs (such as job losses) to the employees, officers and shareholders. Since the problem of potential insolvency is at present concentrated in the public banking system, the government is obviously willing to write off capital already invested, but wants to minimize any additional costs.

Interestingly, as was made clear in the Report of the RBI’s Working Group on Resolution, this resolution framework is merely the replication in the Indian context of a regime recommended by the Basel-based Financial Stability Board (FSB), in its formulation of the “Key Attributes of Effective Resolution Regimes for Financial Institutions”. The FSB was established in the aftermath of the global financial crisis of 2007-08, which was centred on the US, UK and Europe. However, in those jurisdictions, the resolution of the post-crisis problem of potential insolvency of banks came through government purchases of equity and liquidity infusion by central banks. The Indian government and central bank have, on the other hand, chosen to exploit the FSB resolution framework to pursue their own agenda of saving the state at the expense of the banks and their stakeholders.

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