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Fixing the financial architecture

An empowered, well-funded resolution authority is urgently needed to strengthen the financial sector

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A bank failure makes major headlines as it affects the lives of many depositors and, in some cases, generates systemic stress or even instability. Often that is the case with the failure of non-banking finance companies (NBFCs) as well. It is because deposit-taking is considered a "high-intensity" promise that must be honoured and failure to do so invites serious consequences to all stakeholders. Even non-deposit taking NBFCs are indirect deposit-takers since their main source of funds is borrowing from the banks and the public.

The recent instances of such failures and their consequences are fresh in our minds: PMC Bank, Yes Bank, IL&FS, DHFL, SREI and Reliance Capital, all in rapid succession. Understanding the NBFC-bank linkage and its impact on the real sector, the Reserve Bank of India (RBI) has belatedly brought NBFCs under the Prompt Corrective Action framework, rightly softening the regulatory distinction between the banks and NBFCs.

The quick resolution of failure of high-intensity promising organisations has been an area of serious policy debate in advanced financial jurisdictions for decades. As a result, specialised organisations have been created to address such events with minimum disruption to the systems and the economy. The US Federal Deposit Insurance Corporation and the Canadian Deposit Insurance Corporation do precisely this. They insure deposits; supervise financial institutions for safety, soundness, and consumer protection; and make large and complex financial institutions resolvable.

In India, however, the regulators have been reluctant to give up their turf by insisting on a "cradle to grave" approach towards the entities under their regulatory oversight. Despite such a general posture, when the Financial Sector Legislative Reforms Commission (FSLRC) recommended a specialised authority, the Resolution Corporation (RC), to resolve failing financial institutions, there was not much resistance to the idea per se, though on details some differences persisted. A recognition of the importance of such an organisation was clear. The government acted on this proposal of the FSLRC by introducing the Financial Resolution and Deposit Insurance, or FRDI, Bill in 2017.

A road map to avoid any ambiguity or friction between the regulator and RC — as laid out by the FSLRC in terms of a five-stage approach —was also part of the FRDI Bill. It included:

1. Low risk to viability: RC will monitor the covered financial service provider, or FSP based on available data.

2. Moderate risk to viability: RC will conduct a special examination of the health of the covered FSP, communicate its concerns to the latter and may levy a premium surcharge.

3. Material risk to viability: In addition to 1 & 2 above, the RC will seek a resolution plan and intensify its engagement with the covered FSP.

4. Imminent risk to viability: Within 90 days of such a determination, the RC will apply for receivership of the covered FSP and the regulator must appoint the RC as the receiver.

5.Critical risk to viability: The RC will cancel or terminate all policies of insurance and apply for liquidation.

In all stages, except five, the regulator could apply its regulatory tools and intensify engagement with the FSP, till it was placed under the receivership of the RC. As such the role of the regulator was never undermined by the introduction of

RC as a specialised authority to deal with the failure of FSPs and to manage deposit insurance, including its pay-outs.

Despite many positives, the FRDI Bill was withdrawn in 2018 following disagreement on one sub-clause regarding funding resolution. This provision of "bail-in"— partly using depositors' money in case of shortage of funds in resolving the failure of an FSP— was not a recommendation of the FSLRC. It recommended a well-funded RC through adequate capital, deposit insurance cover, risk-based premium and lines of credit from the government during major crises. Given this, the entry of a sub-clause for "bail-in" in the FRDI Bill, its withdrawal without much effort to save the Bill by removing the controversial sub-clause belie logic.

Though the RC, conceived long ago, is awaiting birth, the complex cases of IL&FS and DHFL reopened the eyes of the policymakers. However, they opted for using the now successful Insolvency and Bankruptcy Code, 2016 (IBC), a sub-optimal option, in resolving DHFL. Though an FSP is prone to insolvency for similar reasons as a company, additionally, the stress of companies spills over to the FSPs, leading to the famous "twin balance sheet" problem. Though the IBC experiment in the case of DHFL largely succeeded, the slow pace of resolution and the end result were far from satisfactory. The sub-optimal solution, if continued for long, is likely to be the regular solution, creating incentives to resist the optimal solution.

An FSP is structurally different from a company, though it may be registered as a company. An FSP uses "others'/clients" money for its business while a company uses equity and debt (debt is "other people's money" and cushions the differences somewhat). Differences in concerns of stress and objectives of resolution require a different approach for resolution of an FSP vis-a-vis a real sector entity.

Quick resolution of FSPs' stress is important for effective consumer protection. In the case of a systemically important financial institution speed becomes paramount in preventing spill-overs and systemic instability. The failure to strengthen the institutional architecture in tune with such regulatory requirements is myopic. Bad banks are only temporary solutions; till their own non-performing assets become overwhelming. Fintech disruptions are adding enormous weight of uncertainties on FSPs. Wake up! An empowered, well-funded resolution authority is an urgently needed pillar for strengthening the financial sector's regulatory-institutional architecture.

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