Resolving Financial Bankruptcies: A Case of Government Overreach?

The Indian finance ministry recently put up a draft Financial Resolution and Deposit Insurance Bill for public comments. The Bill proposes to establish a comprehensive framework for resolution of financial firms (founded on the premise that bankruptcy of a financial firm can have implications that go beyond the firm's shareholders and extend to its consumers and, at times, to the wider economy).

As the reader knows, the Insolvency and Bankruptcy Code (IBC) was recently enacted to provide for bankruptcy of non-financial firms. The Financial Resolution and Deposit Insurance Bill is meant to serve as its counterpart for financial firms (unless a given category of financial firms is notified to be subject to the IBC; in which case, it will be excluded).

Briefly, the Bill proposes to establish a Resolution Corporation (Corporation) and empowers it with the tools to resolve Covered Service Providers, essentially a category of financial firms including banks, insurance companies and payment systems, in the event they are assessed to be in the zone of non-viability. The Bill also empowers the Corporation to issue deposit insurance to commercial (and certain notified co-operative) banks.

This piece will critique two important features of the Bill as applied to banks; the allocation of powers between the Corporation and the appropriate regulator and the criteria proposed to be adopted for defining risk to viability.

Who Should Define Risk to Viability?

The Bill establishes a "prompt corrective action regime"defined in terms of "risk to viability" to the financial firm concerned. The risk to viability is categorised in five risk buckets from low through to critical, with moderate, material and imminent being the intermediate categories.

The Bill further empowers the Corporation to define the criteria of these risk buckets in consultation with the "Appropriate Regulator" taking several factors into account. These factors include a mix of subjective (like "capability of management") and objective criteria (like "capital adequacy" and "leverage ratio"). The Corporation retains the final say if it disagrees with the regulator about classification of a firm in "material risk to viability" category. It can classify a firm in "imminent" and "critical" buckets. On the other hand, the appropriate regulator retains the exclusive power to classify a firm in "low" and "moderate" risk buckets.

This seems counter-intuitive. The appropriate regulator, the RBI in this case (and not the Corporation), appear to be best suited to define the risk to viability framework under the Bill.

Firstly, the Corporation is not proposed to be a prudential regulator for financial firms that are "going concern". It is proposed to supervise and resolve a firm in the zone of distress. The institutional capacity for prudential regulation of firms while they are going concern already resides with the appropriate

regulator. Saliently, RBI has prescribed prudential regulatory standards for banks for several decades hitherto and presently implements a PCA (prompt corrective action) regime for commercial banks.

Secondly, the Corporation is broadly designed along the lines of the Federal Deposit Insurance Corporation (FDIC) in the United States. Analysis of FDIC's constituent statute also indicates that the appropriate banking regulator is empowered to define the relevant risk buckets. The FDIC is empowered take over the supervisory role once a given financial firm breaches the "critically undercapitalised" threshold. This is consistent with its role a resolution authority as a "critically undercapitalised" entity presumably is in need of resolution. The RBI representative on the committee framing the bill pointed out that empowering the Corporation to create a risk to viability framework alongside the existing PCA regime will only lead to divergent risk assessments. The Committee nonetheless made the Corporation the primary regulator empowered to define it. Multiple risk buckets create the possibility of regulatory arbitrage.

What Should Be The Criteria To Define Risk To Viability?

Assuming the Corporation should retain the authority to define risk to viability for banks, the Bill provides a mix of subjective and objective criteria to define risk to viability. Financial markets crave certainty. As such, it appears prudent for the Corporation to rely solely on quantitative features to define risk to viability. Defining the risk based on quantitative criteria assumes further importance because it reduces the likelihood of errors and disagreement between Corporation and the regulator concerned at the time of classification.

For example, imagine a situation where the RBI and the Corporation disagree on whether a bank concerned is correctly classified in the "material risk" bucket under the Bill because the RBI thinks the incumbent management has capacity but the Corporation thinks differently. The current version of the Bill provides that any differences of opinion will be resolved by consultation with the Corporation having the final say. However, as the events leading up to the Lehman Brothers bankruptcy indicate, franchise value of a financial firm with a deteriorated capital adequacy evaporates very quickly. As such, it is important that any friction between classification of the firm concerned in a given risk bucket be as minimal as possible.

This, in turn, will enable the resolution to be affected seamlessly. For instance, the PCA regime implemented in the United States defines the risk buckets in terms of total capital, Tier-I capital and leverage ratio. All these metrics are quantitative and as such are easily ascertained. In a country like India, where the emphasis has always been on timely resolution of financial firms and institutions, it is even more necessary to put in place processes that limit the possibility of human errors and don't create barriers to quick decision-making.

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