31 May 2014

COMMENTS ON REPORT OF THE WORKING GROUP ON RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS

The Sub-Committee of the Financial Stability and Development Council (FSDC) constituted a high level Working Group to suggest extensive strengthening of the resolution regime taking into consideration the structure of Indian financial institutions and the Financial Stability Board's Key Attributes of Effective Resolution Regime for Financial Institutions. The Report of the Working Group (WG) on Resolution Regime for Financial Institutions (Report) has been released for public comments.

Comments from CUTS International on the Report of the WG are as follows:

1. Objectives of the resolution framework

The Report mentions that objectives of resolution framework should include, *inter alia*, protection and maintenance of stability of the financial system.

The financial crisis has renewed[1] interest world over in Hyman P. Minsky's Financial Instability Hypothesis. The Hypothesis states that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.[2] In other words, Minsky believed that stability is inherently destabilising as it induces behavioural responses that erode margins of safety, reduce liquidity, raise cash flow commitments relative to income and profits, and raise the price of risky relative to safe assets--all combining to weaken the ability of the economy to withstand even modest adverse shocks.[3] The initiation of financial crisis has itself been characterised as the Minsky moment.[4]

Post-crisis, there has been a strong argument in favour of replacing the need for 'stability' with 'resilience'. It has been argued that if stability leads to fragility, then it follows that stabilisation too leads to increased system fragility. Resilience, on the other hand, focuses on

[1]Janet L. Yellen, *A Minsky Meltdown: Lessons for Central Bankers*, Levy Economics Institute of Bard College, April 2009

[2]Working Paper No. 72 on the Financial Instability Hypothesis published by the Jerome Levy Economics Institute of Bard College, May 1992

[3] Laurence H. Meyer, *Lessons from the Asian Crisis: A Central Banker's perspective*, Working Paper No. 276, Levy Economics Institute of Bard College New York, April 1999

[4]When a market fails or falls into crisis after an extended period of market speculation or unsustainable growth.

adaptability and survival amidst change, and develops system's ability to deal with sudden changes.[5]

Consequently, it is suggested that the objectives of resolution framework be amended to make financial system resilient.

2. Scope of resolution framework

The WG recommends that financial resolution framework in India should cover all financial institutions, including securities, commodity market firms and non-bank financial companies. It has also been suggested that parent undertaking or the holding company regulated by the financial sector regulator, of the financial groups, must also be covered. The WG has also recommended that the financial company holding structure be introduced in Indian financial system.

While one can understand the intention to protect consumers' interest in covering the universe of financial firms, such huge responsibility could also act as non-starter for the FRA. Moreover, securities and commodities market firms such as alternate investment funds and portfolio investors and non-bank financial companies also operate in the financial sector, which might not necessarily represent interests of vulnerable and retail investors in the markets. One might also argue that as the primary intention of a resolution regime is to avoid any systemic risk, only large financial institutions that could put strain on system if not efficiently resolved, should be covered. Consequently, the cost and efforts involved in resolving such securities, commodity market and non-bank financial firms, unless systemically important, is likely to outweigh the benefits of such resolution.

However, one cannot overlook the limitations in applying corporate insolvency laws to financial institutions, the unique function performed by financial intermediaries, and their close proximity to vulnerable depositors and investors. As has also been highlighted in the Report, financial regulations have provided excessive powers to the regulators to interfere in the management of financial firms, in the name of ensuring stability. In addition, the regulatory powers in relation to public sector financial firms are limited than those in relation to their private sector counterparts. For instance, normal corporate insolvency laws do not apply to public sector firms unless approved by the government.[6] Consequently, even if a

[5] Jayanth R. Varma, *Financial stability, financial resilience, and systemic risk,* http://www.iimahd.ernet.in/~jrvarma/blog/index.cgi/Y2013/financial-stability.html, and http://www.macroresilience.com/

[6] See, State Bank of India Act and the Life Insurance Corporation of India Act

public sector firm is bankrupt, it would not be subjected to insolvency unless directed so by the government. Such liberty is not available in case private sector firms.

The WG has attempted to hit three birds by one stone. By covering all financial firms, it bypasses the corporate insolvency regime, excessive powers conferred to financial regulators, and also attempts to maintain stability. In this noble attempt, it seems the WG has bitten more than it can chew, and increased the possibility of the Report becoming a showpiece in government offices, rather than being acted upon.

Considering all the above factors, following phased approach is suggested in relation to the scope of Resolution Corporation:

1. In the beginning (phase I), only systemically important financial institutions and financial market infrastructure institutions be covered by the resolution regime.

2. In phase II, all firms that directly interact with consumers (banks, insurance companies, pension funds, mutual funds etc.) must mandatorily be covered by resolution regime.

3. In phase III, all the remaining firms must be given an option to get covered under the resolution regime, on payment of a prescribed fee.

Such approach will help the resolution corporation in building capacity and experience in the resolving firms, and also contribute to the resolution fund, while proportionately spreading the cost of resolution.

The phased approach suggested above will also be consistent with the phased approach for recovery and resolution planning, as suggested by the WG.

In addition to the above, it is suggested that efforts be made to improve the corporate insolvency regime in India and curbing the excessive powers to financial regulators. Further, the preferential treatment given to the public sector firms must be done away with and competitive neutrality must be ensured between public and private financial sector firms.

The WG, while recommending the non-operative financial holding company, has also recommended resolving the holding/parent company. One of the reasons for suggesting the non-operative financial company structure was to limit the spill-over effect of failing of one of the subsidiaries (a particular category of financial firm) on another and the holding company. Consequently, unless the holding company is systemically important, resolving such entity would not necessarily be prudent. This might also lead to adverse impact on healthy subsidiaries of such holding company.

3. Structure of the resolution authority

The WG has recommended that the FRA be institutionally independent of the regulators/supervisors and the government, and it should be empowered by law coordinate/ cooperate with financial sector regulators.

In order to ensure that FRA remains institutionally independent, the members of FRA could be selected on the basis of a rigorous selection criteria, by an a group of independent experts.

Further, to ensure effective coordination and cooperation with relevant regulators during the resolution process, a time-bound mandatory communication hotline (on case to case basis) might be established between the FRA and the relevant regulator, wherein suggestions of the regulator, provided within the specific time period, would mandatorily be required to be considered by the FRA, and could be rejected only after providing adequate reasons.

4. Temporary public ownership as a resolution tool

Amongst other resolution tools, the WG has recommended temporary public ownership as a tool of last resort. The decision is required to be taken by Government of India (Ministry of Finance), on recommendation by FSDC, and it is expected that there should be intensive consultation between concerned regulator and the FRA before placing the institution under TPO.

As correctly realised by the WG, this tool requires the government to guarantee the obligations of the failed institution and may require the government to inject new equity into it. This potentially undermines the public finances. Consequently, clear accountability needs to be established for utilisation of such tool. As no other institution, but the legislature is directly responsible to the public, it should have the obligation to decide if TPO should be invoked. If the Parliament is not in session, the decision should be ratified in the next session. The FRA and regulatory institution must place their report before the FSDC on invoking TPO, which should place such report before the legislature, through the Ministry of Finance, after annexing the deliberations and opinion of FSDC. The legislature is then expected to debate on findings of FRA, regulator, and FSDC and take a decision if TPO needs to be invoked.

5. Features of the resolution fund

With respect to features of the resolution fund, the WG has recommended that in the event a systemic institution is under stress, sufficient backstops, including temporary funding support from the Government, with safeguards, may be provided to ensure adequate liquidity. In addition, it has recommended that the FRA may raise funds from the market through issue of bonds; wherein government guarantee may have to be extended, if required.

It is suggested that the resolution fund must be made of ex ante and ex post levies on the financial firms, and it should be ensured that adequate measures are adopted to bridge the gap between the funds available and required for resolution. The additional funds utilised must be recouped/reimbursed by ex-post levies on the financial firms, as soon as possible. Government assistance must be taken at the last resort, and it should be repaid in full. In addition, proper planning must go into prediction of the amount required, should resolution take place.

6. Determination of SIFI

The WG has recommended that regulators must employ certain parameters to identity systemically important financial institutions under their respective regulatory jurisdiction.

As interconnectedness and complexity are important criteria to identify SIFIs, it would be necessary to take a system wide view and avoid a sector specific view to determine if an institution is SIFI. Consequently, the most appropriate authority to determine if an institution is a SIFI or not would be the FSDC and not the respective financial regulator.

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About CUTS

CUTS International, established in 1983, is a leading economic policy research, advocacy and networking, non-governmental group in India, with offices in Nairobi, Lusaka, Accra, Hanoi and Geneva. Over the past thirty years, CUTS has led reform agendas in the areas of regulation, competition, consumer protection, and international trade.

CUTS has long experience of working in financial sector, specifically on areas of financial consumer protection, regulation and competition. For more information, see www.cuts-international.org