ILLUSTRATION BY AJAY MOHANTY

Who will bear the loss?

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SNAKES & LADDERS

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In every country, there are events in the economy where things go wrong, where business plans fail, where crises occur. We must build rule of law arrangements that will generate predictability about state responses, and the allocation of losses. This involves three things: The bankruptcy code (for most enterprises), the resolution corporation or RC (for some financial firms), and systemic risk regulation (for financial sector crises). Policy work is in motion on all three fronts.

The market economy inevitably has surprises. Innovation and growth are unpredictable and so are failures and crises. All that we can know is that failures will most assuredly happen. Creation, preservation and destruction are all valuable in the circle of life. A government that tries to prevent firms from failing will extinguish the essence of capitalism.

We must, however, create institutional arrangements that deal with the failure of firms (either financial or non-financial), and systemic financial crises. The key intuition is to think about loss allocation. By the time the government and the public see that a firm is in trouble, a loss has taken place. The only question left is who should bear it.

As an example, consider a bank that gets into trouble. It is unable to pay its depositors. There are three groups on the table: Shareholders, depositors and taxpayers. A political contest takes place where each tries to push the loss onto the others. There is extreme unpredictability about what happens. Political negotiation takes time, and the passage of time always drives up the size of the loss.

The solution to this is to have a well-defined script that kicks into action, which attacks both these problems. The procedure should be swift, so as to reduce the size of the loss. The procedure should avoid political negotiations, and have predictability about loss allocation.

A mature market economy is one in which everyone knows that things go wrong occasionally, but are comfortable that they will be swiftly resolved, and have prior notice about how losses will be allocated. The private sector can then make plans and invest in an atmosphere of confidence. Removing political negotiations also helps the private sector to focus on business and reduce their time allocation to government relationships.

How do we achieve these happy outcomes? There are three pillars of institutional capacity that get this done. The first is the bankruptcy code, which kicks in when a normal firm defaults. The second is the RC, a specialised bankruptcy code for two kinds of financial firms. The third is systemic risk regulation, which deals with preventing and addressing systemic financial crises.

India is at a historic moment, where all these three elements are being constructed. The Insolvency and Bankruptcy Code (IBC) was enacted by Parliament, and is now in the difficult stage of being implemented by the Department of Company Affairs. The 2016 Budget speech promised legislation for the RC and also the first building block towards systemic risk regulation: The creation of a database called the Financial Data Management Centre (FDMC).

The bankruptcy code is designed to work for conventional firms, but is incompatible with the problem of bankruptcy for two kinds of financial firms: Those that have made promises to households (e.g. a bank or an insurance company) and those that are systemically important (e.g. a very big hedge fund).

For these two cases, pre-emptive intervention is required even before default is announced. This requires the RC, which will intervene in a bank when it still has positive net worth. The RC would watch over these two kinds of financial firms, over and above the normal micro-prudential regulatory process, and autonomously make decisions when some players have to be removed from the game. The action generally taken by the RC is to seize control of the firm, expropriate the shareholders, and sell off the firm.

There is a simplistic notion that is sometimes found in India, that a regulator like Insurance Regulatory and Development Authority (Irdai) is the feudal lord governing all thoughts and actions of insurance companies. This is incorrect: For example, when an insurance company pays income tax, it has nothing to do with Irdai. In a similar fashion, all modern financial law involves carefully defining the objectives of regulators and then holding them accountable for narrow objectives. Irdai should be about consumer protection and micro-prudential regulation of insurance companies, and nothing more. Similar thinking applies to the relationship between the Reserve Bank of India and the banks. For the financial firms that the RC will deal with, they will deal with the micro-prudential regulator when things are good, and power will gradually shift to the RC as they go into distress.

Last week, the Ministry of Finance released a draft law governing the RC. This has introduced some modifications in the Financial Sector Legislative Reforms Commission (FSLRC) law for the RC. This is a law that will be vigorously contested by private persons, as is the case with the bankruptcy code, and will require thorough scrutiny to ensure that it is sound.

We may hope that opposition parties support this, as happened with the IBC. After this will come the formation of the RC. In 2014-15, M Damodaran led a DEA task force that made the project plan for building the RC. This will need to be set in motion with a sound management team and board of directors.

In over two years, the Bharatiya Janata Party government is moving on financial reform in six areas: (a) The Sebi-FMC merger; (b) moving from SAT towards FSAT; (c) non-debt capital controls regulation-making power shifted from RBI to MOF; (d) FDMC; (e) RC; and (f) inflation targeting. These add up to a good chunk of FSLRC. However, while there are political breakthroughs, the execution is weak. Each of these fronts requires a technically sound team that will do sustained work, so that these important wins go from media headlines to actual gains in the economy.

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