Indian Financial Code's Revised Draft

Critique of Two Proposals

MANDAR KAGADE

The Revised Draft of the Indian Financial Code's proposal to establish a Monetary Policy Committee with a majority of government nominees and no veto power to the Reserve Bank of India Governor have attracted a lot of attention. However, the code has some other critical proposals, including a Financial Stability and Development Council (the super-regulator for systemic risk) that will radically alter the financial regulation landscape of India. This article scrutinises two important proposals—the Financial Development Council and systemic risk regulation, and the "prompt corrective action" regime.

Mandar Kagade (*mandar_kagade@isb.edu*) is at the Bharti Institute of Public Policy, Indian School of Business, Mohali.

The Ministry of Finance released the "Revised Draft Indian Financial Code" (henceforth, Code) for public comments in July. Since its release, the Code's proposal of a Monetary Policy Committee with a majority of government nominees, and the absence of veto for the Reserve Bank of India (RBI) Governor have attracted a lot of attention. However, the Code has some other critical proposals including the proposed Financial Stability and Development Council (that will act as the super-regulator and monitor systemic risk) that will radically alter the financial regulatory landscape of India. This commentary will critique two of its salient proposals. At the outset, I argue that the objectives and function of the proposed Financial Stability and Development Council (FSDC) appear to promote the familiar, "too big to fail" risk in the Indian financial system. I further argue that the constitution of its membership is such that it would create perverse incentives to resort to bailouts of financial institutions. Later, I analyse the "prompt corrective action" regime that is proposed for financial service providers who benefit from deposit insurance, and point out that it appears to have failed to account for one of the key lessons from the global financial crisis of 2008—asymmetric incentives created by the design of executive compensation were one of the principal causes of the crisis. I argue that prudential regulation of covered service providers can benefit from inclusion of power to regulate the design of bankers' pay that it currently lacks.

The 'Too Big to Fail' Problem

The Indian Financial Code has proposed to constitute the FSDC pursuant to Chapter 76 of the Code with the objective of fostering the stability and resilience of the financial system by identifying and monitoring systemic risk and taking all required action to eliminate it. Despite the otherwise laudable objectives, the existence and the functions of the FSDC in its current form create a significant risk of "too big to fail" moral hazard in the Indian financial markets.

First, the FSDC, through its executive committee, is tasked to designate certain financial service providers (FSP) as "Systemically Important Financial Institution" (SIFI). While such identification is important as it alerts the markets about the location of concentrated risk, the identification itself creates implicit moral hazard among the market constituents and potential counterparties because it sends a strong signal that the given FSP is irreplaceable in the financial ecosystem. Once investors and potential counterparties know that a particular FSP is a SIFI, they have a strong incentive to not monitor its financial health themselves because they will rationally discount the risk that the SIFI will be allowed to fail. Put differently, the cost of capital required by investors and counterparties for doing business with the SIFI concerned will be at a discount to its real cost of capital (Skeel 2010). This lack of market discipline is likely to induce a further moral hazard among the shareholders and the management of the SIFI concerned as they will be motivated to take "heads, I win, tails, you lose" risks as they will internalise all the profits from taking the extra risks and will "socialise" the losses among the taxpayers and the counterparties, if the bets go wrong. In other words, these SIFIs will become "too big to fail" (Wilmarth 2011).[1]

Second, it is arguable that the FSDC and the regulator concerned will themselves monitor a designated SIFI pursuant to its mandate under the Code. However, I submit that since the FSDC and the other regulators are situated outside the SIFI, any monitoring, however rigorous, will only happen with a time lag. As the great financial crisis of 2008 teaches us, the downward spiral from a merely illiquid FSP to an insolvent FSP can take place rapidly. As such, monitoring from the outside leaves the SIFI

(and consequently), the financial system at large, exposed to failure.

The FSDC is modelled on the lines of the Financial Stability and Oversight Council (FSOC) constituted by the Wall Street Reform and Consumer Protection Act, 2010 (popularly, the Dodd–Frank Act). Like the FSDC, the FSOC too has the mandate to identify a SIFI. However, in contrast to the Indian financial code, the Dodd–Frank Act also mandates the FSOC to act to promote market discipline by eliminating moral hazard.[2] The Indian financial code fails to provide any explicit mandate to the FSDC for elimination of moral hazard. If we are to retain a super-regulator like the FSDC at all, then we are better off curtailing its discretion to resort to bailouts. This can be done by explicitly prescribing that it balance its systemic risk concerns against the competing objective of moral hazard mitigation. Therefore, Section 311 should be amended to explicitly provide for promotion of market discipline among shareholders, creditors, and counterparties of SIFIs, as one of the objectives of the FSDC.

Risk of Bailout

The FSDC is mandated to "provide advice to the central government in relation to the provision of extraordinary assistance" on determination that a financial system crisis has arisen. The composition of the Council is such that the FSDC will have the disincentives to advise in favour of rendering extraordinary assistance more often than otherwise exposing the taxpayers' money to significant "bailout risk."

Among others, the board of the FSDC comprises the finance minister as the chairperson, the RBI chairperson as the nominee of the RBI, the financial authority chairperson as a nominee thereof, and the corporation chairperson as a nominee thereof.

Thus the board comprises a minister—a politically elected figure—and representatives of three regulators respectively. Since the regulators concerned are also charged with the mandate of prudential regulation of FSPs under the code, they are likely to have the incentive to advise the central government to render extraordinary assistance to the FSP concerned. This is because, if the FSPs/SIFIs at the centre of systemic financial crisis are not bailed out through extraordinary assistance and allowed to fail, the regulators would lose their "reputational capital" as the public at large would perceive that the failure happened under their watch. Likewise, the central government too will have considerable incentives in saving face as failure of a SIFI can have potentially catastrophic effects in the short term, which can be politically costly. In the light of foregoing incentives, the FSDC appears to have a "structural bias" in favour of bailing out a FSP/SIFI using taxpayers' funds than letting it fail. The Code fails to provide adequate protection against those disincentives. As such the Code should explicitly incorporate the following in Section 330 (5)(b):

> The council must ensure that subordinated debt holders, any other unsecured counterparties and the shareholders of the SIFI/FSP are excluded from any assistance whatsoever if it advises the central government to provide fiscal or other extraordinary assistance in the interests of stability of financial system.

This will ensure that if the FSDC does advise fiscal and extraordinary assistance in the larger interests of financial stability, it is not at the expense of moral hazard among the subordinate debt holders and equity owners. Moreover, it will also ensure injection of market discipline. With their investments on the hook, the bondholders (and to an extent) shareholders will monitor the FSP/SIFI more diligently and mitigate the risk that the FSP/SIFI's management makes imprudent investments in the first place.

Furthermore and for the same reason as above, Section 305(7) should be deleted from the code, as it presently stands. Section 305(7) contemplates provision of compensation to the owners of a SIFI whose undertaking is acquired by a company owned by the central government because it cannot be resolved otherwise. Since this acquisition is essentially in the nature of a bailout of the SIFI concerned, market discipline dictates that no compensation need be paid to the owners of the SIFI. Providing such compensation will create moral hazard incentives for the owners and reduce market discipline.

Compensation Arrangements

The Code should provide that the regulator and the corporation also take into account the executive compensation arrangements of the senior management of the covered service provider (CSP) concerned for determining the category of risk to viability.

Section 293 mandates that the regulator concerned (RBI or the financial authority) and the corporation to place the CSPs into several categories on the basis of risk to viability; in other words, risk of insolvency. Clause (2) of Section 293 prescribes the features of a CSP that the regulator and corporation may take into account for the purposes of categorising the CSP into one of the several categories. These features are as follows:

- Adequacy of capital
- Asset quality
- Capability of management
- Earnings sufficiency
- Liquidity of the CSP
- Sensitivity of CSP to adverse market conditions

The Code does not explicitly require the regulator to factor in, the nature of compensation arrangements (structure and design of compensation) for categorising CSP in terms of risk to solvency. As such, it fails to learn from one of the most important lessons of the 2008 crisis. One of the more important lessons that the crisis taught us was that senior management at banks and other financial institutions that are backstopped by deposit insurance respond differently to the risk of insolvency. Deposit insurance induces a moral hazard among the bank managers by protecting the bank from retail "bank runs" and therefore from failure. Prevailing compensation instruments like stock and stock options amplify the moral hazard and create perverse incentives for the bank management to take excessive risks (as they internalise all the gains and socialise the losses on the taxpayer through the insurance mechanism) (Bebchuk and Samann 2010). While, a high proportion of debt-based compensation arrangements induce prudence

in their decision-making by exposing the management to risk of default.

Compensation arrangements of the senior management of CSP concerned have important implications on whether the CSP concerned has a significant risk to its viability or otherwise. Senior management that is significantly compensated in stock and stock options has excessive risk-seeking incentives that heighten the risk that the CSP concerned would fail. As such, regulators and the corporation should factor in the compensation arrangements in deciding which CSP should be categorised in which risk bucket, pursuant to Section 293 in addition to other features specified by Clause (2). Furthermore, for the same reasons, as discussed, the corporation should also account for the compensation arrangements in determining the premium a particular CSP must pay, for being covered by deposit protection.

Executive Compensation

First, Section 295 (4) empowers the regulator concerned to order the CSP classified in the category of "material risk to viability" to take certain actions, namely, recapitalise or sell assets. While recapitalisation of Tier I/Additional Tier 1 capital and shrinking by selling assets are certainly important to turn the CSP around, the regulator should also be empowered to require the CSP to introduce design changes to the executive compensation arrangements its senior management are subject to. As previously argued, senior management that is significantly compensated in stock and stock options has excessive risk-seeking incentives that heighten the risk that the CSP concerned would fail. If the design of compensation arrangements is left unchanged, those incentives would remain unchanged and any turnaround in the CSP concerned is likely to be short-lived.

Second, if the senior management has accumulated significant amounts of stock they would be extremely reluctant to recapitalise the CSP concerned at a discount for fear of getting diluted. As such, recapitalisation of the CSP would become difficult, if not downright impossible, without the power to introduce appropriate changes in the design of executive compensation of the senior management at the CSP concerned. As academic literature analysing the reasons of bankruptcy of Lehman Brothers Inc points out, the senior management, especially the chief executive officer (CEO) Richard Fuld had accumulated significant stocks of Lehman Brothers. So, when potential acquisitions were discussed to acquire the company, Fuld held out and resisted recapitalisation because he feared significant dilution in his personal wealth. Ultimately, Lehman Brothers could not be recapitalised in time and had to file for bankruptcy.

Without being exhaustive, changes in the design of executive compensation of the senior management can take one of several forms: (i) Reducing the proportion of equity-based compensation from their package by (among other things), ordering the CSP to buyback the stock and liquidate investment of the senior management. (ii) Order the CSP concerned to compensate its senior management in contingent convertible bonds that convert into equity when the tier I capital falls below a stipulated threshold. Market practice in Europe indicates banks in the United Kingdom (Barclays) and Switzerland (Credit Suisse and UBS) are already compensating their senior management through (variants of) contingent capital bonds. Since these bonds convert into equity when the tier I capital falls below a stipulated threshold, they expose the senior management's personal wealth to risk of default and thereby generate high incentives for the senior management to be prudent in their investment choices and keep the CSP well capitalised (Kaal 2012).[3]

NOTES

1 Arguing that too-big-to-fail creates moral hazard incentives for managers, depositors, and other uninsured creditors of SIFIs.

2 See Section 112 (a)(1)(B) of the Dodd–Frank Act (listing promotion of market discipline and prevention of moral hazard among shareholders, creditors and counterparties, as one of the purposes of the FSOC).

3 Discussing the use and market practice of including contingent capital bonds in designing executive compensation and the benefits they confer). See also Kagade and Verma (2015).

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