Will Indian financial crisis revive bail-in bill?

By Elisa Barwick

In the face of a gathering financial storm, the spectre of India's bail-in legislation—withdrawn in July 2018 after popular outrage at the proposal—is again looming in the consciousness of financial and economic circles. Bail-in laws allow regulators to confiscate bank liabilities such as bonds or deposits to recapitalise failing banks.

The Indian government tabled its Financial Resolution and Deposit Insurance Bill 2017 in August of that year, at the same time as Scott Morrison tabled Australia's Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017. Pressure on both governments to pass the legislation was coming from the Bank for International Settlements (BIS) and its Financial Stability Board (FSB), which is coordinating a global bail-in regime ahead of a new global crisis. In a November 2017 statement, ratings agency Moody's had bemoaned the fact that the Asia-Pacific region was lagging behind the rest of the world.

The two bills met with opposite fates. While Australia's was rammed through in February 2018 with a mere handful of MPs present in the Parliamentary chambers, India withdrew its legislation in July 2018 due to significant opposition from the population, unions (including of bank employees) and politicians. A Change.org petition collected over 150,000 signatures opposing the bill. The Indian bill had followed the government's 2016 ban on large denominations of physical cash, which fuelled suspicion over the bail-in law, whereas in Australia the government's proposed ban on large cash transactions followed the passage of bail-in.

India's banking system is now suffering the impact of housing and debt bubbles that are bursting at the seams. Minoru Kimura, Executive Officer of Asia Pacific at Nippon Life Insurance, warned that the crisis in Indian asset management companies, riddled with bad debt, is "similar to the 2008 Lehman global shock".

In September accounts were frozen and lending ceased at the Punjab and Maharashtra Co-operative Bank (PMC) on orders of the Reserve Bank of India, which claimed it was necessary to prevent a bigger future crisis. PMC is one of India's largest co-operative banks. Co-operatives, which emerged from agricultural co-ops, service small communities and local industry. According to economist Ajit Ranade writing for the *Free Press Journal* on 30

Worried depositors gather outside a Punjab and Maharashtra Co-operative Bank branch. Photo: Twitter

September, 46 of the 1,542 urban co-op banks are assessed by the RBI as having a negative net worth. Over the last year eleven banks have been subject to RBI freezes on new lending, until their capital situation improves. This month RBI also swept up Lakshmi Vilas Bank (LVB) into what it calls its Prompt Corrective Action framework, while the shares of Yes Bank Ltd, a commercial bank that had leant heavily to developers and shadow banks, plunged almost 34 per cent in two days.

Housing crisis

Withdrawals from PMC were initially restricted to 1,000 rupees (only $20!) per account, then increased to 25,000 rupees (about $500), limits which could last six months or more. PMC's troubles stemmed from its heavy exposure to Housing Development and Infrastructure Ltd (HDIL), a bankrupt Mumbai real estate company.

Many developers are in strife given a liquidity crunch in the more lightly regulated shadow-bank lending sector. According to Bloomberg's 4 October article "US$63 billion of zombie building sound alarm for Indian banks", non-banking financial companies have fuelled a five-year property boom which is now on the rocks. The crunch started around a year ago with the collapse of the AAA-rated Infrastructure Leasing & Financial Services (IL&FS), which led to a halt of building on US$63 billion worth of residential property developments.

Commercial bank lending to shadow banks with large exposures to realty froze up after the IL&FS collapse. Commercial banks had increased lending to their non-bank counterparts by more than 50 per cent over five years. The wind-back hit shadow banks with a large exposure to housing, like Indiabulls Housing Finance, forcing them to pay more to borrow from overseas. A slowing of property sales is now feeding a vicious cycle.

"The biggest risk is, at its core, a liquidity crisis. A liquidity crisis left unattended balloons into a solvency crisis," said Duvvuri Subbarao, who was Reserve Bank Governor during the global financial crisis, Bloomberg reported. Shadow banks rose in India as commercial banks tightened up lending in an effort to reduce bad debts. Now there are even more bad debts in the system. Credit Suisse and Fitch Ratings estimate total bad loans could rise to a record 12 per cent in 2020, according to Bloomberg.

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China continues to crack down on its shadow banking sector

8 Oct.—China's shadow banking sector shrank to a three-year low in the first half of 2019, according to a Moody's report covered by Xinhua. As part of "government efforts to contain financial risks", Xinhua reported, the authorities "have been stepping up efforts to rein in risky shadow banking activities in recent years amid a broader crackdown on financial irregularities", while increasing "efforts to encourage bank lending to small private businesses". Broadly defined shadow banking assets declined by nearly 1.7 trillion yuan (about $357 billion) in the first half of 2019 to 59.6 trillion yuan, the lowest level since the end of 2016, according to Moody's.

Bail-in or national banking?

As economist Soumyen Sikdar stipulated in the 2 October *Telegraph* (India), the crisis has brought financial restructuring back "to the top of the priority list" of the Indian government. "The financial resolution and deposit insurance bill was an important component of that", said Sikdar, stating that its withdrawal was supposed to be temporary. While expressing scepticism about the protections assured for depositors in other bail-in jurisdictions, Sikdar says India may yet see bail-in laws introduced. It is possible that a "reframed version" of the bill, he said, "will contain the bail-in provision, perhaps in a disguised form".

Ranade, in the *Free Press Journal*, asked if the financial resolution bill might be the solution to the financial problems India is currently facing, going on to pose many more questions, however, about the nature of banking today. "In the wake of the 2008 global financial crisis, there was a massive flight of deposits from private and foreign banks into public sector banks in India", he wrote—"an implicit demonstration of trust by the depositor community". Under bail-in regimes, on the other hand, depositors "take flight more quickly and the chances of more banks collapsing will go up", Sikdar ruminated.

That is not to say that deposits are automatically safe just because banks are government-owned or -backed. As in Australia, a reorganisation of the system to clean out speculation, with US 1930s Glass-Steagall-styled laws, and a reorganisation of personal and commercial loans to keep people in their homes and in business, is required. An audit of troubled banks, along with regulatory agencies that actually regulate, is prerequisite to establishing a healthy banking sector.

Since the prime ministership of Indira Ghandi until liberalisation was introduced in the 1990s, nationalisation of banking expanded dramatically in India, with up to 91 per cent of banking in public hands. Today, around two-thirds of Indian banking still takes place in the public sector via 12 commercial banks, down from 20. India could quickly utilise national credit to pull itself out of the crisis. So long as the investment goes to the real economy rather than speculation or inflated real estate ventures, it will unleash the economic growth necessary to pay back the loans.