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Concerns with Financial Regulation - IL&FS Default

What is the issue?

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- The Infrastructure Leasing and Financial Services (IL&FS) trouble exposes the weakness in India's financial regulatory architecture.
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- It calls for appropriate reforms in regulatory mechanisms as the consequences are widespread.
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What happened to IL&FS?

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- Infrastructure Leasing and Financial Services (IL&FS) is a large infrastructure finance company.
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- Some of its subsidiaries defaulted on their debt as a consequence of which its credit was sharply downgraded recently.
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- If tax-payer money is used to save IL&FS, it would be another drain on the Union Budget.
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- Notably, the Centre's fiscal is already burdened by mismanagement and regulatory failures in the banking sector.
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What went wrong?

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- There were shortfalls in ensuring institutions in place to monitor and regulate systemic risks.
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- IL&FS is a non-bank financial company regulated by the RBI.
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- But the RBI does not have all the information to understand risk to other financial firms arising from its debt.
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- Pension funds, provident funds, mutual funds and insurance companies hold the debt of IL&FS subsidiaries.
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- But RBI does not regulate these and hence will not have the full picture.
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- The RBI may know only about bank loans to the conglomerate.
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- But the ripple effects of financial shocks can be felt across sectors and not just financial markets.
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What does it call for?

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- The failure of one company can create a risk to the financial system as a whole as witnessed from bankruptcy of Lehman Brothers.
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- Such “systemic risk” needs to be monitored, as, if a firm is large, it is considered “too big too fail”.
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- Even if not too big, if deeply integrated with the business of other firms, it may be “too networked to fail”.
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- In either case, such firms and their real-time networks need to be monitored.
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- For better response, the regulator must know who will get hit if such firms fail, by how much, and what will be the consequences.
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- Such firms can be put under enhanced supervision and at all times there needs to be a full picture of their assets and liabilities.
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- To ensure financial stability, this job needs to be given to an agency with powers to monitor risk-cutting across sectors.
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What are the proposed reforms?

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- **Regulation** - Financial Sector Legislative Reform Commission recommended in 2012, legislative and architectural reforms for financial regulation.
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- This included a body that would monitor systemic risk.
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- The Financial Data and Management Centre would have the legal powers to collect all regulatory data along with sectoral regulators.
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- The 2016-17 Budget announced the setting up of such a data centre and consequently a draft bill was proposed.
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- However, concerns raised by financial regulators are delaying the process of implementation.
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- So as of now, if there is a trouble, the regulators will be let off but the government will have to bear the consequences.
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- **Resolution** - Financial firms, both bank and non-bank, need to have an orderly mechanism for crisis resolution.
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- The resolution corporation was proposed to be set up through the Financial Resolution and Deposit Insurance Act.
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- This would have watched the company, and examined whether it is systemically important.
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- It would have asked it to prepare a living will if needed, and then stepped in before the firm defaulted.
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- But the opposition to the legislation led to the withdrawal of the Bill.
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What next?

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- Given the above, the options are now limited and the firm can be forced sold.

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- But again the question of 'whom to' remains as the LIC is already buying up all the weak remains in the financial sector.
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- Otherwise, IL&FS can be taken through Insolvency and Bankruptcy Code.
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- This would mean its subsidiary firms that are non-financial firms could be sold one by one through the bankruptcy process.
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- But none of these are easy or fast solutions; the regulatory mechanisms need a relook.
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Source: Indian Express

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