Conservative banking, not bail-in, will bail us out

Risk is in-built in banking. If, one day, all the customers of any bank turn up demanding their deposits, the bank would be unable to repay them. Banks don't face a run on their deposits because customers trust banks. Governments often bail out banks, and don't liquidate them, because they support the business of banking.

The Financial Resolution and Deposit Insurance (FRDI) Bill 2017 now pending before the joint committee of Parliament contains a new method for saving a failing bank — a 'bail-in' of customers deposits instead of a 'bail-out' by the government.

It sees no moral hazard in recapitalising a bank with customers' deposits while the owners of banks are granted immunity by the 'limited liability' of a corporate identity. The bill aims at financial stability through the lens of an accountant.

The Resolution Corporation (RC), the proposed super regulator (the Reserve Bank, SEBI and IRDAI would all report to the RC) and the government are empowered to use uninsured deposits of customers to set off bank losses. The bankrupt bank carries on with its business but with 'good' assets and insured deposits. Subsequently, the RC would bring in new management that infuses fresh capital by buying the equity of the now 'healthy' bank!

The 'bail-in' owes its origin to the 2008 bankruptcy of the 'too big to fail' Lehman Brothers that spooked central bankers in G7 countries. Lehman Brothers was forced to file for bankruptcy due to its inability to pay $3 billion to its creditors.

This triggered a chain reaction among banks and insurance firms financially interconnected with Lehman Brothers. As a consequence, the Financial Stability Board was set up and it proposed the 'bail-in' as a key attribute to cope with bank failures wherein the price for 'financial stability' is paid by the customer. The government argues that deposit insurance protects 93% of the depositors who keep up to Rs. 1 lakh in their bank accounts. This is a half truth. These depositors account for only 30% of total bank deposits. Deposit insurance can never be adequate protection for the remaining 7% retired or aged customers who have deposited their life savings in a bank.

Stress test shocker

It is naive to believe that 'bail-in' shall never be applied. The unstable character of banking is highlighted in the routine stress tests conducted by the Reserve Bank. According to the December 2017 Financial Stability Report, if customers of 54 commercial banks in India were to withdraw 15% of their uninsured deposits, 18 banks would fail to repay the deposits of customers.

Similarly, if the top three borrower groups of each bank default, then six banks would fail to maintain their minimum capital requirement of 9%. In a severe economic downturn, one bank can trigger failure of 18 out of the 54 banks only because of financial interconnectedness. The safeguards in application of a 'bail-in' appear fragile.

It would be difficult to categorise riskiness of a bank fluctuating rapidly among low, moderate, imminent and critical levels. Prioritising uninsured deposits over unsecured creditors is a marginal advantage since a bank is not likely to have too many unsecured creditors other than customers.

Circa 2015, the official administrator of Lehman Brothers was left with a surplus of roughly £7 billion in hand! In the end, no one suffered a loss; not even retail customers.

This raises a serious question on the *raison d'être* of 'bail-in'. In 2008, if 'bail-in' had been law, customer deposits would have been needlessly appropriated. It is equally disturbing that 'bail-in' may be triggered for reasons unrelated to banking.

In 2013, European creditors dictated a 'bail-in' on the Laiki Bank in Cyprus in addition to other austerity measures and reforms as a precondition to a €11-billion bail-out package by the European Union and the International Monetary Fund.

Despite contentious credentials, 'bail-in' is the showstopper of the FRDI bill. If the 'limited liability' clause can protect the personal wealth of corporate borrowers despite the huge loans their bankrupt companies owe to public sector banks, the Centre must protect all retail customers from the 'bail-in' clause.

Financial stability can be achieved by conservative, old fashioned banking instead of 'bail-in or bail-out'.

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