Insolvency of Financial Institutions and the Imperative for a Shift in Credit Culture.

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INTRODUCTION

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- In the realm of economic reforms, the Insolvency and Bankruptcy Code, 2016 (IBC/Code) has emerged as a transformative force in addressing insolvency and bankruptcy matters across a spectrum of entities.
- A strong and reliable credit culture is vital to a nation's economic development. Ideally, the Code is a game changer in Indian economic laws, strengthened the insolvency resolution process by providing a "creditor-in-control" model for companies and "regulator-in-control" for financial institutions
- The need for a framework to deal with FSPs was felt in the market and was also expressed in various cases such as that of *Randhiraj Thakur v. Jindal Saxena Financial Services.*

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BUSINESS FAILURE

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- Business failure is a topic no entrepreneur wants to face, but it is a reality that many businesses have to confront at some point.
- A failed business can cause immense financial and emotional stress, not to mention the loss of time and resources that have been invested in the venture.
- Several potential factors might lead to a firm's failure, including inadequate planning, unprepared growth, cash flow pressure, flawed business strategy, shrinking clientele, etc.

BUSINESS FAILURE

Types:

- Preventable
- Unavoidable
- Intelligent

CASE STUDIES - DOMESTIC

1. Infrastructure Leasing & Financial Services Limited:

- Infrastructure Leasing & Financial Services Limited (IL&FS) is a systemically important Core Investment Company with the Reserve Bank of India and is engaged in the business of giving loans and advances to its group companies.

Issues:

- IL&FS hadn't disclosed bad loans on its books for years despite a big part of its loan book having soured.
- Unscrupulous, negligent and dormant management decisions were the main root cause of failure.

CASE STUDIES - DOMESTIC

- Poor fund management and controls
- "Deficient audit" by the auditors
- IL&FS had a big mismatch in assets and liabilities and enormous liquidity problems
- Uday Kotak very quickly assessed the situation, and classified the companies under three codes—red, green and amber"

CASE STUDIES - DOMESTIC

2. Reliance Capital: The Company operates in wide range of financial services such as Life and general insurance, Commercial and home finance, and other various activities.

ISSUES

Financial Mismanagement:

a) Excessive indebtedness

b) Diversification failures

c) Non-performing assets (NPAs)

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CASE STUDIES - DOMESTIC

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Corporate Governance Issues:

a) Opacity and lack of transparency

b) Allegations of financial irregularities

c) Weak corporate leadership

d) Bad Decision Making

e) A major red flag was thrown up in June 2019 when Price Waterhouse & Co (PWC) resigned as the statutory auditor of Reliance Capital

CASE STUDIES - DOMESTIC

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External Factors:

a) Macroeconomic slowdown

b) Stricter regulatory environment

c) Litigation and legal disputes

CASE STUDIES - DOMESTIC

3. Dewan Housing Finance Corporation Ltd.

- The Dewan Housing Finance Corporation Ltd. (henceforth DHFL) was an AAA-rated deposit-taking Housing Finance NBFC (Non-Banking Financial Company) regulated by the National Housing Bank (NHB). DHFL was established to enable access to economical housing finance to the lower and middle income groups in semi-urban and rural parts of India.

ISSUES

a) Weak Auditing especially concealing loan and repayment terms in the financial statements.

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CASE STUDIES - DOMESTIC

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b) No proper inspection and furnishing of information of group companies.

c) Corporate governance failure.

d) Wadhawan's (Promotor) influential position in Indian society.

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CASE STUDIES - INTERNATIONAL

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1. Lehman Brothers:

- Lehman Brothers was a global financial services firm that played a significant role in the financial markets for over a century. The Company was involved in various financial services, including investment banking, asset management, and fixed-income sales and trading.

- **Issues:**

a) Repeal of the Glass-Steagall Act

b) Unethical Management practices

c) Liquidity crisis

d) Collateralized Debt obligation and Derivative crisis

CASE STUDIES - INTERNATIONAL

- **Issues:**

e) Global Financial Crisis.

f) Exposure to Subprime Mortgages.

g) Leverage and risky financial products.

h) Lack of adequate capital.

i) Regulatory Oversight and failure of Government Intervention.

j) Poor Risk Management Practices.

CASE STUDIES - INTERNATIONAL

2. Silicon valley Bank:

a) SVB was founded in 198 with the goal of supporting innovation and entrepreneurship in the technology and life sciences sectors.

b) Throughout the Covid-19 pandemic, SVB's expansion accelerated substantially, and its total assets reached their peak in the first quarter of 2022, with a value of $218 billion, making it the 16th largest bank in the U.S.

c) SVB has been recognized for its outstanding contribution to innovation and entrepreneurship, receiving numerous awards and accolades over the years.

CASE STUDIES - INTERNATIONAL

- **Issues:**

a) Rapid growth

b) Interest rate regime

c) New regulations

d) Deposit concentration

REGULATORY RESPONSES TO FINANCIAL INSTITUION INSOLVENCY

- While the financial sector is heavily reliant on continued public confidence, the ability of the public to correctly assess the firm's financial position is limited. Consequently, loss of public confidence in a financial firm may lead to its premature destruction.
- IBC initially excluded Financial Service Providers ('FSPs') from its scope. However, section 227 of the IBC empowered the Central Government, in consultation with the appropriate financial regulator, to bring FSPs, or categories thereof, within the purview of the IBC.
- On November 15, 2019, the Central Government exercised this statutory power and issued the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 ('the Rules').

REGULATORY RESPONSES TO FINANCIAL INSTITUIION INSOLVENCY

- Immediately afterwards, the Ministry of Corporate Affairs extended the Rules to Non-Banking Finance Companies ('NBFCs') including Housing Finance Companies ('HFCs') with asset size of Rs. 500 crore or more.
- Subsequently, the National Company Law Tribunal ('NCLT') admitted the insolvency application filed against DHFL making it the first FSP to be brought under the ambit of the Rules.
- Section 227 of the IBC allows the Central Government to notify FSPs or categories of FSPs for their insolvency and liquidation proceedings under the IBC. Using this power, the Rules were framed as an interim measure to deal with "any exigency pending introduction of a full-fledged enactment to deal with financial resolution of Banks and other systemically important financial service providers".

REGULATORY RESPONSES TO FINANCIAL INSTITUIION INSOLVENCY

- The Rules provide for the appointment of an Administrator and the powers and functions of the resolution professional or the liquidator. In the context of NBFCs, it could be that the Administrator appointed under the Rules will be the same person that is appointed by the RBI under provisions of the RBI Act.

CREDIT CULTURE IN INDIA

- The credit culture and assessment methodologies may vary among banks and depend on the specific type of loan, the borrower's profile, and the purpose of the credit. Indian banks typically follow a combination of asset-based and business-based credit evaluation approaches.
- Asset-Based Credit Assessment.
- Business-Based Credit Assessment.
- Combination of Both.
- Risk Mitigation.

CREDIT CULTURE IN INDIA

- It's important to note that the credit culture may also depend on the type of bank. The corporate credit culture comprises all those principals, policies, experience, credit management, strategies, rules & regulations, and risk management etc., which define the lending environment and determine the lending behaviour acceptable to financial creditors.
- Underlining the scope of credit culture, Y. V. Reddy, former Governor, Reserve Bank of India (RBI) said, "the whole issue of credit culture and credit system should encompass the legal and institutional aspect of the policy environment, the way the saver or depositor and the borrower – both small and big are treated and the way banks position themselves to face these challenges".

CREDIT CULTURE IN INDIA

- The sole objective of this entire corporate credit culture is to ensure flow of credit from financial creditors to corporates and servicing of loan by the debtor with interest rate as per the mutually agreed timeline.

CONCLUSION

The Need for Shift in Credit Culture

- Currently, much of the focus of bank regulators, when it comes to credit culture, appears to be on ensuring ethical behavior and curtailing risk taking in banks.
- It's not simple to establish and keep up a great credit culture in the bank. However, that culture will have a significant impact on bank's long-term success.
- The need for a paradigm shifts in credit culture is increasingly evident. Financial institutions must move from a short-term, profit-centric culture to one that prioritizes prudence, risk assessment, and long-term sustainability.

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