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Chapter 7 - Regulatory Forbearance

Regulatory Forbearance refers to policy adopted by central bank and other government institutions which permits banks and financial institutions to continue operating even when their capital is depleted.
The RBI adopted Regulatory Forbearance in 2008 in the aftermath of 2008 Global Financial Crisis. It helped prevent bank failure contagion. The policy relaxed the norms for restructuring of stressed assets. It was no longer mandatory to downgrade the restructured asset as Non-performing asset and required no additional provisioning.
Restructured asset or loans are those which got extended repayment period, reduced interest rates, conversion of a part of loan into equity, provision of additional financing etc.
However, the policy should have discontinued when economy recovered in 2011, evident from GDP, IIP, export and credit growth.

EFFECT ON BANKS:

a) They restructured loans even for unviable firms. Because this improved appearance of Bank's account, showed inflated profit.
b) this also required Banks to pay increased dividend to its shareholders (including Governments in case of PSBs). As a result, Banks became severely under-capitalized.
c) Undercapitalization led banks to adopt risky lending practices and distorted incentive led to misallocation of credit.

The P. J. Nayak Committee (2014), constituted by RBI, highlighted the twin concerns stemming from the forbearance regime, the ever-greening of loans by classifying NPAs as restructured assets and the resultant undercapitalization of banks. It observed that the existing tier-I capital for public sector banks is overstated because of the regulatory forbearance which RBI provides on restructured assets. The report had estimated that if regulatory forbearance were withdrawn immediately in May 2014 and a prudent 70% provision cover were provided for restructured assets, tier-1 capital of the public sector banks would be written down by INR 2.78 lakh crores.

Effect on Corporates:

a) As they received easy money, firms invested in unviable projects. Lax of monitoring increased the injudicious credit supply.

Effect on Corporate Governance:

a) A borrowing firm's management's ability to obtain easy credit strengthened their influence, deteriorated the firm's established governance mechanism
b) Quality of firm's board degraded, misappropriation of resources increased.
c) Forbearance provides incumbent managers an opportunity to window-dress their balance sheet, show good performance during their tenure and thereby enhance post-retirement career benefits.

WAY FORWARD

An analysis of the regulatory forbearance and the resulting banking crisis offers key learnings for the current regime of regulatory forbearance following the Covid crisis.

1) forbearance represents emergency medicine that should be discontinued at the first opportunity when the economy exhibits recovery,

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2) policymakers should lay out thresholds of economic recovery at which such measures will be withdrawn. These thresholds should be communicated to the banks in advance so that they can prepare for the same.
3) Regulatory forbearance should be accompanied by restrictions on zombie lending to ensure a healthy borrowing culture.
4) A clean-up of bank balance sheets through measures such as Asset Quality Review is necessary when the forbearance is discontinued.
5) A clean-up exercise should be accompanied by mandatory recapitalization based on a thorough evaluation of the capital requirements post an asset quality review.
6) There is need to enhance the quality of Banks and Financial institutions' governance to avoid ever-greening and zombie lending. The regulator may consider penalties on bank auditors if ever-greening is discovered as part of the toolkit of ex-ante measures. This would thereby create incentives for the auditor to conduct the financial oversight more diligently
7) Finally, the legal infrastructure for the recovery of loans needs to be strengthened de facto. The Insolvency and Bankruptcy Code (IBC) has provided the de jure powers to creditors to impose penalties on defaulters. However, the judicial infrastructure for the implementation of IBC – comprised of Debt recovery tribunals, National Company Law Tribunals, and the appellate tribunals must be strengthened substantially