ANALYSIS OF THE FINANCIAL RESOLUTION AND DEPOSIT INSURANCE BILL

- *Pranav Bafna*[*]

ABSTRACT

Although the 2007-08 financial crises wreaked havoc across the board, it also served as a catalyst for change. Overwhelmed by the financial ramifications of their impudent behaviour, many financial institutions found themselves on the verge of going bust. Their lack of preparedness in dealing with such a financial catastrophe put billions of dollars' worth of bank deposits at risk. Although the financial institutions were bailed out by the taxpayers' money, it exposed the hollowness in their incumbent insolvency mechanisms.

To prevent such a situation from recurring, several economies have revamped their insolvency mechanisms for financial institutions. Taking cognizance of its hypersensitive financial sector, the Indian government has also tabled the Financial Resolution and Deposit Insurance Bill before the Parliament.

Although certain provisions of the Bill have received a hostile response from the media, this article seeks to separate the facts from fiction. This article seeks to highlight certain significant provisions of the Bill which merit the readers' attention. Further, this article would also mention the criticisms and recommendations forwarded to the drafting committee by other regulatory stakeholders. While the Bill adopts a two-

[*] B.A. LL.B. Candidate, IV Year, ILS Law College, Pune.

pronged approach to protect the interests of financial institutions and their associated depositories, its success hinges on how well it reconciles the interests of all the affected stakeholders.

1. INTRODUCTION

The financial industry is the 'heart and soul' of any thriving economy. Just like the famed 'Titanic', it was often regarded as 'too big to fail'. Just like the mighty ship - devoid of emergency preparedness - the financial sector lacked adequate resolution mechanisms to deal with such a situation. Consequently, on being hit by the 2007-08 'iceberg', it wreaked havoc across the globe.

2. BACKGROUND

It was in response to this unfortunate event that countries got exposed to the hollowness in their insolvency resolution mechanisms. A glaring instance of this apparent lacuna could be identified in the United States of America's inability to deal with the simultaneous failure of its non-banking financial institutions and the catastrophic failure of its systemically significant banking institutions. The federal government of the United States of America found themselves in a catch twenty-two situation, wherein, they had to choose between letting the financial firms go into regular corporate bankruptcy (in the case of Lehman Brothers) or bail them out (in the case of American International Group, AIG). The lack of clarity in dealing with such a situation resulted in an unprecedented

nervousness, which rubbed salt in the wounds of an already hyper-sensitive financial market.

Consequently, several economies have acted against its resolution-making incapacity by strengthening the existing mechanisms and expanding their resolution making capabilities. The Financial Stability Board, established in 2009, succeeded the erstwhile Financial Stability Forum with a broader mandate to promote financial stability. One of the integral features of its Mandate is to assess vulnerabilities affecting the global financial system as well as to identify and review, on a timely and on-going basis within a macroprudential perspective, the regulatory, supervisory, and related actions needed to address these vulnerabilities, and their outcomes.[1] Thus, most of the policies developed in pursuit of this agenda form the backbone of the legislation, which intends to promote a financially stable economic environment.

While Indian lenders withstood the meltdown of 2007-08 fairly well, they embarked on an ill-advised lending spree, backing many infrastructure projects that were snarled in bureaucracy.[2] Bad loans started to pile up. State-owned lenders, which account for around two-thirds of the banking sector, now had “stressed” loans of 10.5 trillion rupees, about a fifth of their cumulative loan book.[3] Due to its structural incapacity of dealing with a financial meltdown of this magnitude, the Indian economy

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[1] *Our Mandate,* FINANCIAL STABILITY BOARD, http://www.fsb.org/about (last visited June 29, 2018).
[2] *The round-trip rupee trick-India recapitalises its state-owned banks*, THE ECONOMIST, https://www.economist.com/finance-and-economics/2017/10/28/india-recapitalises-its-state-owned-banks (last visited June 14, 2018).
[3] *Id.*

started to fear the worst.

3. INTRODUCTION OF THE BILL IN THE PARLIAMENT

The Finance Minister of India, in his 2016-17 budget speech announced his intention of creating India's first holistic bankruptcy resolution code – dedicated solely to financial firms. In his words:

> *A systemic vacuum exists with regard to bankruptcy situations in financial firms. A comprehensive Code on Resolution of Financial Firms will be introduced as a Bill in the Parliament during 2016-17. This Code will provide a specialised resolution mechanism to deal with bankruptcy situations in banks, insurance companies, and financial sector entities. This Code, together with the Insolvency and Bankruptcy Code 2015, when enacted, will provide a comprehensive resolution mechanism for our economy.*[4]

Pursuantly, a committee to draft a bill on the resolution of financial firms was constituted on March 15, 2016. On the basis of the findings from the reports of the Financial Sector Legislative Reforms Commission (2013), the High Level Working Group on Resolution Regime for Financial Institutions (2014), and various publications of the Financial Stability Board, the committee successfully drafted the Financial Resolution and Deposit Insurance Bill, 2017 (the 'FRDI Bill').

4. BAIL-IN PROVISION

Before we analyse any finer aspects of this proposed legislation, it would be ideal to address the most controversial issue. Section 48(1) of

[4] Arun Jaitley, Minutes of Budget Speech, 17-19 (Feb. 29, 2016).

the FRDI Bill proposes debt resolution through a variety of resolution mechanisms. Among them, sub-clause (b) enables banks to be 'bailed in' by depositors' funds rather than being 'bailed out' by taxpayers (or potential buyers).[5] The Bail-In provision has been further explained in Section 52 as follows:

> *A bail-in provision means any or a combination of the following:*
> *(a) A provision cancelling a liability owed by a covered service provider;*
> *(b) A provision modifying or changing the form of a liability owed by a covered service provider*
> *(c) A provision that a contract or agreement under which a covered service provider has a liability is to have effect as if a specified right had been exercised under it.*

In other words, the 'bail-in provision' provides capital – through restructuring or conversion of depositors' funds - to an ailing bank in order to absorb its losses and subsequently ensure its survival. Survival in this context refers to the restoration of the capital of the bank, not the safety of depositors' money. It empowers the concerned resolution making institution to unilaterally cancel a liability owed by the bank to its depositors or change the form of an existing liability to another security. Simply said, the financial institution refuses the repayment of its customer's deposits, or converts these deposits into another

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[5] *Bail-In Doubts – On Financial Resolution Legislation*, THE HINDU, http://www.thehindu.com/opinion/editorial/bail-in-doubts/article21261606.ece (June 13, 2018).

financial instrument in lieu of their deposits being utilised for recapitalising the said bank.

5. *RAISON D'ÊTRE* FOR CRITICIZING THE BAIL IN PROVISION

Undoubtedly, having one's hard-earned money being forcefully taken away by its – bona fide appointed - custodian is a scary thought for any person. In a literary context, this banking saga has all the ingredients of a full-fledged Shakespearean tragedy. Out of the three protagonists, the government and the corporate borrower are projecting their victimhood as a badge of honour, while the customer - the real victim- is projected as the unsung hero in spite of him being compelled to part with his hard-earned money.[6]

This section has serious ramifications on the dynamics shared between the customer and its bank. It turns a safekeeping or deposit into a 'mortgage-able' commodity in the hands of the financial institution. Further, putting away money in a bank for safe custody would be akin to buying shares of a company. While the government has nudged citizens towards joining the formal banking system through initiatives such as the Jan Dhan Yojana and drastic measures like demonetisation, forcefully injecting depositors' hard-earned money to cure a fragile banking system, prima facie, appears to be self-contradictory.

In an attempt to allay fears against the alleged misgivings about the aforementioned provision, the Ministry of Finance vide a Press Release

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[6] Meera Nangia, *Banking on Legislation*, THE HINDU, http://www.thehindu.com/opinion/op-ed/banking-on-legislation/article20005363.ece (last visited June 13, 2018).

dated 7th December, 2017, sought to clarify the intention of introducing the bail-in clause. According to the Press Release:

> *The provisions contained in the FRDI Bill, as introduced in the Parliament, do not modify present protections to the depositors adversely at all. They provide rather additional protections to the depositors in a more transparent manner.*
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> *The FRDI Bill is far more depositor friendly than many other jurisdictions, which provide for statutory bail-in, where the consent of creditors/depositors is not required for bail-in.*[7]

6. THE BAIL-IN PROVISION VIS-À-VIS THE EXISTING POSITION OF DEPOSITORS

In light of the aforementioned press release, it becomes imperative to understand the current position of depositors. Presently, the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides an insurance cover of up to Rupees one lakh to protect depositors against cancellation of license or issuance of an order for winding up or declaration of insolvency. Further, this insurance cover is available only to commercial banks and eligible cooperative banks as defined under the Deposit Insurance and Credit Guarantee Corporation Act. It is pertinent to note that the DICGC does not insure deposits of governments, inter-bank deposits, and deposits of State Land Development Banks with state cooperative banks. Hence, it is quite evident that the DICGC fails to secure a large quantum of depositories. To eliminate this lacuna, the FRDI Bill proposes to replace the DICGC with the Financial Resolution and

[7] Ministry of Finance, *Provisions of the Financial Resolution and Deposit Insurance Bill, 2017 meant to protect interests of depositors*, PRESS INFO. BUREAU (Dec. 7, 2017).

Deposit Insurance Corporation ('the Corporation').

7. ARGUMENTS IN FAVOUR OF THE BAIL-IN PROVISION

As highlighted in the earlier paragraphs, the bail-in provision has been subjected to significant hostility from the general public, thus, it is essential to separate the facts from fiction. In the proposed mechanism, the Corporation will collect premium and fees from the insured service providers and covered service providers, respectively. The money collected shall be used to constitute a corporation insurance fund and a resolution fund which shall be used exclusively for its designated purpose. Unlike its predecessor, the proposed fund shall protect a plethora of financial firms, giving greater security to depositors' interests in case of a firm facing a financial clout. Further, in Section 55(2), it is explicitly provided that the bail-in provision shall be used only as a last resort. It stipulates that the tool of bail-in should be resorted to only after attempts of recovery has been made and had not been successful.

To provide greater consistency in the resolution making process, the resolution corporation is obliged to follow a prescribed hierarchy while distributing the assets of the insolvent institutions. It is important to note that uninsured depositors are placed at a higher pedestal than unsecured creditors. This order of distribution has been stipulated in Section 79 of the FRDI Bill.

Section 55 of the Bill also guarantees that the use of the bail-in clause does not deprive a depositor of a higher quantum of claim which he would have received had another resolution mechanism been adopted.

Thus, the aforementioned safeguarding provisions ensure that the bail-in clause is not exercised in a prejudiced manner.

Most importantly, before terming this as a draconian law, it should be noted that the law provides for an *ex-ante* consent for certain liabilities to be bailed in.[8] As mentioned in the Ministry of Finance Press Release, some of the most developed resolution regimes in the world have a much more stringent and mandatory regime in place. For instance, the EU Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism empower authorities to unilaterally impose a mandatory restructuring of shareholders' and creditors' claims.[9] This is not the case in the incumbent Bill.

To conclude our analysis, the introduction of the 'bail-in' provision is an attempt to prevent the aftermath of the 2007-08 like financial apocalypse in future. In the build-up to the crisis, several large financial institutions made numerous unprecedented and irresponsible decisions. When the crisis hit and the fear of bankruptcy loomed, the de facto risk takers were not penalised for their imprudent behaviour. Instead, governments resorted to recapitalisation of the affected banks by bailing them out using public funds. The concept of 'bail-in' seeks to break this cycle of moral hazard and distributional inequity associated with ad hoc government handouts.[10]

Pursuant to a detailed critique on the 'bail-in' clause, one can

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[8] Sohini Sengupta, *Another Tool of Resolution*, THE HINDU, http://www.thehindu.com/opinion/op-ed/another-tool-of-resolution/article22086691.ece (last visited June 14, 2018).
[9] *Id.*
[10] *Id.*

safely conclude that the stigma surrounding it is unfounded. With only a select few countries inducting this provision in its resolution mechanisms, the literature available on it is largely academic. Indeed, the Government of India will be taking a bold step forward in its crusade for insolvency resolution.

8. NEED FOR CREATING THE FRDIC

While the bail-in clause has stolen all the limelight, the creation of the Financial Resolution and Deposit Insurance Corporation (FRDIC) is another significant milestone. The proposed institution endeavours to ensure stability and resilience in the financial system, protect the financial interests of depositories, and ensure responsible usage of public funds. It is expected that most of the regulated financial service providers are expected to fall within its purview, and hence its analysis is imperative.

A major drawback in the current insolvency mechanism is it functions on a reactive and not on a proactive basis. Further, due to the growing complexity of financial firms, it has become imperative for regulatory institutions to identify the early warnings of failure. To ensure that the financial ecosystem is braced for the impact of potential insolvency, the Corporation should assess the probability of failure of a financial organization timely. The FRDIC in tandem with the respective regulatory institution shall classify firms on the basis of a five-stage 'risk to viability' framework. When a firm reaches a 'critical risk to viability' threshold, the FRDIC would become its liquidator after making an application in this regard to the National Company Law Tribunal. By

appointing FRDIC as the liquidator, it can be ensured that the resolution and liquidation tools are utilised in an unbiased manner, thereby benefitting all stakeholders.

9. Constitution of FRDIC

The proposed FRDIC will have representation from the Ministry of Finance, Reserve Bank of India, Securities and Exchange Board of India, Insurance and Regulatory Development Authority of India, and the Provident Fund Regulatory Development Authority. By securing representation from all the concerned regulatory institutions, one can feel assured that the Corporation will not operate arbitrarily.

The Committee set up to Draft the Bill deserves credit for taking into account the significance of cross-border bankruptcy resolution in today's globalized economy. Many financial firms operate on a global level. The lack of coordination between the domestic authorities and its foreign counterpart could make the resolution proceedings cumbersome and could potentially undermine the financial interests of its domestic customers. To prevent this communication vacuum, Chapter 16 of the Bill grants FRDIC the authority to enter into a cooperation agreement with its foreign counterparts. Needless to say, the aforementioned initiatives would play an integral role in securing financial stability and resilience in the economy.

10. Shortcomings In The Existing Insolvency Framework

In order to appreciate the potential benefits of this institution, it is

imperative to understand the shortcomings in the existing insolvency framework. Regulation of financial institutions has been plagued by saturation and lack of standardization. For instance, while the Banking Regulation Act, 1949 generally deals with banks, the State Bank of India and its subsidiaries are regulated by an additional legislation which is the State Bank of India Act, 1955. Further, the resolution mechanism for commercial banks is different from that of cooperative banks. In addition to this lacuna, regulatory institutions have often found themselves in a dichotomy of whether they must ensure a smooth and speedy resolution or delay the resolution proceedings in the hope of revival in fortunes. This lack of decisiveness has often caused significant damage to India's economic climate and has burnt a significant hole in the pockets of the public exchequer.

Another chronic problem that the Indian economy faces is the lack of competitive neutrality among financial institutions. While public sector financial firms are backed by an implicit or explicit financial guarantee from the government, there is no such financial backing available to private institutions. Further, the drafting committee in its report expressed its concern with regards to the rose tainted mirror through which public sector firms are viewed by the general public. The report remark that "[the] exemptions from the mainstream resolution systems, may be creating a perception of safety in the minds of the consumers, and an expectation that they will be insulated from the failure of such firms."[11]

Due to a lack of instruments available for insolvency resolution,

[11] DEPARTMENT OF ECON. AFFAIRS, MINISTRY OF FINANCE, REPORT OF COMMITTEE TO DRAFT CODE ON RESOLUTION OF FINANCIAL FIRMS 13-15 (Sep. 21, 2016).

institutional incapacity, and legislative lacunae to effect a smooth and timely resolution, there is an urgent need for a statute which serves as a parachute for a nose-diving financial institution. On a lighter note, it is quite ironical that a country which is promoting incubators at one end needs to start revamping its ventilators at the other end.

11. MISCELLANEOUS BENEFITS OF THE FRDI BILL

On the basis of the aforementioned analysis, it can be said that the FRDI Bill has tactfully resolved a large number of shortcomings in the incumbent resolution mechanism. Additionally, a few other benefits of the proposed legislation are listed below. Section 52 endeavours to complete the entire insolvency proceedings within an ambitious deadline of two years and the provisions of the Bill apply pari materia to all its participants. In this context, Schedule 2 of the Bill provides a comprehensive list of 'covered service providers' that will fall within the ambit of the proposed legislation.

In addition to the previously mentioned financial entities, Chapter 5 of the FRDI Bill extends its applicability to a very important set of financial institutions. Section 26 of the Bill provides that the provisions of the Bill shall apply pari materia to Systemically Important Financial Institutions (SIFI) as well. Section 25 of the Bill vests power with the Central Government to identify any financial service provider on the basis of its size, complexity, nature, volume of transactions, and interconnectedness with other financial service providers. Recognizing the theory of 'too big to fail', the bill grants the Corporation some additional

powers in respect of SIFIs when it comes to their resolution or bankruptcy. All such institutions are expected to provide the requisite information in such frequency and manner as may be prescribed by the FRDI Regulations.

By bringing such institutions within the ambit of the FRDI Bill, it ensures that legislation is watertight and covers all the necessary service providers. Further, through periodic reporting, the Resolution Corporation is ensuring that the financial health of an entity is constantly being tracked for any signs of leakage. Although this additional institution increases the fear of additional compliance burden, timely information sharing between the existing regulatory institutions and the FRDIC could significantly reduce the reporting that needs to be done by an organization.

12. FEEDBACK FROM THE RBI

In response to the proposed draft bill, regulatory institutions have also provided some constructive feedback which merits attention. The Reserve Bank of India (RBI) had remarked that the Resolution Corporation should add value to the financial sector by ensuring efficient resolution of the financial firms in the most cost-effective manner rather than acting as an additional watchdog. The RBI has also recommended that the Corporation should intervene only after an institution reaches 'critical risk to viability' stage. Any intervention from the Resolution Corporation prior to that will become an unnecessary burden for the financial firms and dilute the existing powers vested with the regulatory bodies.

13. FEEDBACK FROM THE IRDA

The Insurance Regulatory and Development Authority (IRDA) has also highlighted a significant void in the proposed legislation. The IRDA has suggested that in order to protect the interests of Indian consumers of foreign financial entities, the FRDIC in tandem with the regulator concerned must have the power to take control of its Indian operation if the ailing institution attains a "critical risk to viability" threshold. Such power to initiate action must exist, irrespective of a Memorandum of Understanding existing with the country of the troubled financial organisation, vis-à-vis, the IRDA has suggested that a suitable provision be incorporated for plugging the aforesaid loophole.

14. OPINION OF THE AUTHOR

In my opinion, the proposed legislation is an honourable attempt at providing a secure macroeconomic environment within which financial institutions could operate. Further, with the Indian economy being predicted to enjoy an exceptional growth trajectory, the likelihood of irresponsible and unwarranted lending increases significantly. The recent default by the Infrastructure Leasing and Financial Services and its group companies is a glaring instance of the non-performing assets mess extending beyond the banking space and affecting the aggregate financial services sector. Therefore, the author argues that the FRDI Bill is a *sine qua non* for securing the interests of all the stakeholders operating in a highly volatile financial environment.

15. CONCLUSION

To conclude, with the FRDI Bill being pitched on the plank of greater protection of financial interests, the Bill has a moral as well as legal responsibility to ensure that depository interests are placed at a pedestal higher than those of its monetary custodians. At an academic level, the proposed Bill does tick in the boxes while acknowledging the need to protect depository interests as well. While consistency, transparency, and accountability are the bed rock of a "high flying" business environment, a sound parachute will always be reassuring in case of turbulence. The FRDI Bill will serve as this parachute to India's economic growth story.