The Financial Resolution and Deposit Insurance Bill, 2017 – Key Highlights and Issues

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Introduction

Presently in India there is a systemic vacuum which exists with regard to bankruptcy situations in financial firms.[1] The Insolvency and Bankruptcy Code, 2016 which was enacted on 28th May, 2016 deals with the insolvency and bankruptcy of corporates, limited liability partnerships, partnerships and individuals, it does not cover with in its ambit financial service providers. The existing legal framework for resolution of such financial service providers has many limitations including multiple authorities for different financial providers, different laws for similar entities, limited instruments for resolution under respective legislations, lack of special resolution related legal provisions for many financial firms etc.[2] The failure of a financial service provider may have huge ramifications on the financial stability of a country and may hurt the economy. For instance, the Lehman Brothers Bankruptcy in 2008 led to failure of many large financial intermediaries and large-scale bailouts by governments. Thus, in order to safeguard the stability of the financial system and to minimize systemic risk, and to minimize losses for society without the need to rely on tax payer support,[3] it is imperative to have a sound resolution framework for resolution of financial firms. It is with this objective that the Financial Resolution and Deposit Insurance Bill, 2017 ("FRDI Bill") was introduced in the Lok Sabha on 10th August, 2017. The Bill is currently being examined by a Joint Committee of the two Houses of Parliament.

Key Highlights

I. Unified legal framework – the present framework for different institutions is as under:

Banks and Non Banking Finance Companies: The process for resolution of a banking company is provided in the Banking Regulation Act, 1949. This excludes public sector banks where the respective statutes prohibit such actions by any agency other than the Central

[1] Budget Speech 2016-17, Finance Minister, Shri Arun Jaitely.
[2] Report of Committee to Draft Code on Resolution of Financial Firms Department of Economic Affairs, Ministry of Finance dated 28th September, 2016.
[3] Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment from COM (2012) 280 final, Explanatory Memorandum, para 3; BRRD Recitals (6)-(8).

Government. For instance, the State Bank of India covered under the State Bank of India Act, 1955, banks nationalised under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, regional rural banks covered under the Regional Rural Banks Act, 1976 can only be liquidated by an order passed by the Central Government and are exempted from any laws relating to winding up of companies. As regards Non Banking Finance Companies, RBI may file an application under the Companies Act, 2013 for winding up.

Cooperative Banks – The functioning of cooperative banks is regulated by the registrars of cooperatives at the state level, or by a combination of regulations by the states and the centre. The RBI may require winding up of a cooperative bank for similar reasons for which it applies for winding up of scheduled commercial banks. However, this may not in all cases lead to swift winding up of the cooperative banks. Typically, winding up and liquidation of cooperative banks takes several years.[4]

Insurance Firms: Insurance Firms are covered under the Insurance Act, 1938, which provides for the following methods of resolution namely: appointment of administrator by the Insurance Regulatory and Development Authority of India (IRDAI), winding up through National Company Law Tribunal (NCLT) and amalgamation.

Pension funds – Resolution of pension funds is governed by the Pension Fund Regulatory Authority of India Act (PFRDA Act).

Therefore, the present regime comprises of different regulators for different institutions, which creates an anomalous situation with only limited modes of resolution. The FRDI Bill provides for a comprehensive mechanism, which brings in uniformity and specialized tools for resolution.

II. **Applicability of the FRDI Bill:** The FRDI Bill applies to financial service providers including financial market infrastructure institutions, banking institutions, insurance service providers, and other financial institutions. It also includes financial firms which are systemically important, whose failure may disrupt the financial system and hurt the real economy. Such institutions are referred to as systemically important financial institutions ("SIFIs"). The Central Government may, in consultation with the appropriate regulator, by an order published in the Official Gazette, designate a financial service provider as a SIFI, keeping in view the size, complexity, nature and volume of transactions with other financial service providers, interconnectedness with other financial service providers, nature of services provided by the financial service providers

[4] Report of Committee to Draft Code on Resolution of Financial Firms, Department of Economic Affairs, Ministry of Finance dated 28th September, 2016.

and whether they are difficult to substitute, and such other matters as may be prescribed[5].

III. **Setting up of Resolution Corporation**: As stated above at present there are different regulators for various service providers (for instance, Reserve Bank of India (RBI) for banks, and Insurance Regulatory and Development Authority of India (IRDAI) for insurance companies), which prevents specialised resolution capabilities from getting developed, and impedes cross-sectoral learnings.[6] The FRDI Bill provides for the setting up of a Resolution Corporation for protection of consumers of specified service providers and of public funds for ensuring the stability and resilience of the financial system and for matters connected therewith or incidental thereto.[7] The Resolution Corporation has been given the following powers and functions: to provide deposit insurance to banking institutions, to specify the criteria for classification of a specified service provider into one of the categories of risk to viability, to act as an administrator for the specified service provider which has been classified in the category of critical risk to viability, to exercise powers in relation to certain termination rights in respect of specified service providers, to resolve a specified service provider which has been classified in the category of critical risk to viability, and to act as a liquidator for a specified service provider against which an order of liquidation has been made.[8]

IV. **Classification of risk:** The Resolution Corporation, in consultation with the respective regulators will specify the criteria for classifying service providers based on their risk of failure. The different categories of risk to viability as provided under the FRDI Bill are:

a. *low*, where the probability of failure of a specified service provider is substantially below the acceptable probability of failure;

b. *moderate*, where the probability of failure of a specified service provider is marginally below or equal to acceptable probability of failure;

c. *material*, where the probability of failure of a specified service provider is marginally above acceptable probability of failure;

d. *imminent*, where the probability of failure of a specified service provider is substantially above the acceptable probability of failure;

e. *critical*, where the probability of failure of a specified service provider is substantially above the acceptable probability of failure, and the

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[5] See Clause 24 of the Financial Resolution and Deposit Insurance Bill, 2017.
[6] *Ibid.*
[7] Statement of objects and reasons, The Financial Resolution and Deposit Insurance Bill, 2017.
[8] See Clause 13 of The Financial Resolution and Deposit Insurance Bill, 2017.

specified service provider is on the verge of failing to meet its obligations to its consumers.

When there is low and moderate risk to viability, the substantive powers to inspect and collect information lies with the respective regulator. In a case where any specified service provider is classified in the category of material or imminent risk to viability, the specified service provider shall submit a restoration plan to the appropriate regulator and a resolution plan to the Corporation within ninety days of such classification. When a specified service provider is classified in the category of critical risk to viability, the Resolution Corporation will take over the administration of a financial firm from the date of its classification. Further, the Resolution in this case would be done by the Corporation. Thus it would be seen that the resolution tools and powers apply in a situation of financial distress short of insolvency, where the institution's failure cannot be prevented in any other way.[9]

V. **Stringent timelines:** The FRDI Bill like the Insolvency and Bankruptcy Code provides for stringent time lines for conducting the resolution process. It states that the process of resolution shall be completed within a period of year from the date when a service provider is classified to be at critical risk to viability. This time limit may be extended by the Resolution Corporation for a further period not exceeding one year by way of an order and for reasons to be recorded in writing. The service provider will be liquidated if its resolution is not completed during this time period. [10]

VI. **Methods of Resolution:** The FRDI Bill in its Chapter – X provides for the various methods for resolution of a specified service provider classified in the category of critical risk to viability, which include, transferring the whole or part of the assets and liabilities of the covered service provider to a viable commercial purchaser, bailing-in the liabilities, merger, amalgamation or acquisition, liquidation, or a combination of these instruments. The Resolution Corporation may also choose to temporarily run the covered service provider under a bridge entity and then use one of the other instruments of resolution to resolve it.[11] The key principles while choosing a viable instrument should be that, no creditor should be worse off than they would have been had the entire firm been placed in liquidation. For financial market infrastructures and insurance companies, the main objective should be to ensure continuity of services for the consumers.[12]

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[9] Michael Schilling, 'Resolution and Insolvency of Banks and Financial Institutions' (Oxford University Press, 2015) at page 9.

[10] Clause 56 of the Financial Resolution and Deposit Insurance Bill, 2017.

[11] Report of Committee to Draft Code on Resolution of Financial Firms, Department of Economic Affairs, Ministry of Finance dated 28th September, 2016.

[12] *Ibid.*

VII. **Deposit Insurance:** The FRDI Bill takes care of the depositors and provides for setting up of a Corporation Insurance Fund for the purposes of providing deposit insurance.[13] The Corporation Insurance Fund is to be utilised for specified purposes, including the payment in cases of liquidation; for payment under a scheme of compromise or arrangement or amalgamation sanctioned for an eligible co-operative bank; or a scheme of resolution, except bail-in. The payment out of the Corporation Insurance Fund will have priority over other claims in resolution.

VIII. **Liquidation and distribution of assets:** The Resolution Corporation with the approval of the National Company Law Tribunal can liquidate the assets of a service provider. The Proceeds from the sale of assets will be distributed in the following order of priority: (i) amount paid by Corporation as deposit insurance to insured depositors, (ii) resolution costs, (iii) workmen dues for 24 months and secured creditors, (iv) wages to employees for 12 months, (v) amount to uninsured depositors and other insurance related amounts, (vi) unsecured creditors, (vii) government dues and remaining secured creditors (remaining debt if they choose to enforce their collateral), (viii) remaining debt and dues, and (ix) shareholders.

IX. **Safeguards:** The FRDI Bill provides for certain safeguards while carrying out the resolution, such as, ensuring the continuity of critical functions of the specified service provider; ensuring that no creditor of the specified service provider is left in a worse position as a result of application of any method of resolution, than such creditor would have been in the event of its liquidation; protecting the client funds, and client assets of the specified service provider, to no less an extent than they would be protected in liquidation; and such other safeguards as may be specified by regulations made by the Corporation. It further provides for certain additional safeguards for the use of bail-in as a method of resolution.

Issues

Bail in: Clause 52 of the FRDI Bill gives the Resolution Corporation the power to carry out bail-in, as a method of resolution, either through a bail-in instrument or a scheme made specifically for this purpose. It empowers the Corporation to cancel a liability, and to modify or change the form of a liability, including the power to convert an instrument from one class to another, replace an instrument with another, create a new security, and for central counterparties specifically, direct a haircutting of collaterals and margins, and the issuance of equity to creditors. This instrument is typically used where continuation of services of the failed financial firm is considered necessary, but the option of selling the firm is not feasible. Recently, there has been much ado about use of bail – in

[13] See clause 21 of the Financial Resolution and Deposit Insurance Bill, 2017.

as a tool of resolution as the depositors apprehended that they may have to bear a part of the cost of the resolution by a corresponding reduction in their claims. It was however clarified by the Ministry of Finance that the provisions contained in the FRDI Bill, as introduced in the Parliament, do not modify the present protections to the depositors adversely at all. They rather provide additional protections to the depositors in a more transparent manner. It was further clarified that the FRDI Bill is far more depositor friendly than many other jurisdictions, which provide for statutory bail-in, where consent of creditors / depositors is not required for bail-in and the Government's implicit guarantee for Public Sector Banks remains unaffected.[14] This assurance does bring in some clarity and a sense of security to the minds of the depositors, however, the provisions can really be tested only with the passing of time, and once the provisions are put in place.

No mechanism for redressal of grievances: The Bill empowers the regulator or the Resolution Corporation, as the case may be to classify a financial firm into any of the five aforesaid categories. Based on such classification, the necessary corrective action is taken. There is no provision in the Bill for any aggrieved person to challenge the classification so ordered. Further, there are provisions for ordering members of the financial firms to return the performance based incentive, in the event their actions or omissions resulted in the financial firm being classified under "critical risk". In the present Bill, there is no provision for appeal to challenge such an order. Similarly, the FRDI Bill disallows the proposed corporation's resolution process from being challenged in courts. Under general rule of law principles, parties whose rights are adversely affected must be provided with an opportunity to challenge the action before an independent judicial body/ authority, which further entails a fair and impartial hearing. It is however due to the urgency with which action needs to be taken when a financial service provider or a SIFI is in trouble, the framework for judicial review is designed in a manner that it does not jeopardize the efficiency and efficacy of the early intervention and/ or resolution process,[15] which is the reason for the restricted judicial review. However, the framework for judicial review has to comply with the constitutional prerequisites and some scope of judicial intervention should be provided for.

Cross border resolution: The FRDI Bill provides limited provisions with regard to foreign resolution action wherein the Central Government may enter into an agreement with the government of any country outside India for enforcing the provisions of this Act. Many financial firms operate on a global level and lack of provisions or uniformity may lead to dichotomy.

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[14] "Provisions of the Financial Resolution and Deposit Insurance Bill, 2017 meant to protect interests of depositors ", Press Release dated 7th December, 2017, Ministry of Finance.

[15] IMF and World Bank, An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency (April 2009) 23-4.

CONCLUSION

Indian banks are under constant regulation and supervision and backed by adequate capital. However, after the global financial crisis, installation of a robust regime for dealing with ailing banks and financial institutions is a priority in many jurisdictions including India. The FRDI Bill strengthens the stability of the financial system by providing a comprehensive and unified resolution regime which ensures an effective and efficient resolution, while also taking care of the depositors. However, certain major issues like lack of adequate provisions with regard to cross border regulation and judicial intervention would still need to be looked into.