Bail-in doubts — on financial resolution legislation

Finance Minister Arun Jaitley has wisely sought to allay fears about a “bail-in” clause in the Financial Resolution and Deposit Insurance Bill, 2017. Introduced in Parliament this August, it has caused great anxiety about the safety of funds parked by millions of households in bank deposits — fears that it will enable banks to be ‘bailed in’ by depositors’ funds rather than being ‘bailed out’ by taxpayers (or potential buyers). The government has promised a 2.11-lakh crore recapitalisation plan for public sector banks that are now taking haircuts on defaulted loans being put through the Insolvency and Bankruptcy Code. When banks, in turn, face collapse, the fear is that depositors could face similar haircuts or write-downs on the value of their savings in the bank and perhaps be issued securities instead. This provision in the FRDI Bill is purportedly with an eye on resolving bankruptcy scenarios among financial entities, some of which could be too big to fail or systemically important. On Friday, Mr. Jaitley said a ‘lot of corrections’ could still take place; the Bill is currently being reviewed by a parliamentary committee whose report will be considered by the Cabinet. The Bill proposes the scrapping of the Deposit Insurance and Credit Guarantee Corporation (set up in the early 1960s in the aftermath of the collapse of two banks), which guarantees repayment of bank deposits up to 1 lakh in case a bank is liquidated. A new Resolution Corporation under the Finance Ministry will steer financial entities out of the woods and offer a similar cover for deposits. The silence of the Bill on the extent of deposits to be guaranteed is a key source of concern, and may necessitate the need to revisit the existing 1 lakh deposit guarantee, which hasn’t been revised since 1993.

The need for a specialised regime to cope with large financial firms on the verge of going bust is well-understood especially since the global financial crisis of 2008. As a resolution tool for stressed financial firms, the bail-in clause has been the subject of much debate, but it remains the least well-established across the world. Even the committee framing the FRDI law has noted that it should typically be used where continuing a firm’s services is considered vital but its sale is unviable — not as a lazy default option. If lenders don’t believe that a bail-in plan would salvage a firm, triggering the clause could end up causing a run on the bank instead of preventing one. With its thrust on initiatives such as the Jan Dhan Yojana and demonetisation, the government has nudged more people towards the formal banking system. To ensure that those gains are not lost, the government must communicate more clearly the rationale behind the bail-in provision, and the circumstances in which it may ultimately be used, if at all. Most importantly, it must enhance the amount of bank deposits that will remain safe under the new dispensation.

Revving up infrastructure spending is necessary, but not sufficient

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