Banking on legislation

The **recapitalisation of public sector banks** (PSBs) through bailouts, be they as budgetary allocation or some sort of bond issue, has evoked much discussion. The Insolvency and Bankruptcy Code is cited as adequate punishment for defaulting borrower companies. However, under the code, the resolution process has brought little succour to banks as the recovery rate from defaulting companies has so far been merely 15-20% of the original amount lent. Meanwhile, there is no attempt so far by the Reserve Bank of India (RBI) to issue guidance to PSBs to blacklist these entities from getting further loans or prevent their managements from retaining a majority equity stake during the resolution process as penalty for the huge haircuts being taken by banks.

The result is that banks have been continually reporting losses in each successive quarter. Six PSBs have already been placed under prompt corrective action by the RBI. Even the State Bank of India was still stuck with non-performing assets worth 1,88,068 crore as on June 2017.

According to the Financial Stability Board (FSB) Peer Review Report August 2016, 63% of the financial investments ordinary Indians make are within the banking system; PSBs account for 63% of the market share while private banks control 18%. Given the shaky financial condition of most public banks, deposits in these banks are very much at risk. In the best case scenario, there could be a government bailout. Other possibilities are the transfer of their assets and liabilities to a bridge service provider, a merger with an existing bank, or even liquidation. But none of these options guarantees safety of customer money.

What adds to the disquiet is the Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 that was referred to a joint parliamentary committee this August after cabinet approval. This covers bankruptcy of businesses such as banks and insurance. Financial resolution includes solutions for banks facing 'material' or 'imminent' risk to viability depending on their capital and asset worth.

This Bill also introduces the provision for a "bail-in", whose purpose is to provide capital to absorb the losses of a bank and ensure its survival. Here, survival does not mean safety of depositors' money, but restoration of capital of the bank. The bail-in empowers the proposed Resolution Corporation to cancel a liability owed by the bank or change the form of an existing liability to another security.

All of us are aware that money in a savings or fixed deposit account is a liability owed by the bank to its customer. The bank promises to repay the money when demanded by the customer. Since the customer has not taken any security from the bank when handing over his money, legally, the customer is an unsecured creditor of the bank. With a 'bail-in', the bank simply refuses repayment of a customer's money or instead issues securities such as preference shares (with no guarantee of fixed dividends) to a customer. This is in lieu of his deposits which are then used for recapitalisation of the bank.

The only money owed to depositors that cannot be bailed-in is the amount covered by deposit insurance. The Deposit Insurance and Credit Guarantee Corporation Act, 1961 which insured deposits worth one lakh for each depositor has been repealed by the cabinet. The FRDI Bill further empowers the Resolution Corporation to decide the amount insured for each depositor. Thus, it is possible that the insured amounts will not only vary for customers in different banks, but may also be different for different customers of the same bank.

The 'bail-in' clause changes the nature of relationship between the customer and the bank. It would mean that money is no longer safe in a bank. An account would lose its sovereign guarantee and instead become an investment. Putting away money in a bank would be akin to buying shares of a company or units of a mutual fund. The customer would need to monitor the level of toxicity of his bank with respect to its losses and accordingly keep switching bank accounts.

The banking saga has all the ingredients of a full-fledged Shakespearean tragedy. Out of the three protagonists, the government as the majority shareholder and the corporate borrower are wearing their victimhood as a badge of honour. Whereas, the real victim, the customer, is the unsung hero coerced into parting with his money.

The reality is that without customer deposits, a bank cannot carry on its business. It has to be understood that banking business is not the same as any other business. A bank customer cannot be treated on a par with an unsecured creditor of a regular business. The customer is not privy to the lending decisions in a bank unlike any vendor or investor dealing with a company. Hence the rules for bankruptcy of a regular business cannot be applied to bank failures. For the sake of justice and fairness to its citizens, the government must take a stand and defy the FSB’s diktat on the ‘bail-in’ clause.

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The definition of harassment needs to be constantly updated, and the process for justice made more robust

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