The Financial Resolution and Deposit Insurance Bill, 2017 was introduced in Parliament during Monsoon Session 2017.[1] The Bill proposes to create a framework for monitoring financial firms such as banks, insurance companies, and stock exchanges; pre-empt risk to their financial position; and resolve them if they fail to honour their obligations (such as repaying depositors). To ensure continuity of a failing firm, it may be resolved by merging it with another firm, transferring its assets and liabilities, or reducing its debt. If resolution is found to be unviable, the firm may be liquidated, and its assets sold to repay its creditors.

After introduction, the Bill was referred to a Joint Committee of Parliament for examination, and the Committee's report is expected in the Winter Session 2017. The Committee has been inviting stakeholders to give their inputs on the Bill, consulting experts, and undertaking study tours. In this context, we discuss the provisions of the Bill and some issues for consideration.

What are financial firms?

Financial firms include banks, insurance companies, and stock exchanges, among others. These firms accept deposits from consumers, channel these deposits into investments, provide loans, and manage payment systems that facilitate transactions in the country. These firms are an integral part of the financial system, and since they transact with each other, their failure may have an adverse impact on financial stability and result in consumers losing their deposits and investments.

As witnessed in 2008, the failure of a firm (Lehman Brothers) impacted the financial system across the world, and triggered a global financial crisis. After the crisis, various countries have sought to consolidate their laws to develop specialised capabilities for resolving failure of financial firms and to prevent the occurrence of another crisis. [2]

What is the current framework to resolve financial firms? What does the Bill propose?

Currently, there is no specialised law for the resolution of financial firms in India. Provisions to resolve failure of financial firms are found scattered across different laws.[2] Resolution or winding up of firms is managed by the regulators for various kinds of financial firms (i.e. the Reserve Bank of India (RBI) for banks, the Insurance Regulatory and Development Authority (IRDA) for insurance companies, and the Securities and Exchange Board of India (SEBI) for stock exchanges.) However, under the current framework, powers of these regulators to resolve similar entities may vary (e.g. RBI has powers to wind-up or merge scheduled commercial banks, but not co-operative banks.)

The Bill seeks to create a consolidated framework for the resolution of financial firms by creating a Resolution Corporation. The Resolution Corporation will include representatives from all financial sector regulators and the ministry of finance, among others. The Corporation will monitor these firms to pre-empt failure, and resolve or liquidate them in case of such failure.

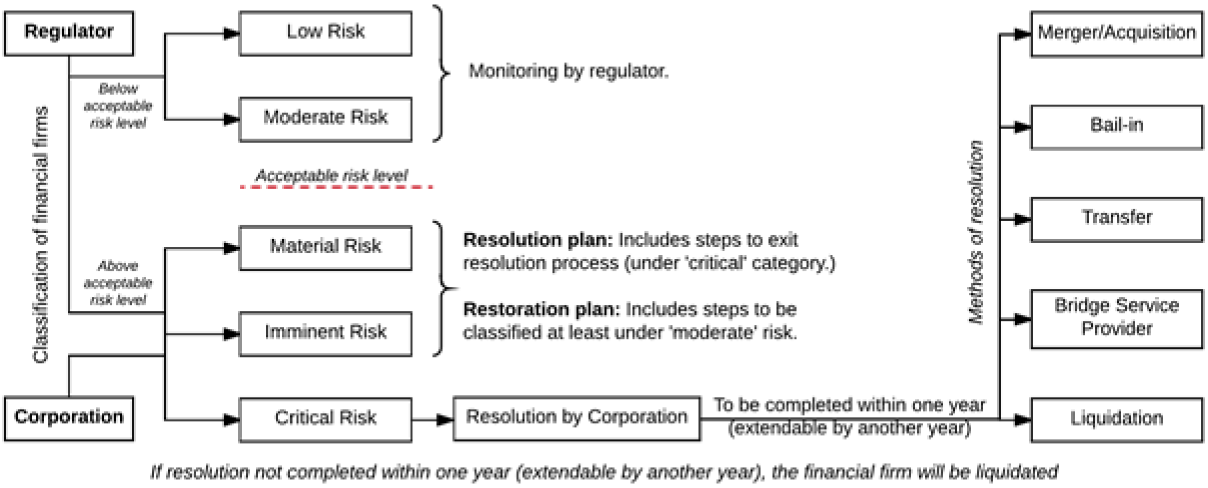
How does the Resolution Corporation monitor and prevent failure of financial firms?

Risk based classification: The Resolution Corporation or the regulators (such as the RBI for banks, IRDA for insurance companies or SEBI for the stock exchanges) will classify financial firms under five categories, based on their risk of failure (see Figure 1). This classification will be based on adequacy of capital, assets and liabilities, and capability of management, among other criteria. The Bill proposes to allow both, the regulator and the Corporation, to monitor and classify firms based on their risk to failure.

***Corrective Action*:** Based on the risk to failure, the Resolution Corporation or regulators may direct the firms to take certain corrective action. For example, if the firm is at a higher risk to failure (under 'material' or 'imminent' categories), the Resolution Corporation or the regulator may: (i) prevent it from accepting deposits from consumers, (ii) prohibit the firm from acquiring other businesses, or (iii) require it to increase its capital. Further, these firms will formulate resolution and restoration plans to prepare a strategy for improving their financial position and resolving the firm in case it fails.

While the Bill specifies that the financial firms will be classified based on risk, it does not provide a mechanism for these firms to appeal this decision. One argument to not allow an appeal may be that certain decisions of the Corporation may require urgent action to prevent the financial firm from failing. However, this may leave aggrieved persons without a recourse to challenge the decision of the Corporation if they are unsatisfied.

Figure 1: Monitoring and resolution of financial firms



Sources: The Financial Resolution and Deposit Insurance Bill, 2017; PRS.

How will the Resolution Corporation resolve financial firms that have failed?

The Resolution Corporation will take over the administration of a financial firm from the date of its classification as 'critical' (i.e. if it is on the verge of failure.) The Resolution Corporation will resolve the firm using any of the methods specified in the Bill, within one year. This time limit may be extended by another year (i.e. maximum limit of two years). During this period, the firm will be immune against all legal actions.

The Resolution Corporation can resolve a financial firm using any of the following methods: (i) transferring the assets and liabilities of the firm to another firm, (ii) merger or acquisition of the firm, (iii) creating a bridge financial firm (where a new company is created to take over the assets, liabilities and management of the failing firm), (iv) bail-in (internally transferring or converting the debt of the firm), or (v) liquidate the firm to repay its creditors.

If the Resolution Corporation fails to resolve the firm within a maximum period of two years, the firm will automatically go in for liquidation. The Bill specifies the order of priority in which creditors will be repaid in case of liquidation, with the amount paid to depositors as deposit insurance getting preference over other creditors.

While the Bill specifies that resolution will commence upon classification as 'critical', the point at which this process will end may not be evident in certain cases. For example, in case of transfer, merger or liquidation, the end of the process may be inferred from when the operations are transferred or liquidation is completed, but for some other methods such as bail-in, the point at which the resolution process will be completed may be unclear.

Does the Bill guarantee the repayment of bank deposits?

The Resolution Corporation will provide deposit insurance to banks up to a certain limit. This implies, that the Corporation will guarantee the repayment of a certain amount to each depositor in case the bank fails. Currently, the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides deposit insurance for bank deposits up to 1 lakh rupees per depositor.[3] The Bill proposes to subsume the functions of the DICGC under the Resolution Corporation.

[1]. The Financial Resolution and Deposit Insurance Bill, 2017, http://www.prsindia.org/uploads/media/Financial%20Resolution%20Bill,%202017/Financial%20Resolution%20Bill,%202017.pdf

[2]. Report of the Committee to Draft Code on Resolution of Financial Firms, September 2016, http://www.prsindia.org/uploads/media/Financial%20Resolution%20Bill,%202017/FRDI%20Bill%20Drafting%20Committee%20Report.pdf

[3]. The Deposit Insurance and Credit Guarantee Corporation Act, 1961, http://www.prsindia.org/uploads/media/Financial%20Resolution%20Bill,%202017/DICGC%20Act,%201961.pdf.