

Legislative Brief

The Financial Resolution and Deposit Insurance Bill, 2017

The Bill was introduced in Lok Sabha on August 10, 2017 by the Minister of Finance, Mr. Arun Jaitley.

The Bill was referred to a Joint Committee of Parliament (Chair: Mr. Bhupender Yadav) on August 10, 2017.

The Committee is expected to submit its report on the last day of the first week of the next session of Parliament.

Recent Briefs:

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June 9, 2017

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Highlights of the Bill

- ◆ The Bill establishes a Resolution Corporation to monitor financial firms, anticipate risk of failure, take corrective action, and resolve them in case of such failure. The Corporation will also provide deposit insurance up to a certain limit, in case of bank failure.
- ◆ The Resolution Corporation or the appropriate financial sector regulator may classify financial firms under five categories, based on their risk of failure. These categories in the order of increasing risk are: (i) low, (ii) moderate, (iii) material, (iv) imminent, and (v) critical.
- ◆ The Resolution Corporation will take over the management of a financial firm once it is classified as 'critical'. It will resolve the firm within one year (may be extended by another year).
- ◆ Resolution may be undertaken using methods including: (i) merger or acquisition, (ii) transferring the assets, liabilities and management to a temporary firm, or (iii) liquidation. If resolution is not completed within a maximum period of two years, the firm will be liquidated. The Bill also specifies the order of distributing liquidation proceeds.

Key Issues and Analysis

- ◆ The Resolution Corporation will exercise certain powers including: (i) classification of firms based on risk, and (ii) directing the management of a firm to return their performance based incentive. However, the Bill does not specify a review or appeal mechanism for aggrieved persons to challenge the decision of the Resolution Corporation.
- ◆ A financial firm will have to be resolved within two years of being classified as 'critical'. However, the point at which the resolution process ends is not specified in the Bill.
- ◆ Under the Bill, the Resolution Corporation will take over a firm classified as 'critical'. However, it *may* choose to resolve the firm. It is unclear why the Corporation is given a choice to undertake resolution.
- ◆ The Bill specifies that the Corporation will take over the administration of a firm, and exercise the powers of the board of directors, as soon as the firm is classified as 'critical'. However, it also allows the Corporation to supersede the board of a firm if it is classified as 'critical'. The provision allowing the Corporation to supersede the board of a firm classified as 'critical' may be redundant.
- ◆ The Bill requires financial firms to pay fees to the Resolution Corporation, including those specified in Clause 33. However, Clause 33 does not specify fees that these firms will be required to pay.

PART A: HIGHLIGHTS OF THE BILL¹

Context

Financial firms include banks, non-banking financial companies, insurance companies, pensions funds, stock exchanges, and depositories. These firms accept deposits from consumers, invest these funds, and provide loans. Often these firms borrow from each other. Failure of a firm may result in adverse consequences for other financial firms, and could trigger off system-wide financial instability. Such failure may be resolved by merging the failing firm with another firm, transferring its assets and liabilities, or reducing its debt. If resolution is found unviable, the firm may be liquidated, and its assets sold to repay creditors.

In 2008, the failure of a large financial firm impacted countries across the world, and led to a global financial crisis.² After the crisis, several countries such as the US and those across Europe developed specialised resolution capabilities for addressing such failure.^{2,3,4}

Currently in India, there is no specialised law for the resolution of financial firms. Monitoring and resolution of firms are managed by the respective regulators. Over the last few years, expert committees have noted certain limitations in the current framework which include: (i) involvement of multiple regulators preventing specialised resolution capabilities for the entire financial sector being developed, (ii) regulators exercising forbearance and delaying resolution in the hope of reviving a firm, and (iii) availability of limited methods to resolve firms.^{2,5} Committees have also noted that currently there are no provisions to resolve certain financial firms such as companies managing mutual funds or securities firms. The powers of regulators to resolve similar entities also varies (e.g., RBI has powers to wind-up or merge scheduled commercial banks, but not co-operative banks).^{2,5}

In this context, the Financial Resolution and Deposit Insurance Bill, 2017 was introduced in Lok Sabha on August 10, 2017.¹ The Bill seeks to establish a Resolution Corporation to monitor financial firms (along with regulators), and resolve them in case of failure. Note that the Insolvency and Bankruptcy Code, enacted in 2016, addresses the failure of non-financial firms such as companies and partnership firms.⁶

Key Features

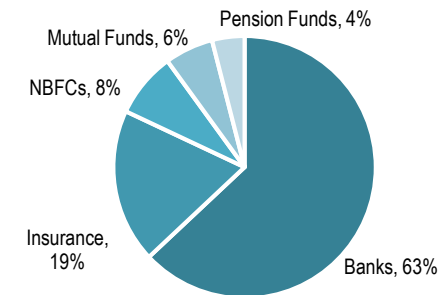
The Bill seeks to establish a Resolution Corporation to monitor financial firms and resolve them in case of failure. It repeals the Deposit Insurance and Credit Guarantee Corporation Act, 1962 and amends 22 other laws.¹

- **Coverage:** The Bill will apply to banks, insurance companies, stock exchanges, depositories, payment systems, non-banking financial companies, and their parent companies. The central government may notify any other entities or funds to be covered under the Bill.

Resolution Corporation

- The Bill seeks to establish a Resolution Corporation which will comprise 11 members: (i) a Chairperson, (ii) a representative each from regulators (i.e., RBI, SEBI, IRDA and PFRDA), (iii) a representative of the Ministry of Finance, (iv) three members appointed by the central government, and (v) two independent members. The Chairperson and members will have expertise in subjects including finance, economics, and resolution.
- **Functions:** The Resolution Corporation will classify financial firms based on their risk of failure, undertake resolution or liquidation of financial firms in case of failure, provide deposit insurance to consumers, and monitor systemically important financial institutions. The Corporation may investigate the activities of financial firms or undertake search and seizure operations if provisions of the Bill are being contravened.
- **Risk based classification:** Financial firms will be classified under five categories based on their risk of failure by either the Resolution Corporation or the regulator (i.e., the RBI for banks, IRDA for insurance companies, and SEBI for stock exchanges). These categories are: (i) low, (ii) moderate, (iii) material, (iv) imminent, and (v) critical. The Corporation may classify firms in three of these five categories, while the regulators may classify firms under any of the five categories (see Figure 2). Such classification will be based on objective criteria such as adequacy of capital and debt. In case of a difference of opinion, the Corporation and regulators will consult each other. After such consultation, the order of the Corporation will be final, and binding on the financial firm.
- **Monitoring:** The Corporation and regulators will monitor financial firms based on their risk of failure. As this risk increases above acceptable levels (under ‘material’ or ‘imminent’ categories), the Corporation or the regulator may direct the firm to take certain actions to mitigate risk of failure. These include: (i) preventing the firm from accepting deposits, (ii) prohibiting it from acquiring other businesses, or (iii) increasing its capital.

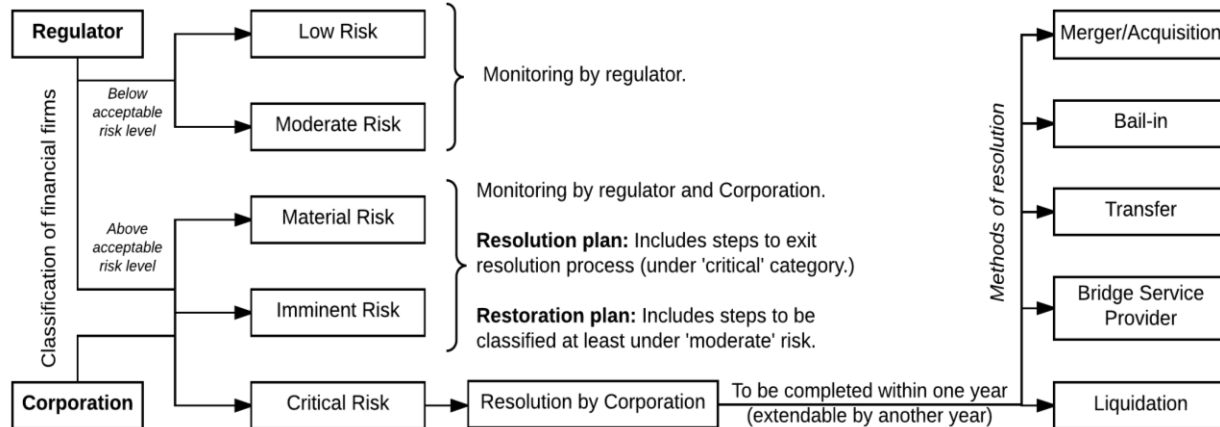
Figure 1: Distribution of financial assets in India



Sources: Report of the Working Group on Resolution Regime for Financial Institutions; PRS.

Further, firms in the ‘material’ and ‘imminent’ categories will formulate resolution and restoration plans. The Corporation may supersede the board of a firm, if it is classified under the ‘imminent’ or ‘critical’ categories, for a maximum period two years.

Figure 2: Monitoring and resolution of financial firms



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

- **Deposit insurance:** The Resolution Corporation will provide deposit insurance to banks up to a certain limit (to be notified). This implies that repayment of a certain amount to each depositor will be guaranteed by the Corporation, in case a bank fails. The Corporation will subsume the functions of the Deposit Insurance and Credit Guarantee Corporation, which currently provides deposit insurance of up to one lakh rupees.

Resolution Process

- **Resolution:** The Resolution Corporation will take over the administration of a financial firm from the date of its classification under the ‘critical’ category. The Corporation will resolve the firm using various 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.
- **Methods of resolution:** The Resolution Corporation may resolve a financial firm using any of the following methods: (i) transferring the assets and liabilities of the firm, (ii) merger, acquisition or amalgamation 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 firm), (iv) bail-in (internally transferring or converting the debt of the firm), or (v) liquidation (subject to approval by the National Company Law Tribunal).

If the Resolution Corporation fails to resolve the firm within two years, the firm will be liquidated to repay its debt. Proceeds from liquidation will be distributed in an order of priority specified in Figure 3.

Figure 3: Order of priority for distributing assets

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- Deposit insurance
 - Resolution costs (including liquidation costs)
 - (i) Workmen dues for 24 months, and (ii) secured creditors
 - Wages to employees for 12 months
 - Uninsured deposits and insurance related amounts
 - Unsecured creditors
 - (i) Government dues, and (ii) remaining secured creditors (remaining debt if they enforce collateral)
 - Remaining debt and dues
 - Shareholders

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

Other Provisions

- **Systemically important financial institutions (SIFIs):** The central government may designate a financial firm as a SIFI. This would include financial firms whose failures may have a significant impact on the stability of the financial system. Classification as a SIFI would require any firm which is not covered under the Bill, to also comply with its provisions.
- **Offences:** The Bill specifies penalties for certain offences committed by members of a financial firm. These offences include concealment of property and destruction or falsification of evidence. Penalties will vary based on the nature of the offence, with the maximum penalty being imprisonment for five years, along with a fine.
- **Funds:** The Corporation will constitute three Funds: (i) Corporation Insurance Fund for deposit insurance, (ii) Corporation Resolution Fund for resolution expenses, and (iii) Corporation General Fund for all other functions.
- **Bar on jurisdiction:** The Bill prohibits any court or tribunal from entertaining matters related to the decisions of the Resolution Corporation or regulators, unless specified in the Bill.

PART B: KEY ISSUES AND ANALYSIS

Certain powers of the Corporation may not have a review mechanism

Bill:
Clauses
36, 37, 51,
133

The Bill establishes the Resolution Corporation to monitor financial firms (such as banks, insurance companies, stock exchanges, and depositories), pre-empt their failure, and resolve or liquidate them in case of failure. Failure of these financial firms may impact financial stability as they hold consumer deposits, extend credit, facilitate investment in the economy, and also borrow from each other. Therefore, the Resolution Corporation may have to exercise its powers with urgency, and address such a failure to avoid any risk to the financial system. The Bill does not specify a review or appeal mechanism for some of these decisions.

One argument to not allow an appeal may be that certain decisions of the Resolution Corporation may require urgent action to prevent the failure of a financial firm. However, this may leave aggrieved persons without a recourse to challenge the decision of the Resolution Corporation if they are unsatisfied. Given that clause 133 of the Bill prevents courts from entertaining any matters related to decisions of the Resolution Corporation, the only remedy available to a person aggrieved by an order of the Corporation is to file a writ before the High Courts under Article 226 of the Constitution.⁷ The RBI Working Group on Resolution Regime for Financial Institutions (2014) had recommended that an appeal and grievance redressal mechanism should be available for stakeholders to challenge an improper decision of the Corporation.² We discuss two instances where an appeal mechanism is unavailable, below:

Classification of financial firms based on their risk of failure

The Resolution Corporation may classify a financial firm under the ‘material’, ‘imminent’ or ‘critical’ categories. Before such classification, the financial firm will be given an opportunity to be heard. However, the final order passed by the Resolution Corporation will be binding on the financial firm, and has to be complied with.

Depending on its classification, the firm may be subject to corrective action or resolution, including steps which: (i) prevent it from accepting deposits, (ii) prohibit it from acquiring other businesses, or (iii) require the firm to raise additional capital by issuing securities or selling assets. The Resolution Corporation will take over the management of a firm under the ‘critical’ category, and resolve it. The Bill does not specify a mechanism for an aggrieved financial firm to appeal the classification order of the Resolution Corporation.

Ordering members of financial firms to return performance based incentive

Under the Bill, the Resolution Corporation may designate a proportion of remuneration given to the chairperson, chief executive officer (CEO) or director of a financial firm, under ‘material’ or ‘imminent’ category, to be linked to their performance. Subsequently, if the financial firm is classified as ‘critical’, the Resolution Corporation may order the chairperson, CEO or director to return their performance based incentive after giving them an opportunity of being heard. Such direction may be issued to these officers if their actions or omissions resulted in the financial firm being classified under ‘critical’ risk.

The Bill does not specify a mechanism for an aggrieved person to challenge the order of the Resolution Corporation. This order directing a person to return the performance based incentive will be final, and a failure to comply with it will result in recovery being initiated in the manner specified in the Income Tax Act, 1961.

Lack of clarity in certain parts of the classification and resolution process

Under the Bill, the Resolution Corporation or the regulators may classify financial firms in any of the five categories based on its risk of failure: (i) low, (ii) moderate, (iii) material, (iv) imminent, or (v) critical. In this context, we examine certain processes in the Bill which may be unclear.

Bill:
Clauses
45, 48, 58,
81

End of the resolution process unclear in certain cases

The Bill specifies that the Resolution Corporation will take over the administration of the financial firm once it is classified as ‘critical’. The Resolution Corporation may then resolve the financial firm using any of the following methods: (i) transfer of assets and liabilities to another entity, (ii) merger or acquisition, (iii) transferring assets and liabilities of the financial firm to a temporary firm known as a bridge financial firm, (iv) bail-in (involving internal restructuring of liabilities including conversion of debt into equity), or (v) liquidation. However, the Bill does not indicate the point at which the resolution process will be deemed to be complete.

For some of these methods, such as transfer or merger, the completion of the resolution process may be inferred from the point when the new management takes over the administration of the firm. In case of liquidation, the Bill specifies that the National Company Law Tribunal will approve the dissolution of the financial firm after all its assets have been sold. However, for some other methods such as bail-in, the point at which the resolution process is complete may be unclear.

Note that under the Insolvency and Bankruptcy Code, 2016, the resolution process for a defaulting company ends when a resolution plan is approved by the National Company Law Tribunal. Further, the Tribunal passes an order lifting the moratorium on any lawsuits against the company.⁶

Resolution Corporation takes over the financial firm but may choose to resolve it

The Bill establishes the Resolution Corporation to monitor financial firms, prevent risk to their financial health, and resolve them in case of failure. Clause 58 of the Bill specifies that upon being classified as ‘critical’, the Resolution Corporation will take over the administration of a financial firm to continue its operations. However, Clause 48 of the Bill states that the Resolution Corporation *may* choose to resolve the financial firm. Since the purpose behind taking over the administration of the financial firm is to resolve it, it is unclear why the Resolution Corporation is being given a choice to undertake resolution.

Corporation superseding the board of a ‘critical’ firm’ may be redundant

Bill:
Clauses 58 (1), 62 (1) Under Clause 58 of the Bill, the Resolution Corporation takes over as the administrator of a financial firm as soon as the financial firm is classified as ‘critical’. As the administrator, the Resolution Corporation will: (i) manage the operations of the financial firm, and (ii) exercise the powers of the board of directors, among others. However, Clause 62 (1) of the Bill allows the Resolution Corporation to supersede the board of directors of the financial firm if it is classified as ‘critical’.

Given that the powers of the board of directors of the financial firm are vested in the Resolution Corporation as soon as it is classified as ‘critical’, a separate provision allowing the Corporation to supersede a firm’s board when it is classified as ‘critical’ may be redundant.

Fees payable by financial firms under section 33 not specified

Bill:
Clauses 22 (1), 33 Clause 22 (1) of the Bill requires financial firms to pay the Resolution Corporation: (i) fees for resolution, and (ii) fees for administrative expenses including fees charged under Clause 33. However, Clause 33 does not mention fees which the financial firms will be required to pay to the Resolution Corporation.

1. [The Financial Resolution and Deposit Insurance Bill, 2017.](#)
2. [Report of the Working Group on Resolution Regime for Financial Institutions, Reserve Bank of India, January 2014.](#)
3. [Banking Resolution and Recovery Directive, European Union, Directive 2014/59/EU of the European Parliament and of the Council, May 15, 2014.](#)
4. [Key Attributes of Effective Resolution Regimes for Financial Institutions, FSB, 2014.](#)
5. [Report of the Committee to Draft Code on Resolution of Financial Firms, September 2016.](#)
6. [The Insolvency and Bankruptcy Code, 2016.](#)
7. Writ is an extraordinary remedy available to all persons for enforcing their constitutional and legal rights, or to compel public authorities to discharge their relevant duties.

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Annexure: Comparison of international laws with the proposed framework

Table 1 below compares the provisions of the Financial Resolution and Deposit Insurance Bill, 2017 with the laws of other countries.

Table 1: International comparison of resolution laws

| Action | United States | United Kingdom | Australia | India (Proposed Bill) |
|----------------------------------|--|--|---|--|
| Authorities | <ul style="list-style-type: none"> ▪ Regulators: Four regulators for banks including Federal Reserve Board. Securities and Exchange Commission regulates brokers and stock exchanges. ▪ Resolution Authority: Federal Deposit Insurance Resolution Corporation (FDIC). | <ul style="list-style-type: none"> ▪ Regulators: Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) regulate the financial sector. ▪ Resolution Authority: Bank of England or Her Majesty's Treasury (equivalent of Ministry of Finance). | <ul style="list-style-type: none"> ▪ Regulators: Securities and Investments Commission regulates securities. Australian Prudential Regulation Authority (APRA) and Reserve Bank monitor the financial sector. ▪ Resolution Authority: APRA. | <ul style="list-style-type: none"> ▪ Regulators: RBI (banks and NBFCs), SEBI (securities markets), IRDA (insurance) and PFRDA (pensions). ▪ Resolution Authority: Resolution Corporation. |
| Coverage | <ul style="list-style-type: none"> ▪ Banks and non-banking financial companies (NBFCs). ▪ Other entities such as holding companies (parent company of a financial firm). | <ul style="list-style-type: none"> ▪ Banks. ▪ Other entities such as investment firms (manage securities and mutual funds) and holding companies. | <ul style="list-style-type: none"> ▪ Banks. ▪ Insurance Companies. ▪ Other entities such as holding companies. | <ul style="list-style-type: none"> ▪ Banks and NBFCs. ▪ Insurance Companies. ▪ Other entities such as stock exchanges, depositories, and holding companies. ▪ Entities notified by the central government. |
| Monitoring | <ul style="list-style-type: none"> ▪ FDIC classifies firms in five risk categories based on capital. ▪ Submission of Resolution Plans and Restoration Plans by firms to FDIC. | <ul style="list-style-type: none"> ▪ Regulators classify firms on a five-point risk to failure scale. ▪ Submission of Resolution Plans by firms to PRA. | <ul style="list-style-type: none"> ▪ APRA supervises and classifies firms in different risk categories based on capital, assets, and management, among others. | <ul style="list-style-type: none"> ▪ Corporation and regulators classify firms on a five-point risk to failure scale. ▪ Submission of Restoration and Resolution Plans by firms. |
| Initiation of proceedings | <ul style="list-style-type: none"> ▪ Upon breach of any conditions (such as adequacy of capital). ▪ FDIC appointed as liquidator by the regulators, or the licensing authority. The FDIC may also appoint itself. ▪ FDIC takes over administration after being appointed as liquidator. | <ul style="list-style-type: none"> ▪ Upon satisfaction of two conditions which include high likelihood of a firm failing. ▪ Assessment by regulators and Bank of England. ▪ Bank of England takes over administration. | <ul style="list-style-type: none"> ▪ Appointment of a statutory manager by APRA. ▪ In case of insurance companies, Court appoints a judicial manager to take control of the firm. ▪ Judicial manager takes over administration. | <ul style="list-style-type: none"> ▪ Upon classification as 'critical'. ▪ Resolution Corporation ▪ (Administration during 'critical' stage, and supersession of board of directors under 'imminent' or 'critical' stage). |
| Time limit | <ul style="list-style-type: none"> ▪ 90 days. | <ul style="list-style-type: none"> ▪ No specified time limit. | <ul style="list-style-type: none"> ▪ No specified time limit. | <ul style="list-style-type: none"> ▪ One year (may be extended by one year). |
| Resolution methods | <ul style="list-style-type: none"> ▪ Purchase and Assumption Transactions (transfer of all or part of assets and liabilities). ▪ Bridge Service Provider (temporary company to operate firm). ▪ Paying off depositors. | <ul style="list-style-type: none"> ▪ Stabilisation tools: <ol style="list-style-type: none"> 1. Transfer of assets and liabilities. 2. Bridge Service Provider. 3. Bail-In (internal reduction of debt). ▪ Bank Insolvency Procedure. ▪ Bank Administration Procedure. ▪ Temporary Public Ownership. | <ul style="list-style-type: none"> ▪ Transfer of assets and liabilities. ▪ Bridge Service Provider. ▪ Merger or Acquisition. | <ul style="list-style-type: none"> ▪ Transfer of assets and liabilities. ▪ Bridge Service Provider. ▪ Merger or Acquisition. ▪ Bail-In. ▪ Liquidation. ▪ Run-off insurance company (allowing insurance policies to run their due course without acquiring new business). |
| Deposit Insurance | <ul style="list-style-type: none"> ▪ Operated by FDIC. ▪ Bank deposits of up to 250,000 US dollars. | <ul style="list-style-type: none"> ▪ Operated by Financial Services Compensation Scheme. ▪ Bank deposits of up to 85,000 pounds. | <ul style="list-style-type: none"> ▪ Financial Claims Scheme operated by APRA. ▪ Bank deposits of up to 250,000 Australian dollars. | <ul style="list-style-type: none"> ▪ Operated by Resolution Corporation. ▪ Limit to be specified through regulations (currently DICGC insures up to 1 lakh rupees). |

Note: Bank Insolvency Procedure is used when the failing firm is put into liquidation and depositors are paid off; Bank Administration Procedure is used to put a part of a failed firm (that has not been transferred to a bridge service provider or private sector purchaser) into administration.

Sources: United Kingdom Banking Act, 2009, United Kingdom Insolvency Act, 1986, United States Code Title 11-Bankruptcy, United States Federal Deposit Insurance Act, 1950, Report of the Working Group on Resolution of Regime for Financial Institutions, RBI, January 2014, The Bank of England's Approach to Resolution, 2014; The Australia Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Act 2010; The Australia Banking Act 1959; Report on Strengthening APRA's Crisis Management Powers, 2012; The Deposit Insurance and Credit Guarantee Resolution Corporation Act, 1961; The Financial Resolution and Deposit Insurance Bill, 2017; PRS.