WITHDRAWAL OF THE FRDI BILL: BAIL-IN AND OTHER PUBLIC CONCERNS

Vardaan Bajaj[*]

ABSTRACT

The Financial Resolution and Deposit Insurance Bill, 2017 (FRDI Bill) was tabled in the Parliament in August 2017, however, it has recently been withdrawn by the Central Government due to enormous pressure from public and other institutions. This article aims to discuss the important aspects of the FRDI Bill and points out to the concerns that were emerging out of this Bill, inter alia, the "bail-in" clause, protection of bank deposits, and the proposed resolution mechanism, conflicts with the existing regulatory body, overlooking disclosures, and inaptness of ownership neutrality model in India. These concerns eventually led to the doom of this Bill.

1. INTRODUCTION

It is worthwhile to note that, the Insolvency and Bankruptcy Code (IBC) was enacted in the year 2016, with an aim to resolve the issues of insolvencies and bankruptcies of corporate persons, partnership firms, and individuals. However, IBC does not cover financial firms and their insolvency resolution was proposed to be governed by the FRDI Bill.

[*] B.Com. LL.B. (Hons.) Candidate, V Year, Gujarat National Law University, Gandhinagar.

In the face of distinct laws for resolution of similar financial service providers such as banks, insurance companies, non-banking financial companies, pension fund, or mutual fund run by an asset management company, *etc.*, the FRDI Bill was introduced with an aim to deal with bankruptcy situations and to provide a single legislation for resolution of such institutions.

The bill aimed to establish a framework to carry out the resolution of certain categories of financial service providers in distress, to provide deposit insurance to consumers of certain categories of financial services, and for designation of Systemically Important Financial Institutions by the Central Government for resolution. It sought to protect customers of financial service providers in times of financial distress. It also sought to decrease the time and costs involved in resolving distressed financial entities.[1]

2. EXISTING RESOLUTION FRAMEWORK TO RESOLVE FINANCIAL FIRMS

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 financial firms is managed by different regulators for various kinds of financial firms, for example, the Reserve Bank of India (RBI) for banks, the

[1] R. Raghavan, *FRDI Bill 2017 – Key Objectives, Salient Features and Benefits*, ALL BANKING ALERTS, http://allbankingalerts.com/frdi-bill-2017-objectives-sailent-features-benefits/.
[2] DEPARTMENT OF ECON. AFFAIRS, MINISTRY OF FINANCE, REPORT OF COMMITTEE TO DRAFT CODE ON RESOLUTION OF FINANCIAL FIRMS (Sep. 28, 2016).

Insurance Regulatory and Development Authority (IRDA) for insurance companies, and the Securities and Exchange Board of India (SEBI) for stock exchanges.

The procedure of resolution of a banking institution depends upon its type. A banking institution can be a scheduled commercial bank, co-operative bank, or public sector bank. A scheduled commercial bank may either be merged forcibly by Reserve Bank of India (RBI) with another bank which is regulated by the directions of RBI.[3] Winding-up procedure can also be initiated by an order of High Court on the application of RBI. Banks like State Bank of India (SBI), Regional Rural Banks (RRBs), and other nationalised banks, can only be wound up on the order of the Central Government.[4]

Under the current framework, powers of the aforementioned regulators to resolve similar entities also vary. For instance, RBI has powers to wind-up or merge scheduled commercial banks, but not co-operative banks.

3. THE PROPOSED MECHANISM

The FRDI Bill specifies various tools to resolve a failing financial firm which includes transferring its assets and liabilities, merging it with another firm, liquidating it, selling it, or closing it down.

---

[3] Banking Regulation Act, 1949, No. 10, Acts of Parliament, 1949, § 44(a).

[4] Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980, No. 40, Acts of Parliament, 1980.

3.1. POWERS OF THE RESOLUTION CORPORATION

The Bill proposed to create a Resolution Corporation[5] to monitor the resolution of financial firms. The Resolution Corporation was to include representatives from the Ministry of Finance, RBI, SEBI, IRDA, and PFRDA among others.[6] The functions of proposed Resolution Corporation included assigning of the risk to viability of a bank (which covered service provider),[7] as namely: low, moderate, material, imminent, and critical; after consultation with RBI. But, only RBI was empowered to classify the bank in low or moderate risk to viability.

Such classification was proposed to be done on the basis of adequacy of capital, assets and liability, asset quality, capability of management, earnings sufficiency, leverage ratio, liquidity of the covered service provider, and sensitivity of the covered service provider to adverse market conditions, and compliance with applicable laws.[8] The Bill provided banks classified under low or moderate risk option to opt for voluntary liquidation under Section 59 of the IBC, subject to any such condition specified by the RBI.[9] Whereas, the bank classified under material or imminent risk to viability were tasked under the Bill to prepare and submit a restoration plan to the RBI and a resolution plan to the Resolution Corporation within ninety days from the date such classification is made. Board of the bank classified as imminent or critical

---

[5] Financial Resolution & Deposit Insurance Bill, 2017, § 3.
[6] *Id.*, § 4.
[7] *Id.*, § 13.
[8] *Id.*, § 36.
[9] *Id.*, § 93.

risk to viability could be superseded by the Resolution Corporation for the maximum period of two years, if it was required in public interest.

The Bill gave power to Resolution Corporation to take over the administration of the bank once it was classified as critical risk to viability. Thereafter, the resolution was to take place within the specified time period, during which no legal action could be initiated against the bank. The resolution can be done, *inter alia*, by transferring the assets and liabilities of the covered service provider to another person, creating a bridge service provider,[10] merger, acquisition, liquidation,[11] bail-in,[12] or a combination of all or any of these methods.[13] Dispute or difference of opinion between the Resolution Corporation and the RBI, if any, was provided to be resolved by consultation, however, final power rested with the Resolution Corporation.[14] The Bill also disallowed the Corporation's resolution process from being challenged in courts.

4. ISSUES EMERGING OUT OF THE BILL

4.1. THE "BAIL IN" CONCERN

As per the Bill, one of the major resolution methods for financial firms on the verge of failure is 'bail-in'. As per this method, failing banks are rescued by internally-restructuring their debts. 'bail-in' was introduced

[10] *Id.*, § 50.
[11] *Id.*, Ch. XII.
[12] *Id.*, § 52.
[13] *Id.*, § 48.
[14] *Id.*, § 37.

in the FRDI Bill in order to ensure that the country's economy is not destabilised in the event of big default by a large bank.

Bail-in differs from bail-out. It is pertinent to note that bail-out involves funds being infused by external sources to resolve a firm; however, bail-in involves internally restructuring the Bank's debt.

The Resolution Corporation can internally restructure the firm's debt by: (i) cancelling liabilities that the firm owes to its creditors; or (ii) converting its liabilities into any other instrument (*e.g.*, converting debt into equity); among others.

Bail-in was dealt in Section 52 of the Bill. Section 52(1) of the Bill stated that if the Resolution Corporation was satisfied that it was necessary to bail-in a specified financial service provider (bank) for absorbing the losses incurred, then an action should be taken under that section by a bail-in instrument or a scheme.[15] Section 52(5) provided that a bail-in provision is one cancelling or modifying a liability owed by a specified service provider.[16] As per Section 52(7), the bail-in instrument or scheme was not to affect any liability owed by a specified service provider to the depositors to the extent such deposits were covered by deposit insurance.[17]

Thus, Section 52 instilled depositors with apprehensions that their money will be used by failing financial institutions to save themselves. Furthermore, the Bill did not specify with clarity as to how the depositors'

[15] *Id.*, § 52(1).
[16] *Id.*, §52(5).
[17] *Id.*, § 52(7).

money that was used for bail-in would be paid back and how there will be no financial crises.

4.2. LIMITED DEPOSIT INSURANCE

It is pertinent to note that, currently the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides deposit insurance for bank deposits to depositors. This body was established under the Deposit Insurance Corporation Act. This insurance cover was extended to depositors of all commercial banks and most cooperative banks. So, in a hypothetical scenario where a bank is liquidated, principal and interest up to a particular amount is insured and hence, protected.

The FRDI Bill proposed to subsume the functions of the DICGC under the Resolution Corporation. The Resolution Corporation mandate included provision of deposit insurance to banks up to a certain limit. This implied that, the Corporation could guarantee the repayment of a certain amount to each depositor in case the bank fails. However, the cause of concern is that under the present regime the deposits up to one lakh rupees per depositor are insured and any amounts above one lakh rupees are not insured. Thus, in a situation where deposits are made in a failing bank that is ‘bailed-in’, the depositors are at a risk of losing their money that is uninsured and above the insured threshold of one lakh.

Furthermore, as per Section 55(2)(b), “only those liabilities may be cancelled the instrument creating which contain a provision to the effect that the parties to the contract agree that the liability is eligible to be the subject of a bail-in.” This means that depositors while signing the contract with the bank can agree to a bail-in; however, the problem is that banks will not give consumer that option and it might be forced upon the consumers.

4.3. CONCERNS OVER CONFLICT WITH THE EXISTING REGULATORY BODY

The advent of the FRDI Bill could have led to a clash between regulatory bodies on multiple grounds. RBI had also raised concerns regarding the functioning of the Resolution Corporation and the resultant conflict with the functions of the regulatory body for the financial institutions.[18] RBI, being the regulatory body for the banks, has the power to classify them as material risk to viability. However, the Bill stipulated that, in case of difference of opinion between RBI and Resolution Corporation, the opinion of Resolution Corporation would prevail and it may re-classify the bank in imminent or critical risk to viability.[19]

Whereas, at the stage of material risk to viability, Prompt Corrective Action (PCA) can be used by RBI to address the issue faced by the bank classified. Intervention of Resolution Corporation in material risk to viability category was bound to create conflict between RBI and Resolution Corporation. Further, both RBI and Resolution Corporation had different ways of assessing risks. This, in turn, would have adversely affect recovery or restoration plans of the respective regulatory body.[20] Instead of working in cooperation and coordination, the Resolution

---

[18] *supra* note 2.
[19] FRDI Bill, *supra* note 5, § 37(4).
[20] *supra* note 2.

Corporation might have ended up questioning the authority of the regulatory body.

4.4. OWNERSHIP NEUTRALITY MODEL NOT APT FOR INDIA

This Bill also adopted an ownership neutrality model with regard to public and private sector banks. The aim of private banks is to provide high-standard facilities to the customers and thereby, increasing profits and spreading business. On the other hand, public sector banks have different aims and they need to serve all the sections of society. If the sovereign guarantee for insulating public sector banks and other public financial institutions from failures is diluted and the powers to resolve them is divested from the government, it will adversely affect the trust and confidence of the depositors in the public sector banks and weaken the entire financial system.

The "ownership-neutral" approach of Resolution Corporation might have turned out to be detrimental to the financial stability of the banking sector.

4.5. OVERLOOKING DISCLOSURES

This Bill also overlooked the disclosures made to the consumers. While there were apt provisions enabling financial institutions sharing information with the regulator or the Resolution Corporation or both, there was nothing in this Bill that said that the information was required to be shared with consumers. One of the reasons could have been that, if consumers came to know about their bank moving to High or moderate risk from low risk, they could have panicked. However, in today's world of instant-information sharing and social media, it is unlikely that the knowledge of risks of banks will not be percolated to the general public. It is far more efficient for banks and regulators to share information than to consciously suppress it.

5. CONCLUSION

It can be said that, at present, there is no comprehensive legal framework for resolution and liquidation of financial firms in India, therefore, the FRDI Bill was a step in the right direction. However, the loopholes in the bill, as pointed out above, eventually led to the withdrawal of this bill.

Another plausible reason for the withdrawal of the Bill was the pressure created on the government, because of the angst amongst the depositors related to their money in banks, especially after the recent scams and loan defaults like Nirav Modi -PNB Scam, Vijay Mallya's default in loan repayment, *etc.*

The Bill has been withdrawn but the issues it sought to address still remain to persist. Bank failure can pose an enormous risk on the overall financial stability. Thus, the need for a specialized framework to cope with large financial corporation on the verge of collapsing cannot be overstated.

One of the major drawbacks in the FRDI Bill was that it was largely based upon the regulatory reform framework of the Financial Stability Board (FSB). This organization has identified some of the banks as "globally-systemically important financial institution"[21] and provides a resolution regime for them. Solutions to insolvency of financial firms provided by FSB, to a large extent, are universal in approach. However, the problem is that India is not on the same level as other advanced countries in terms of economy and regulation machinery and hence without simply emulating a foreign framework, the Indian Government should reappraise the situations of Financial entities in a better way and then come up with a bill which is more suitable for India.

In the end, the author believes that, even though the Bill has been withdrawn, there is still an urgent need persisting to enhance the insurance cover on deposits in banks, which is currently limited to merely Rs one lakh.

[21] *2017 List of Global Systemically Important Banks (G-SIBS)*, FINANCIAL STABILITY BOARD http://www.fsb.org/wp-content/uploads/P211117-1.pdf (last visited Oct. 25, 2018).