Report of
Committee to Draft Code on Resolution of Financial Firms

Department of Economic Affairs
Ministry of Finance

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1 About the Committee

In his Budget Speech 2016-17, the Finance Minister had announced:

> *A systemic vacuum exists with regard to bankruptcy situations in financial firms. A comprehensive Code on Resolution of Financial Firms will be introduced as a Bill in the Parliament during 2016-17. This Code will provide a specialised resolution mechanism to deal with bankruptcy situations in banks, insurance companies and financial sector entities. This Code, together with the Insolvency and Bankruptcy Code 2015, when enacted, will provide a comprehensive resolution mechanism for our economy.*

Following this announcement, on March 15, 2016, the Ministry of Finance issued an Office Order to constitute a committee to draft and submit a Bill on resolution of financial firms, enclosed at Annex I. The Committee has the following members:

- Shri Ajay Tyagi, Additional Secretary (Investment), Department of Economic Affairs - Chairperson
- Representative of
  - Department of Financial Services - Member
  - Reserve Bank of India - Member
  - Deposit Insurance and Credit Guarantee Corporation - Member
  - Securities and Exchange Board of India - Member
  - Insurance Regulatory and Development Authority of India - Member
  - Pension Fund Regulatory and Development Authority - Member
- Adviser (FS), DEA - Member
- Adviser (Capital Market), DEA - Member Convener

The Committee engaged Vidhi Centre for Legal Policy to assist with drafting of the Bill. The National Institute of Public Finance and Policy provided assistance under the NIPFP-DEA Research Programme. Representatives of these institutes served as special invitees on the Committee.

The Committee is now submitting a draft Bill. The proposed title of the Bill is: *The Financial Resolution and Deposit Insurance Bill, 2016*. In this

Report, the Committee is putting forth its views on what would be a sound legislative framework for resolution and deposit insurance for financial firms in India. These views have been translated into legislative text in the accompanying Bill. In its work, the Committee has greatly benefited from reports of the Financial Sector Legislative Reforms Commission (2013), and the High Level Working Group on Resolution Regime for Financial Institutions (2014). The research and analysis done for those reports made it possible for this Committee to complete the task of drafting the Bill in a short span of time. The Committee also perused the publications of Financial Stability Board (FSB), and reviewed the best practices in other jurisdictions.

2 The Case for a Specialised Resolution Regime for Financial Firms

Financial firms are regulated with the objective of protecting consumers and promoting integrity, stability and resilience of the financial system. For these objectives to be achieved, it is important that the probability of failure of financial firms is maintained at an acceptably low level. Therefore, prudential regulation aims to ensure safety and soundness of financial firms by regulating, inter alia, the capital held by financial firms, risk management and internal control systems in financial firms, measures to manage the mismatch between liquidity of assets and liabilities, incentives in the financial firms, and other aspects. However, in financial firms, zero failure of financial firms is not always possible. Regulation will sometimes fail, and a prudentially regulated financial firm will become insolvent. Moreover, some instances of firm failure are good for creative destruction of inefficient firms. However, it is important to ensure that the failure of a financial firm is *orderly*, so that consumers are protected and systemic stability and resilience are preserved, without relying on taxpayer-funded bail-out.

The Insolvency and Bankruptcy Code, which is a comprehensive reform of the legislative framework for insolvency and bankruptcy, was enacted earlier in 2016. The Code at present does not cover financial firms, and empowers the Central Government to notify which financial firms may fall under the Code's purview. Implicit in this is the recognition that financial firms are different from other firms, and their failure may be handled differently. Financial firms are different from other firms in that compared to their own resources, they handle large amounts of consumers' money. Banks, insurance companies, payment systems, etc channel a large part of the savings of households and firms. Some of the financial firms are also systemically important, as their failure may disrupt the financial system and hurt the real economy. This is why, unlike most non-financial firms, financial firms tend to attract intrusive interventions from statutory regulators, including frequent on-site inspections, close off-site monitoring of business, detailed restrictions on business, and so on. Standard insolvency and bankruptcy processes are usually not considered suitable for financial firms, especially those handling consumer funds, and those considered to be of systemic significance. Such processes, even if they are efficient, tend to drag on for longer periods of time than are acceptable for instances of financial firm failure, exacerbating the threats to consumer funds and systemic stability. Also, the fear of a financial firm going into a long-winded process may trigger "runs" on these firms even when they have not really failed. Hence, it is important to have a credible resolution regime under an expert statutory institution that is able to ensure efficient, orderly and fair resolution of financial firms.[1] A specialised resolution corporation has been recommended by the FSLRC and the High Level Working Group on Resolution Regime for Financial Institutions.

Many countries have developed specialised resolution regimes for various categories of financial firms. The Financial Stability Board recommends operational independence as a Key Attribute of resolution regimes. In several jurisdictions, including USA, Canada, Malaysia, Mexico, Japan, Korea, etc., these are in the form of separate institutions with resolution powers. As financial firms are increasingly operating under conglomerates, no single regulator has a complete view of the risks and optimal resolution strategies for conglomerate as a whole. There is a need for setting up an independent financial resolution corporation. This corporation would also subsume the existing deposit insurance function performed by the Deposit Insurance and Credit Guarantee Corporation, as the resolution and deposit insurance functions usually go hand in hand. So, as a new institution is established, the DICGC would cease to exist.

Resolution regimes have gone through many stages of evolution. The global financial crisis of 2007-08 revealed certain limitations of resolution frameworks in many countries, forcing their governments to bail out failing financial firms or to allow them to go through the regular bankruptcy process. Although most countries had deposit insurance systems that helped mitigate losses to consumers of banks, many countries did not have specialised

[1]Only certain financial firms that do not handle consumers' money and do not pose systemic risk may be covered under the Insolvency and Bankruptcy Code, as the rationale for covering under a specialised resolution regime does not apply to such firms.

resolution regimes. They relied on temporary administration of failed financial firms or the liquidation process under their regular bankruptcy systems. These proved to be inadequate during the crisis.

Most of the resolution regimes did not have the capability to resolve non-banks and systemically important banks. For example, in the US, the Federal Deposit Insurance Corporation's advanced resolution capability, which had, over the years, resolved thousands of failed banks and credit institutions, was deemend to be inadequate for handling failure of certain non-banks and rapid failure of some systemically important banks. The government had to choose between letting the firms go into regular corporate bankruptcy system (eg. Lehman Brothers) or bailing them out (eg. AIG).

Since the global financial crisis, several countries have begun building, strengthening or expanding their resolution capabilities (discussed later). The Financial Stability Board (FSB) and other multilateral associations and agencies have published substantial research and standards for designing and building sound resolution regimes. The existing legal framework for resolution in India is far from adequate, and therefore a new legal framework and organisational capacity is required to ensure that failures of financial firms in India can be orderly.

3 Present Legal Framework for Deposit Insurance and Resolution in India

The legal frameworks for different institution-types are summarised in this section. This section also dwells on the two sets of constraints on building a resolution regime: treatment of cooperative banks as per the Constitution; and exemption given in statutes governing public sector financial firms.

3.1 Banking institutions

There are different legal frameworks for scheduled commercial banks and cooperative banks. While the RBI enjoys powers to wind-up or amalgamate a scheduled commercial bank (except those public sector banks whose statutes prohibit such actions by any agency other than the Central Government), it does not have such powers over cooperative banks.

3.1.1 Deposit insurance

The Deposit Insurance and Credit Guarantee Corporation (DICGC), created and governed under the DICGC Act, 1961, provides insurance on deposits. The following banks are covered by the deposit insurance scheme:

- All commercial banks including branches of foreign banks functioning in India, Local Area Banks and Regional Rural Banks.
- All eligible cooperative banks as defined in the DICGC Act. Eligible cooperative banks are those functioning in states/union territories that have amended their Cooperative Societies Act such that RBI may order the Registrar of Cooperative Societies to wind up a cooperative bank or to supersede its committee of management; and the Registrar may not take any action of its own accord for winding up, amalgamation or reconstruction of a cooperative bank without prior sanction from RBI.

Banks are granted insurance cover upon the payment of an insurance premium. DICGC does not insure deposits of governments, inter-bank deposits, deposits of State Land Development Banks with State cooperative banks, any amount due on account of and deposit received outside India, and any amount which has been specifically exempted by DICGC with prior approval from RBI. In case of a bank failure, such uninsured deposits are subject to recoveries from liquidation.

If an insured bank is wound up or goes into liquidation, every depositor is entitled to their deposits up to Rs. one lakh, as on the date of cancellation of licence or of the order for winding up or liquidation. The liquidator must submit to DICGC a list of the deposits, within three months of assuming charge. DICGC must pay the amount within two months from receiving such lists. In case of amalgamation of a bank, DICGC pays the difference between the amount due to the depositors (or Rs. one lakh, whichever is less) and the amount actually received under the scheme.

3.1.2 Resolution of scheduled commercial banks

The general process to be followed in the case of a failing banking company is provided in the Banking Regulation Act, 1949 (BR Act). The Act provides for three types of resolution instruments: forced mergers (including reconstruction), acquisition of undertaking, and court-ordered winding up. The main instrument of resolution under RBI's purview is forced merger, where an insolvent bank is forcibly merged with another bank. In such cases, RBI applies to Central Government for a moratorium on a banking company, after which the RBI prepares a scheme for merger with any other firm.

The Central Government may order acquisition of the undertaking of a banking company under certain circumstances, upon receipt of a report from the RBI. No undertaking of any banking company shall be so acquired unless such banking company has been given a reasonable opportunity of showing cause against the proposed action.

RBI may apply to High Court to wind up a banking company in specific circumstances, including, if the banking company:

- fails to comply with paid-up capital and reserves requirements;
- is no longer entitled to carry on banking business in India;
- is prohibited from receiving fresh deposits under BR Act or RBI Act, 1934; or
- fails continuously to comply with any other requirements of BR Act.

RBI may also apply for winding up if it believes that:

- a court-sanctioned arrangement cannot work satisfactorily;
- the banking company is unable to pay its debts; or
- the continuance of the banking company is prejudicial to the interests of its depositors.

3.1.3 Resolution of Cooperative Banks

The legislative competence of the Union and State Governments is determined by Article 246 of the Constitution read with the Seventh Schedule. Matters falling in List I of the Schedule are within the exclusive competence of the Union; those in List II are within the exclusive competence of the State; whereas those in List III fall in the concurrent competence of the Union and State. Entry 45 of List I pertains to 'banking' over which the Union is solely competent to legislate. The subject-matter of 'bankruptcy and insolvency' is enshrined in Entry-9 of List III and confers concurrent jurisdiction on the Union and the States to legislate on this issue. Entry 32 of List II deals with cooperative societies and vests exclusive legislative competence in the States in this matter. A cooperative bank located in a single state, is regulated by the RBI and the Registrar of Cooperative Societies (RCS) of its state. A cooperative bank operating in multiple states is registered under the Multi-State Cooperative Act, and regulated by RBI and the Central Registrar of Cooperative Societies (CRCS).

Multi-state cooperative banks are wound up under the direction of the Central Registrar, and state cooperative banks under the respective state's RCS. However, the Multi-State Cooperative Societies Act says that the the Central Registrar shall make an order for the winding up of a cooperative bank if so required by the RBI. Similar provisions have been included, through amendments in cooperative society Acts of states. The RBI may require winding up of a cooperative bank for similar reasons for which it applies for winding up of scheduled commercial banks. However, such a recommendation by the RBI may not in all cases lead to swift winding up of the cooperative banks. Typically, winding up and liquidation of cooperative banks takes several years.

3.2 Resolution of insurance firms

The framework is limited to the Insurance Act, 1938, which envisages three methods of resolving insurance firms:

1. *Appointment of administrator:* If the Insurance Regulatory and Development Authority of India (IRDAI) finds that a life insurer is acting in a manner prejudicial to the interests of policyholders, it may, after giving the insurer an opportunity to be heard, appoint an administrator to manage the insurer's affairs. The administrator would work under the direction and control of IRDAI. The administrator would, as soon as possible, file a report with the IRDAI on the best course of action for the policyholders. The administrator's suggestions may include, transfer of the business to some other insurer; carrying on of the business for the original sum insured with the addition of bonuses that attach to the policies or for reduced amounts; or winding up; etc. On the filing of this report, the IRDAI may take such action as it thinks fit for promoting the interests of policyholders.

2. *Winding up:* National Company Law Tribunal (NCLT) would govern the winding up proceedings, which would be as per the company law, except as otherwise provided. Winding up may be directed if:

    - A petition is made by requisite number of shareholders or policyholders, with court sanction.

- An application is made by IRDAI on grounds that the insurer:
  - has continuously failed to comply with the Insurance Act.
  - is deemed insolvent (e.g., based on its failure to maintain solvency margins) based on returns furnished or any investigation made.
  - its continuance is prejudicial to the interests of policyholders or the general public.

3. *Amalgamation:* If the Authority is satisfied that in the public interest, or in the interests of the policy-holders, or in order to secure the proper management of an insurer, or in the interests of insurance business of the country as a whole, it is necessary so to do, he may prepare a scheme for the amalgamation of that insurer with any other insurer. Such scheme can only be prepared if the other insurer has given his written consent to the proposal for such amalgamation

The Act also provides for voluntary winding up on limited grounds: an insurer may wind up voluntarily only to effect an amalgamation; or if it cannot continue its business due to its liabilities.

3.3 Resolution of Non Banking Financial Companies

Under the Reserve Bank of India Act, 1949, RBI may file an application under the Companies Act, 2013 for winding up a Non Banking Financial Company if it determines that it:

- is unable to pay its debt;
- has become disqualified to carry on the business of a non-banking financial institution; or
- has been prohibited by the Bank from receiving deposit by an order and such order has been in force for a period of not less than three months.

Winding up application can also be filed if the RBI determines that the continuance of the non-banking financial company is detrimental to the public interest or to the interest of the depositors of the company. A copy of every winding up application made by the RBI is to be sent to the Registrar of Companies. All the provisions of the Companies Act, 2013 relating to winding up of a company apply to a winding up proceeding for an NBFC initiated on the application made by the RBI.

3.4 Resolution of pension funds

The Pension Fund Regulatory Authority of India Act (PFRDA Act) includes the following provisions that are relevant for resolution of intermediaries regulated by PFRDA:

- **Management by Administrator:** Section 19 of the PFRDA Act empowers the PFRDA to make a report to the Central Government if the Authority has reason to believe that a Central Recordkeeping Agency (CRA) or Pension fund is acting in a manner that is prejudicial to the interest of the subscribers and the Central Governmentt may, if it deems fit, appoint an administrator to manage the affairs of the Pension fund or the CRA under the direction and control of the Authority.
- **Attachment of assets of intermediary:** Under Section 31(1) of the PFRDA Act 2016, the Authority has the power to make orders for attachment, retention, preservation , interim custody and sale of any asset or property which is regulated by the provisions of the PFRDA Act, upon application by any person
- **Supersession of the management of the intermediary** Under Section 31, PFRDA has the powers to supersede the Governing Board or Board of directors or management of the intermediary in accordance with the provisions of the Regulations and appoint an administrator to manage the affairs of the intermediary.
- **Transfer of assets from one pension fund to the other:** As Pension Funds only mange the pension assets held by the Custodian standing in the name of the NPS Trust for the benefit of the subscribers, if deemed necessary by the Authority on Cessation, cancellation or suspension of the Certificate of Registration, PFRDA (PF) 2015 regulations provide that the Authority may direct the pension Funds to transfer the assets, records, documents and information to another pension fund at its own cost.

3.5 Resolution of Public Sector Financial Firms

Public ownership of financial firms, especially in the banking industry, creates peculiar problems for resolution:

- The State Bank of India Act, 1955, exempts the State Bank of India (SBI) from any laws relating to winding up of companies, and can only be placed in liquidation by order of the Central Government, and the liquidation would happen in such manner as the Government directs. Although the SBI Act provides for acquisition of other banks by SBI, it does not provide a framework for acquisition of SBI by other banks.
- The Regional Rural Banks Act, 1976, also exempts the Regional Rural Banks (RRBs) from any laws relating to winding up of companies, and can only be placed in liquidation by order of the Central Government, and the liquidation would happen in such manner as the Government directs. The RRB Act also provides for amalgamation of RRBs with other RRBs.
- The Banking Companies (Acquisition and Transfer of Undertakings) Act,1970/1980 also provides for exemption from laws on winding up of companies, and states that only an order of Central Government can lead to winding up of the banks nationalised under those Act.
- Section 38 of the Life Insurance Corporation Act, 1959 (LIC Act) provides a similar exemption from winding up and liquidation of the LIC. Policies issued by LIC are also backed by sovereign guarantees. Section 37 of the Act says that the sums assured by all policies issued by the Corporation including any bonuses declared in respect thereof and the amounts assured by all policies issued by any insurer the liabilities under which have vested in the Corporation, and all bonuses declared in respect thereof, whether before or after the appointed day, shall be guaranteed as to payment in cash by the Central Government. Moreover, such guarantees need not be explicit for consumers to expect Government support in cases of failure of State-run financial firms. As the case of Unit Trust of India showed, even implicit guarantee can be invoked, given a certain political and economic context.

3.6 The Insolvency and Bankruptcy Code

The Insolvency and Bankruptcy Code 2016 creates a framework for time-bound insolvency resolution of companies and individuals. The insolvency resolution processes are to be completed within 180 days. If the insolvency resolution is not completed in time, the assets of the borrowers may be sold to repay creditors. Under the Code, resolution will be conducted by licensed insolvency professionals (IPs). These IPs will be members of insolvency professional agencies (IPAs). IPAs will also furnish performance bonds equal to the assets of a company under insolvency resolution. The Code also envisages Information utilities (IUs) to collect, collate and disseminate financial information to facilitate insolvency resolution. The National Company Law Tribunal (NCLT) will adjudicate insolvency resolution for companies. The Debt Recovery Tribunal (DRT) will adjudicate insolvency resolution for individuals and partnership firms. The Insolvency and Bankruptcy Board of India will be set up to regulate functioning of IPs, IPAs and IUs.

3.7 Oversight on amalgamations

The Competition Act (CA) requires all combinations - mergers, amalgamations or any acquisition of control - that exceed specified thresholds to be notified to the Competition Commission of India (CCI) (the regulator for competition issues) for review on any appreciable adverse effects on competition. CCI will not allow a combination unless it is modified to remove such effects. CCI has upto 210 days to respond to a notification of a combination, although Combination Regulations require that CCI shall endeavour to do so within 180 days from the filing of the notice.

In exercise of the powers conferred by clause (a) of Section 54 of the Competition Act, the Central Government, has exempted banking companies in respect of which the Central Government has issued a notification for moratorium under Section 45 of the Banking Regulation Act, 1949, from regulation of combinations for a period of five years. The notification was issued in 2013. However, oversight of combinations of other financial firms continues to be under the purview of the CCI.

3.8 Limitations of the present framework

The current legal framework has certain limitations. In the Committee's view, the following limitations must be addressed, so that the new legislative framework does not lead to the problems that may have occurred in the past:

- **Multiple authorities:** The powers and responsibilities for resolution are given to respective regulators, which prevents specialised resolution capabilities from getting developed, and impedes cross-sectoral learnings. For example, expertise in resolving fund-based businesses can be useful across mutual funds, insurance and pension domains, and specialised capability to conduct such resolution may be best placed in one institution. Also, under the present framework, resolution of conglomerates is difficult.

- **Different laws for similar entities:** Different legislations may apply depending on the type of financial firm being resolved. The Banking Regulation Act, 1949 generally deals with banks, but there are specific legislations which deal with financial firms that have been created or acquired by statute (e.g., the State Bank of India Act, 1955). The resolution of commercial banks is different from that of cooperative banks. This is because most of the functioning of cooperative banks is regulated by registrars of cooperatives at the state level, or at best, by a combination of regulations by the states and the centre.

- **Risk of forbearance:** Since, under the present legal framework, regulators are also given powers to trigger resolution, there is a risk of regulatory forbearance delaying the acknowledgment of problems in a failing financial firm. While the primary role of a regulator is to try and revive a failing institution, resolution only aims at ensuring orderly failure. Regulators may delay resolution in hope of reviving the institution, but this would conflict with the need for timely and speedy resolution. Therefore, a certain degree of independence for resolution regimes is considered desirable,

- **Lack of competitive neutrality:** For public sector financial firms, an implicit or explicit guarantee by government, and exemptions from mainstream resolution systems, may be creating a perception of safety in the minds of consumers, and an expectation that they will be insulated from the failure of such firms. This has detrimental consequences for competition in the financial system. For instance, in times of crises, there is a flight of funds towards public sector banks and away from private banks, which is a competitive advantage arising solely out of ownership. It is important for competitive neutrality that a level playing field be created between public sector and private sector firms. Among other things, this means application of resolution framework to all financial firms - public and private.

- **Limited instruments:** The instruments presently provided under the respective legislations are limited, and so is legislative guidance on the process leading up to the resolution. In the case of a bank, for example, the banking regulator (the Reserve Bank of India) typically uses one of two methods: amalgamation or merger with another bank; or winding up of the bank. Other resolution instruments are not available.

- **Limited institutional capability:** Except for the Insolvency and Bankruptcy Code, resolution-related provisions of laws discussed above are minor parts of larger laws. They do not appear to envisage full-fledged institutional capability to handle failure of financial firms in a quick and efficient manner. These laws have not led to creation of institutional capability for quick and efficient resolution. When a financial firm fails, its regulator puts together a team to handle the failure.
- **Gaps in coverage:** Many types of financial firms do not have special resolution-related legal provisions. For example, respective legislations do not contain resolution-related provisions for companies managing mutual funds, or for securities firms.
- **Competition review:** At present, only banks have been exempted from seeking approvals from CCI before a regulator-initiated amalgamation. Approvals from CCI for amalgamation of other types failing financial firms would lead to delays in resolving those firms, especially when the situation of a firm is deteriorating rapidly.

While drafting the Code, the Committee has attempted to address these limitations. The Committee has also reviewed international best practices and standards, and incorporated many of the learnings in the draft Bill.

4 International standards and practices

In the Committee's view, simply overcoming the limitations of the present resolution frameworks in India may not suffice to create a suitable resolution framework. The regime should also be consistent with international best practices and generally accepted standards for such frameworks. Therefore, the Committee studied guidances issued by the Financial Stability Board, and to the extent suitable, drafted the Bill to be consistent with the Key Attributes given in those guidances. These guidances are supposed to be based on international best practices. Wherever appropriate, the Committee has modified the attributes to account for context-specific factors. The Committee also reviewed country experiences with resolution frameworks, and attempted to gather relevant international experience to identify the features of a suitable resolution regime for India.

According to FSB, the aim of an effective resolution regime is to carry out the resolution of financial institutions without causing either severe systemic disruption or loss to taxpayers, while protecting vital economic functions, thereby making it possible for shareholders and creditors to absorb losses in a manner that respects the hierarchy of the claims in liquidation. For this, an effective resolution regime should:

- ensure the continuity of systemically important financial services;
- protect, where applicable and in coordination with the relevant insurance schemes and arrangements such depositors, insurance policy holders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;
- allocate losses to shareholders and creditors according to the hierarchy of claims;
- not rely on public solvency support, and not create expectation of such support
- avoid unnecessary destruction of value, and seek to minimise the overall costs of resolution in home and host jurisdictions and, where consistent with the other objectives, losses for creditors;
- provide speed, transparency and predictability through procedural clarity
- provide a mandate in law for both domestic and international coordination
- ensure that non-viable firms can exit the market in an orderly way
- be credible, thereby enhancing market discipline and incentivizing market-based solutions

FSB recommends that a resolution regime must have jurisdiction in place to provide a resolution authority with a range of powers and options to resolve a non-viable firm, and should hence include:

- Stablization options for the continuation of important functions either through the sale or transfer of the shares in the firm or the sale of part or all of the firms business to a third party organization such as a bridge institution
- Liquidation options that provide for the orderly closure of the firm in a manner that protects its consumers.

FSB says that any financial institution that would be systemically significant should it fail needs to be subject to a resolution. The resolution regime needs to extend to: holding companies of a firm; non-regulated, yet significant operational entities of a business group; and branches of foreign firms. Financial Market Infrastructures (FMIs) need to have resolution regimes appropriate for FMIs critical role in financial markets, and the choice of resolution powers must take this into account.

FSB recommends that there should be a resolution authority responsible for exercising the powers of a resolution regime over the firms within its scope. If there are multiple authorities, the jurisdiction must identify a lead authority in charge of coordinating the resolution of comprising legal entities.

In addition to upholding the ideas of an effective regime, the authority should: be able to enter into agreements with the authorities of other jurisdictions; have operational independence consistent with its responsibilities, transparency, governance and resources; be accountable and subject to rigorous evaluation to judge its effectiveness; protected against liability for its actions while carrying out resolution powers in good faith; have unimpeded access to firms during the resolution process.

Resolution should only be initiated when a firm is no longer viable and has no prospects of becoming so. The resolution regime must have a timely entry into the firm before its balance sheets are insolvent and its equity is wiped out. Most importantly, the entry of the regime into the firm needs to be subject to suitable standards or indicators of non viability of the firm. General resolution powers should include:

- Removal and replacement of senior management directors
- Appointing an administrator to control and restore the firm
- Operating and resolving the firm through exercise of powers like contracts termination, sale of assets, etc
- Ensuring continuity of essential services
- Overriding shareholders rights
- Establishing a temporary bridge institution to take over firm management
- Carrying out bail-in to ensure continuity of essential services
- Liquidation of the firm, in part or whole.

Resolution instruments should include:

- Transfer and sale of assets and liabilities

- Establishment of a Bridge Institution, which are are third-party organizations with the power to take over the operations and critical functions of the affected firm.
- Bail-in within the resolution
- Special instruments for resolution of insurers: portfolio transfer moving all or part of the insurance business to another insurer without the consent of each and every policyholder; and discontinuing the writing of new business by an insurance firm in resolution while continuing to administer existing contractual policy obligations for in-force business (run-off).

FSB recommends that resolution authorities should be able to: apply one or a combination of resolution powers; apply different types of resolution powers to different parts of the firms business; and initiate a wind-down for non-critical operations. while choosing resolution instruments, the resolution authority should take into account the impact on the group as a whole and in other affected jurisdictions, and undertake best efforts to avoid taking actions that could trigger instability elsewhere in the group or in the financial system.

FSB also makes specific recommendations on legal framework for set-off, netting, collateralisation, and segregation of client assets. It recommends clarity, transparency, and enforceability of the legal framework during a crisis or resolution of firms. FSB suggests that entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights, provided the substantive obligations under the contract continue to be performed. If contractual acceleration or early termination rights are nevertheless exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of resolution. Such a stay should be strictly limited in time, be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty, and not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to resolution, occurring before, during or after the period of the resolution. The stay may be discretionary (imposed by the resolution authority) or automatic in its operation, but the framework should be clear.

FSB also recommends certain safeguards to ensure optimal use of resolution instruments. First, it recommends that resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firms failure or to maximise the value for the benefit of all creditors as a whole. Specifically, FSB recommends that equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt has been written-off entirely (whether or not such debt has been written down earlier). FSB also recommends that creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime (no creditor worse off than in liquidation safeguard). Other safeguards recommended by FSB include:

- protection of directors and officers of the firm under resolution for actions taken when complying with decisions of the resolution authority;
- judicial actions not to put excessive constraints on the resolution authority's capacity to exercise the resolution powers with the necessary speed and flexibility. Instead of providing for judicial actions to constrain or reverse the resolution measures, the resolution law should provide for redress by compensation, if justified.
- possibility of temporary exemptions from or postponement of disclosure requirements required by the firm, where such disclosure could affect the successful implementation of resolution measures.

FSB conducted a thematic review of the status of implementation of key attributes in its 24 members countries. The review was published in March, 2016, It found that France, Germany, Italy, Spain , United Kingom, The Netherlands, and Switzerland have the full range of resolution powers (there are twelve such powers under key attributes). In EU, this is because of the implementation of EU-wide Bank Recovery and Resolution Directive (BRRD). US has all the resolution powers apart from an explicit power for the resolution authority to require continued provision of critical shared services by group companies. Six other jurisdictions (Australia, Canada, Japan, Korea, Mexico, Singapore) have all but two or three of the powers. The powers lacking are continuity powers, bail-in or a stay on the exercise of early termination rights. The remaining ten jurisdictions have four or fewer of the required resolution powers. The review also found that a number of jurisdictions still rely largely on supervisory powers or sector-specific insolvency law without a designated administrative resolution authority with a broad range of powers and the ability to exercise them without prior shareholder or creditor approval. India is an example of such a country. However, based on recent reforms, it appears that this is changing. The trend appears to be that countries are establishing separate resolution regime having a designated administrative resolution authority. Some countries have empowered their deposit insurance corporations to give them broader resolution powers.

There is significant variation in jurisdictions on the criteria for use of resolution powers and their level of detail. The criteria are a combination of one or more of three broad types: criteria based on a determination of (likely or actual) failure; criteria related to the public interest; and criteria aimed at establishing that the use of powers is necessary and proportionate. Among the resolution tools, bail-in is least well established. Only the EU Member States, Switzerland and the US are currently able to achieve a creditor-financed resolution. Only eight jurisdictions, including EU Member States, Singapore and Switzerland, have an explicit statutory power to ensure continued provision of services by group entities. Eleven jurisdictions have statutory provisions for the imposition of temporary stays on the exercise of contractual early termination rights. These include Canada, EU Member States, Japan, Mexico, Switzerland, US. In all cases, the power is exercisable by the resolution authority with no court involvement. The features of the regimes for temporary stays differ across jurisdictions in a number of respects (e.g. classes of contracts covered, types of contractual rights that may be stayed, duration of stay, safeguards etc.).

Seventeen jurisdictions, including Australia, Canada, China, Hong Kong, Japan, Mexico, South Africa, US, etc, have put in place a requirement - either through statute or guidance - for development of recovery plans. Thirteen jurisdictions are engaged in resolution planning.

Only nine jurisdictions currently have explicit statutory powers to require appropriate measures where necessary solely in order to improve their resolvability. Nine other jurisdictions report that supervisory authorities have some powers to require supervised banks to make changes to their business organisation and legal structure, but the purposes for and circumstances under which authorities can exercise such powers vary.

The review also found that thirteen jurisdictions have ongoing or planned reforms to their resolution regimes. In addition to India, these include: Australia, Brazil, Canada, China, Hong Kong, Indonesia, Korea, Russia, Saudi Arabia, Singapore, South Africa, and Turkey.

The Committee has taken note of this progess and the key attributes while drafting the Bill. The Committee has also observed that this is a rapidly evolving area, and many more reforms are likely to happen in the coming years.

5 A New Resolution Regime for India

The need for a specialised resolution regime for financial firms in India has been acknowledged previously. In its report submitted in 2013, the FSLRC recommended a Resolution Corporation, and provided for it in the draft Indian Financial Code that the Commission submitted. In 2014, the High Level Working Group on Resolution Regime for Financial Institutions, co-chaired by the Ministry of Finance and the RBI, also recommended a specialised resolution regime. The Committee has taken cognisance of these recommendations and of international experience of building similar regimes. The Committe has drafted a Bill that would, when enacted, create a resolution regime with the following features:

- An independent Financial Resolution and Deposit Insurance Corporation (FRDIC) that would perform resolution functions for a wide range of financial firms, and provide deposit insurance to banks. Creation of this Corporation would conicide with repeal or amendment of resolution-related provisions in sectoral Acts as listed in Schedules of the Draft Bill, as well as substantial repeal of the DICGC Act to transfer the deposit insurance powers and responsibilities to the FRDIC.
- The FRDIC's board would have representation from financial regulators and the Central Government , and it would also have whole-time and independent members. It would be empowered to recruit and retain suitable human resources in the organisation. FRDIC would be financed by levying premia and fees on the financial firms covered by it. It would create clearly separated funds for deposit insurance, resolution, and general administration.
- The resolution framework would be intergrated with a prompt correction action framework, wherein the roles of the respective regulators and the FRDIC would be clearly defined. Under the framework, the respective regulator and the FRDIC would work in lock-step as the financial situation of a covered service provider deteriorates. While the regulator's emphasis would be on ensuring recovery of the covered service provider, the FRDIC would focus on preparing for resolution and, once the covered service provider fails, on resolving it in a quick and or-

derly manner. As the covered service provider gets close to failure, the FRDIC would get substantial powers to ensure resolvability of the firm when it does fail, while the respective regulator's powers would cease to apply on the covered service provider, if these conflict with the resolution underway. Before that stage, regulators would continue to have substantial powers to pursue recovery of covered service providers.

- Once a financial firm is at the stage at which it is to be resolved, the FRDIC would be deemed to be its receiver, and would be able to apply a range of resolution powers, which would enable it to resolve or liquidate a financial firm. During this time of resolution, there shall be a stay on the commencement or continuance of all legal actions and proceedings against the covered service provider.

- Resolution instruments include: transferring the whole or part of the assets and liabilities of the covered service provider to another person; *bailing-in* the liabilities; merger, amalgamation or acquisition; liquidation; or a combination of these instruments. The FRDIC may also choose to temporarily run the covered service provider under a bridge entity and then use one of the other instruments of resolution to resolve it.

As discussed earlier, for cooperative banks and public sector financial firms, there are impediments to a sound resolution regime. The Committee recommends the following measures to help create a comprehensive resolution regime covering these entities:

- **Cooperative banks:** The problems of cooperative bank resolution outlined above are directly linked to the Constitutional allocation of powers between the Centre and states and requires a close review of the arbitrage opportunities created by such allocation. In the Committee's view, it can be argued that there is no justification for subjecting cooperative banks to a dual (and less effective) regime only because they are incorporated as 'cooperatives'. The Financial Sector Legislative Reforms Commission had recommended that 'State Governments should accept the authority of Parliament....to legislate on matters relating to the regulation and supervision of co-operative societies carrying on financial services'. This is particularly true in the context of resolution of failed cooperative banks.

  While it is possible to argue that since 'bankruptcy and insolvency' falls under the concurrent list, the Parliament has the competence to legislate on resolution of all failed insolvent cooperative banks, in order to protect the proposed law from any legal challenge, the Committee recommends that the Government should consider introducing necessary amendments to the Constitution for carving out all cooperative banks from the legislative competence of the States at least for the purpose of resolution to facilitate direct supervision and enforcement by the Resolution Corporation and RBI under the proposed Bill. If this option is found infeasible, another option would be request individual states to amend their respective cooperative society laws to give powers to the RBI and the FRDIC to supervise and resolve the cooperative banks. They might accept this proposal in the interest of consumers of cooperative banks.

- **Public sector financial firms:** At present the statutes governing these firms make it difficult for FRDIC to resolve them. The Committee is recommending amendments in the statutes to give FRDIC the powers related to winding up that presently the Central Government has in laws such as the SBI Act. In the Committee's view, this would help overcome the problem significantly. However, the ideal option would be to corporatise these firms. Corporatisation of public sector financial firms would enable their resolution by FRDIC. This would entail amendments to their respective laws, registration of these firms under the Companies Act, and their licensing under the respective sectoral laws. This would also enhance competitive neutrality in the financial system.

6 Establishment of the Agency

The Committee recommends that FRDIC be established as a body corporate with head office in Mumbai. The FRDIC board would have a Chairperson, and it should also have representation from Ministry of Finance, RBI, SEBI, IRDAI, and PFRDA. The board should have upto three whole-time members, and two independent members. The term of office of the Chairperson and members should be five years or till they attain the age of sixty-five years. The Committee has drafted provisions on process of appointing or removing members of the board, and the conduct of board meetings. The Committee also recommends giving powers to the FRDIC to appoint officers and employees, and to pay them salaries and allowances it deems suitable for the qualifications and experience of the persons it seeks to recruit. The FRDIC should have substantial powers to conduct searches and seizures, investigations and inspections. However, these powers should be available to the FRDIC in certain circumstances as laid down in the Bill.

7 Objectives

Clear objectives pertaining to the critical tasks of the agency are crucial for achieving high performance in government agencies. Such clarity helps the agency's governance hold the body of the agency accountable, and the Parliament can also hold the agency accountable with respect to achievement of the objectives. The Committee recommends that the FRDIC should pursue the following objectives:

1. Contributing to the stability and resilience of the financial system;
2. Protecting consumers up to a reasonable limit; and
3. Protecting public funds, to the extent possible.

These objectives flow directly from the rationale for FRDIC. The FRDIC should prioritise its actions in a manner that these objectives are met. These objectives are synonymous with building capabilities to monitor covered financial firms, make an early assessment about a firm that is approaching failure, and undertake resolution action quickly. This requires a sophisticated system in which the FRDIC works in partnership with the respective regulator, but ultimately reaches an independent decision as the firm approaches failure.

8 Scope of coverage

In the Committee's view, all regulated financial service providers, except individuals, should be covered by the resolution regime. However, only banks should be given deposit insurance. Therefore, the Committee proposes two forms of registration with the FRDIC:

1. **Covered service providers:** Most regulated financial service providers are expected to be covered for the purpose of resolution, except those that would be notified to be covered in the Insolvency and Bankruptcy Code. The covered service providers under the proposed legislation include financial market infrastructure institutions, banking institutions, insurance service providers, and other financial institutions. These also

include systemically important financial institutions (SIFIs) that would be identified by the Central Government, based on criteria that the Government would prescribe in consultation with the appropriate regulator. RBI's representative was of the view that the identification of individual entities that are considered as systemically important as SIFI, or the identification of financial groups that have entities considered systemically important on solo basis as SIFIs should be left to the appropriate regulators with some exceptions. After considering this view, the Committee decided that it would be better if the designation power is given to the Central Government as no one regulator has the information or power required to classify conglomerates operating in multipe sectors, and many of the large, interconnected institutions in India are conglomerates. Moreover, some conglomerates include non-financial firms that are not regulated by any financial sector regulator. Moreover, in the present system, the Government chairs the Financial Stability and Development Council, which leads the financial stability work on behalf of the State. Designation of SIFIs is consistent with this responsibility that the Central Government presently has.

For certain categories of financial service providers (eg. pension funds), the option is left to the Central Government to notify whether they would be included under this Act. This is because the Committee felt that only certain sub-categories of these financial firms should be covered under the resolution framework. For example, on pension funds, the Committee's view was that only those funds that are making promises of guaranteed returns that may lead to insolvency risk for the asset management companies managing the pension fund may be required to be brought under the resolution purview. PFRDA representative pointed at the provision of the PFRDA Act that requires products with 'minimum assured returns' to be offered. However, the Committee's view is that this decision should be left to a future Central Government notification, to be issued when such products are launched in the market.

All covered service providers would pay fees for resolution, and in the event of failure, the FRDIC would become their receiver to undertake the suitable resolution action. The draft Bill lists the types of institutions that will be categorized as covered service providers, and will be covered by the FRDIC for the purposes of resolution. In order to avoid the possibility of delayed registration or non-registration, the Committee recommends that any firm that gets a license or authorisation to undertake a business that would categorise the firm as covered service provider be automatically deemed to be registered as covered service provider. For this, it is important that regulators immediately inform the FRDIC of such a license or authorisation being issued.

2. **Insured service providers:** The Committee recommends that only banks be given deposit insurance coverage. This coverage would be funded by risk-based premia collected from the registered banks. However, the concept of eligible cooperative banks should be brought in from the DICGC Act, so that only those cooperative banks enjoy deposit insurance coverage. In the Committee's view, banks should have no choice in the matter of getting deposit insurance. It must be mandatory for all banks, and the FRDIC also should compulsorily extend deposit insurance to all banking institutions by registering them as insured service providers. This registration may only be withdrawn under exceptional circumstances, such as cancellation of license, liquidation order, and so on. This would be done in consultation with the appropriate regulator.

The Committee recommends that the branches of foreign financial firms should also be covered under the resolution mechanism, so that the resolution of the branch is triggered if the parent entity is on the verge of failure and the domestic creditors get precedence in the claims on the assets of the branch located in India. This is important to protect the interests of consumers in India.

9 Key Functions and Powers

There are three sets of core functions of the FRDIC:

1. **Assessing risks and preparing for failure:** Financial firms are becoming increasingly complex and, as experiences of various crisis suggest, they may fail rapidly. Since the FRDIC has to resolve the failing firms, it is important that it should get early warning of failure, and prepare in advance. In the absence of this information, it might be late to trigger resolution, or may be ill-prepared to resolve a particular firm. So, FRDIC needs to directly or indirectly monitor the covered financial firms. However, the Committee notes that there is also a need to strike a balance between the burden of dual inspections and the need for the resolution authority to trigger resolution in a timely manner and to prepare for resolution. So, the Committee recommends that

substantive powers and responsibilities to monitor the covered service provider would remain with the respective regulators till it reaches a stage where it is close to failure.

The Committee has formulated a five-stage 'risk to viability framework' that would be specified by the FRDIC in consultation with the appropriate regulator for different categories of financial firms. So, the expertise of regulators and the FRDIC in thinking about risk to viability would go into defining the parameters. The first two stages ('low risk to viability' and 'moderate risk to viability') would be such that the covered service provider's probability of failure is below acceptable level. At these stages, the FRDIC would have no access to information on the covered service providers, and no power to conduct any kind of inspection. The only exceptions are systemically important financial institutions that would submit 'resolution plans' irrespective of their financial situation This plan will help in devising optimal resolution strategies for these firms. Also, SIFIs may, at any point, be jointly inspected by the respective regulator(s) and the FRDIC. FRDIC's participation in the joint inspection during the early stages of risk to viability would only be with the objective of understanding the business and not for classification or any other purposes. RBI's representative was of the view that the joint or independent inspections should be confined to imminent risk and critical risk to viability stages. In the Committee's view, these information gathering and inspection powers for SIFIs are required because of the potential complexity of such firms and the systemic risk posed by them. To ensure orderly resolution of SIFIs, it is crucial that FRDIC has the required information to understand the business, so that it is able to formulate resolution strategies.

The next stage ("material risk to viability") is when it can be said that the firm's financial situation begins to deteriorate, as its proability of failure becomes marginally higher than acceptable level. All firms at this stage would submit resolution plans to FRDIC, and the FRDIC would also get the power to call for information from a covered service provider. At this stage, the FRDIC may also conduct an independent inspection, if, in its opinion, the classification done by the regulator is incorrect. RBI's representative expressed concern that Resolution Corporations intervention at the "material risk to viability" stage could interfere with the restoration plan for the weak banks that RBI would have already initiated at this stage under its Prompt Corrective Action (PCA) framework. In RBIs view, the risk to viability classifications upto imminent risk to viability stage should be left to it. In the event of restoration failing to deliver at the ”material risk to viability” stage, RBI could classify the bank as imminent risk to viability following which the FRDIC could take further action including the initiation of the resolution process. The Committee noted this concern, and decided to recommend allowing the FRDIC to conduct inspection at this stage only after due consultations with the respective regulator. In the Committee’s considered view, this would help guard against the rare possibility of forbearance by a regulator, and would help protect consumers and preserve systemic stability and resilience. Moreover, this would be a limited inspection conducted only to assess the risk to viability of the firm, and not a general supervisory inspection. So, the Committee is recommending fewer monitoring powers to the FRDIC than were recommended by the FSLRC.

The fourth stage is ”imminent risk to viability”, wherein the firm is close to failure. It is expected that a firm would be in this stage only for a limited period of time, before being classified up to material risk to viability or a better stage or classified down to critical risk to viability. At this stage the FRDIC would have substantial powers to inspect the firm and to give it directions to take actions to improve its resolvability.

2. **Resolving failed financial firms:** Once a covered service provider crosses the threshold of failure, the FRDIC would become its receiver. On becoming the receiver, it must take quick and effective action to ensure orderly resolution. These actions include: transferring and disposing assets of the firm; temporary management of the failed firm through a bridge provider; merger, amalgamation or acquisition; or bailing-in the firm. The FRDIC would make payouts from the insurance fund to help resolve the insured service providers, which are presently recommended to include only banks.

   For insurance firms and central counterparties, additional instruments of resolution have been included in the draft Bill. For example, an insurance company may be resolved by being managed as a run-off entity, wherein the claims are settled upto the limit of available resources till the obligations are met. In the latter case, losses may need to be allocated to policyholders and others. For central counterparties, the FRDIC may, in consultation with the appropriate regulator, take measures to allocate uncovered losses caused by participant default, address uncovered liquidity shortfalls by obtaining additional funds from third-party institutions or from participants, replenish financial resources by making cash calls or by recapitalising, and so on. Moreover, the FRDIC may also place a temporary stay on early termination rights of parties of certain financial contracts, if it considers such an action necessary in the interest of systemic stability. RBI's representative was of the view that such stay should not extend to multi-lateral payment systems including CCPs and that there is need to protect the existing provisions in the PSS Act as it provides for settlement finality even in the event of a system participant or CCP going insolvent. The provisions of this Bill should not override the existing provisions as it may introduce ambiguity in the system. The Committee took a view that the power to put a stay on early termination rights triggered by resolution is required, but such powers must be used only when they are necessary to preserve systemic stability, and even then they should be exercised in consultation with the regulator.

3. **Managing funds for deposit insurance, resolution and administration:** The FRDIC will collect premia from the insured service providers, and fees from all covered service providers. The premia should go into a corporation insurance fund. The resolution fees should go into a resolution fund, which would be used to cover the costs of managing the resolutions. The other fees should go into a general fund from which the regular administative expenses of the FRDIC should be met. These three funds must be kept separate, and only used for the designated purposes.

As the firm gets closer to failure, two processes should unfold in such a manner that the regulator would enforce corrective action to bring the firm back into the clear, and the FRDIC would enhance its monitoring and start preparing for the firm's failure. It is in the interest of these agencies to share information and maintain a certain level of coordination, although they should be able to take independent action, depending on the firm's financial health.

10 Assessing risks and preparing for failure

As discussed earlier, the Committee recommends a detailed five-stage framework with a series of intervention measures to be undertaken by the respective regulator and the FRDIC to restore the financial health of the covered firms and to prepare for resolution, respectively. The framework requires determination of certain measures of risk and identification of certain *stages* of the financial condition of covered financial firms. Five stages in terms of risks to viability must be defined, and each covered firm will be classified. RBIs representative drew attention to the existing criteria used by RBI to classify banks into various risk categories and initiating the restoration plan under RBIs PCA framework based on such classifications. He expressed concern that determination of risk to viability based on separate set of criteria fixed by the FRDIC could create potential for a conflict and divergent risk assessments. He therefore was of the view that the risk to viability criteria for banks under the Bill should be determined by RBI. The Committee noted this point of view, and recommends that the FRDIC must specify the criteria for classification in consultation with the respective regulator. This would create the opportuntiy to harmonise the regulator's PCA framework and the risk to viability framework. In each stage, the FRDIC will implement a series of measures as described below:

1. **Low risk to viability:** At this stage, the covered service provider's financial health is such that its probability of failure is well below the acceptable level. At this stage, substantive powers to inspect and collect information should be only with the regulator. Therefore, only the regulator would be able to classify the covered service provider in a stage of risk to viability. However, the FRDIC may seek information from systemically important financial institutions for the purpose of preparing for resolution, as such institutions are expected to submit resolution plan even at this stage.

2. **Moderate risk to viability:** At this stage, the state of the covered service provider is such that it is just below the acceptable probability of failure. The powers of the regulators and FRDIC would be the same as in low risk to viability.

3. **Material risk to viability:** At this stage, the covered service provider first breaches the threshold of acceptable probability of failure. Typically, this stage would be when the covered service provider has breached the prudential regulation requirements. At this stage, the firm would be required to prepare and submit a resolution plan to the FRDIC, and a restoration plan to the respective regulator. The resolution plan will help in devising optimal resolution strategies for the firm, and the restoration plan would outline how and by when the firm plans to come back to a state of low or moderate risk to viability. The format and expected contents of these plans would be specified by regulation - made by respective regulator for restoration plan, and by FRDIC for the resolution plan. The FRDIC would also get powers to call for information from the covered service providers.

At this stage, the regulator would have powers to intervene in the business of the covered service provider, and attempt to revive it. The powers to take corrective actions are already given in the respective Acts, but wherever appropriate, the Committee has recommended additional powers for regulators to ensure prompt corrective actions. For example, the Committee is recommending several powers to be given to the appropriate regulator to ensure recovery of central counterparties. These powers will be available at this stage as well as the next stage.

4. **Imminent risk to viability:** At this stage, the state of the covered service provider is such that it is well above the acceptable probability of failure, and it is close to failure. This classification would happen on the basis of criteria given in regulation. A covered service provider can also be classified to be in this stage if it fails to submit a resolution plan or a restoration plan, if it fails to substantially implement the restoration plan, or if it is determined that there has been a major fraud in the firm that significantly affects the business. This stage is just one step before the covered service provider would go into resolution. Therefore, if the FRDIC seeks to classify a covered service providers to be in this stage, and the regulator's present classification is higher, it would have to hold consultation with the regulator, after which FRDIC may conduct an inspection, and then the FRDIC's classification would prevail. However, for central counterparties, only the respective regulator would have the power to classify into "imminent risk to viability" stage.

   The way the framework is conceptualised, it is expected that a covered service provider would stay in this stage only for a limited period of time, before improving its classification or getting classified into critical risk to viability stage and going into resolution. At this stage, regulators' powers would cease to apply, to the extent that such powers may conflict with the FRDIC's powers. In other words, this is the stage where the covered service provider would substantially go under the purview of the FRDIC. The FRDIC would get substantial powers to place restrictions on the covered service provider to enhance its resolvability. FRDIC would get powers to conduct independent inspections of the covered service provider. However, for central counterparties, the FRDIC's power is limited to joint inspections with the regulators. Regulator can continue to attempt recovery and restoration for central counterparties at this stage as well. These exceptions are being recommended considering the sensitive nature of the infrastructure function performed by the central counterparties, and the risk to the integrity of the system if the market senses any sign of resolution action being triggered. RBI's representative was of the view that there is a need to clearly define the role of the FRDIC, and that the role of FRDIC in relation to banks and other regulated entities should start only at the stage of 'imminent risk to viability'. In the Committee's view, the recommended formulation would achieve this clarity. Only regulator would have the power over CCPs till imminent risk to viability stage, and for other covered service providers, the FRDIC would get extensive powers only at imminent risk to viability. At material risk to viability, FRDIC would get powers to inspect and classify only in exceptional cases where there is a reasonable disagreement between the FRDIC and regulator.

5. **Critical risk to viability:** At this stage, the classification is done through an order in writing. As soon as this is done, the FRDIC would become the receiver for the covered service provider. It would then choose from the available resolution and liquidation tools to resolve the firm. If it sees the need, the FRDIC would apply to the NCLT, requesting to be appointed as liquidator for the covered service provider.

The respective regulator would classify a covered service provider to be in any of the first four stages. However, as discussed earlier, in the third stage ("material risk to viability") the FRDIC may, after consultaton with the respective regulator, conduct an inspection to independently classify the service provider into "imminent" or "critical" stage. This would be allowed only if FRDIC disagrees with the classification done by the regulator, and would be limited to those firms that are classified as being in "material risk to viability stage" by the regulator.

11 Resolution actions

If the covered financial firm continues to deteriorate, and reaches the stage of imminent risk to viability, it will fall within the receivership of the resolution corporation. Once it becomes a receiver an liquidator of a covered financial firm, the FRDIC will have powers over the firm, including the following powers:

1. To act as successor to all rights, titles, powers, and privileges of the firm;
2. To take over the management of the firm;

3. To exercise any of the tools to resolve the firm: sale to another financial firm, the incorporation of a bridge institution, or bail-in.

The tools of resolution that will be available to the FRDIC are:

1. **Acquisition/merger/amalgamation:** The most market-oriented tool of resolution involves selling all or part of the business of a covered firm to a viable commercial purchaser. This tool is useful because it would ensure continuity of services, and may incur minimal resolution cost.

   In the exercise of this tool, the FRDIC must ensure that thorough diligence is followed in inviting bids, giving accurate information, maximising the number of potential purchasers and exploring multiple transaction structures. This primarily requires skills in financial valuation, legal drafting, and arranging purchase and assumption deals. The FRDIC could choose to build all these skills in-house, or it could contract out some of these services to professional agencies. RBIs representative stated that Regulators should not be restrained from exercising their powers under their laws to sanction schemes for voluntary amalgamation proposed by a covered service provider with another, even when that covered service provider is in imminent or critical stages of risk to viability. However, the Committee took a view that continuance of such powers at the last two stages would be detrimental to the resolution process. Voluntary mergers are arranged by the financial firms themselves, and are finally approved/rejected by the regulator. Acquisition/merger/amalgamation faciliated by FRDIC is an important resolution tool, which is expected to be implemented in a manner that allows for competitive bidding, thus maximising the value for the society and minimising the costs to the society. At these stages, voluntary merger may not achieve the same result, as such a merger may not happen through a competitive process. Moreover, once the firm comes close to failure or has failed, its governance processes cannot be trusted to arrange a fair merger. Further, as FRDIC would become the receiver for the firm at critical risk to viability stage, voluntary mergers cannot happen at that stage.

2. **Bridge institution:** In some cases, it may not be possible to find a willing buyer for a failing financial firm. In such cases, especially if the resolution corporation determines that the continued operation of the covered financial firm is essential to provide financial services in the market, the FRDIC can establish a wholly-owned-subsidiary to bridge the time lag between the failure of such an institution and the satisfactory transfer to a third party. The management of the bridge

institution will try to sustain the firm till a suitable buyer is found, or till some other instrument of resolution can be applied. This is an interim solution which will culminate in anotheror a combination of resolution instruments, and/or in liquidation . The objective is always to move the assets back to the market, rather than holding it under the bridge institution for long.

3. **Bail-in:** In this instrument, certain creditors' interests into capital, so that tax-funded bail-outs become less likely. This instrument must be used in the order of hierarchy of claims that are usually honoured in a liquidation. Also, all claims that are equally placed should be written down to equal degrees, so that there is equal treatment of similarly placed creditors. This instrument is typically used where continuation of services of the failed financial firm is considered necessary, but the option of selling the firm not feasible.

4. **Liquidation:** A part or all of the failed firm may need to be put under liquidation, such that its assets are sold or run down over a period of time. This would be time-taking and expensive process, and the Committee expects that this would be used for the entire firm only if the sale is not possible and bail-in is not considered to be an optimal solution. It may also be used for parts of financial firms, when other parts have been sold along with equivalent liabilities. This can be done by dividing the failed firm into a good and a bad part, with the latter going into liquidation. If liquidation is considered necessary, the FRDIC would apply to the NCLT to be appointed as liquidator.

The FRDIC would need to choose one or a combination of these tools depending on the situation. The key principles to inform the choice of the instrument should be:

- No creditor should be worse off than they would have been had the entire firm been placed in liquidation.

- For FMIs and insurance companies, the main objective should be to ensure continuity of services for the consumers.

In addition to those discussed above, certain tools speific to institution-types have also been recommended. For example, for insurance companies, the Committee has included provision on solvent and insolvent *run-off* of a failed insurance firm, and also sale or transfer of insurance portfolio to another firm. For central counterparties (CCPs), certain powers to enable the FRDIC to resolve the CCPs have been included. These include: measures to allocate uncovered losses caused by participant default; measures to address uncovered liquidity shortfalls; measures to replenish financial resources including making cash calls on participants or recapitalizing such central counterparties; measures to re-establish a matched book by a central counterparty including forced allocation of contracts or partial or complete termination of contracts; measures to allocate losses that are not related to participant default including allocating additional capital; setoff, close-out, netting, collateralisation and segregation of member assets; and so on.

12 Additional functions

In addition to the core functions, the FRDIC will need to build other capabilities that flow from the nature of its activities. These functions include:

- *Legal:* Drafting contracts is essential to the work of the FRDIC, because in most instances, resolution will likely be done by purchase and assumption. The FRDIC might also need to contract out certain services to professional firms, and this requires legal skills. There will also be appeals against the resolution actions taken by the FRDIC, and the corporation will need to contest in a court of law.
- *Human resource management:* The FRDIC is likely to be a fairly large, hierarchical organisation comprising of people with varied skills. Such an organisation will require substantial human resource management capabilities.
- *Communications:* The FRDIC will be a consumer-facing agency that will need to communicate to the public its role as a provider of insurance to the covered financial firms. In times of firm failure, especially during a crisis, it will need to communicate aggressively to dispel false rumours and baseless concerns about the covered financial firms. The FRDIC will need to build these communication capabilities.
- *Accounting:* In the regular course of its activity, the Resolution Corporation (RC) will require an accounting system to keep records of its finances.
- *Budgeting:* The corporation will need to have budgeting and resource planning capabilities to ensure it is able to efficiently manage its finances.
- *Audit:* Like any such organisation, the FRDIC will need to build systems of internal audit. This is crucial for this agency because its reso-

lution actions may be contested.

13 Cross-border resolution

As finance has become significantly globalised, the FRDIC will also need to develop appropriate arrangements for firms that require cross-border resolution. Since many covered financial firms will be operating on a global level, an uncoordinated approach by the home and host countries' authorities would create difficulties in the way of resolution of such institutions in a manner that would protect interests of consumers and prevent the risk of a contagion. Deliberations are underway at international policy forums to devise optimal approaches to cross-border resolution. Led by the FRDIC, India may participate in emerging global arrangements on cross-border resolution. It should also be possible for the FRDIC to enter into information sharing and cooperation agreements with the counterparts in other jurisdictions. The Committee has included enabling provisions for entering to agreements with counterparts in other jurisdictions to help manage cross-border resolution of financial firms. However, the Committee recommends that such arrangements should be made on reciprocal basis, keeping in mind the interests of consumers residing in India, and the need to protect stability and resilience of the indian financial system.

14 Building the FRDIC

In the Committee's view, it is important that a detailed implementation plan for building the FRDIC is prepared, and necessary investments are made in the agency. There is also a need to transition smoothly from the present framework to the one envisaged in the draft Bill.

In this regard, the Committee envisages that on the day the relevant provisions of the Act are notified, deposit insurance and resolution powers and responsibilities should rest with the FRDIC. To enable this, substantial amendments to different Acts are included in the Bill. These, inter alia, include repeals of provisions giving resolution powers to respective regulators, and amendments to Acts exempting public sector financial firms from resolution and liquidation provisions in other Acts. The Committee envisages that the public sector financial firms would be registered as companies under the Companies Act, 2013, and would be licensed as other similar financial firms in their respective sectors are licensed. They may continue as majority government owned firms. As far as state cooperative banks are concerned, powers to direct the RCS of respective states to initiate liquidation or take other actions on failed cooperative banks would initially be with the RBI, as given in the respective state Acts. However, the Committee recommends that the States be requested to amend their cooperative society Acts at the earliest to enable FRDIC to exercise powers presently given to the RBI, once the cooperative bank is classified as imminent or critical risk to viability. Since these powers are indirect, and do not include direct resolution action by the RBI, even after the proposed amendments to State Acts, the FRDIC would not enjoy direct powers to resolve state cooperative banks. Giving FRDIC direct resolution powers over state cooperative banks may require a Constitutional amendment. However, it is possible to give FRDIC such powers over multi state cooperative banks, by amending the multi state cooperative societies Act.

The FRDIC would have substantial responsibilities to monitor and resolve a wide range of financial firms and to provide deposit insurance to banking companies. To ensure that it is able to perform its functions effectively, it is advisable that, once the proposed law is enacted, provisions of the law that deal with establishment of FRDIC, constitution of its Board and recruitment of human resources are notified early so that the institutional framework could be established and requisite regulations are notified for facilitating early implementation of the legal framework.

Members:

Shri Rajinder Kumar, Chief General Manager, RBI

Shri M. Ramaiah, Director, DICGC

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Member Convener: Dr. Shashank Saksena, Adviser (Capital Market), Department of Economic Affairs

Chairman: Shri Ajay Tyagi, Additional Secretary, Department of Economic Affairs

Annex I: Office order to constitute the Committee

Annexure II: Regulators' views on certain provisions of the draft FRDI Bill

- **RBI's views:** We thank the Government for providing us an opportunity to engage in the process of the drafting of the captioned Bill. The Drafting Committee has accepted many RBIs suggestions that are aimed at ensuring the efficiency of the resolution regime contemplated. However, as communicated during the deliberations of the Drafting Committee, we have a different view on a few issues as explained below.

  - *FRDIC's general powers with regard to risk to viability determinations and inspections:* The Bill provides for risk to viability determination of CSPs by RBI upto the first two stages of moderate risk to viability stage, and by the RC for the last two stages of imminent risk to viability and critical risk to viability. While the Bill allows the regulators to determine the classification into the middle category - material risk to viability, it allows the FRDIC to have power to reclassify the CSPs in this category in the higher risk categories. RBI is concerned that as per the risk to viability classification proposed under the Bill, the probability of default of the institutions classified in 'material risk to viability' category is only marginally above the acceptable level and at this stage the RBI's primary supervisory tool known as Prompt Corrective Action (PCA) would have just been invoked to address the issues faced by the relevant institution. The proposal in the Bill is also inconsistent with the provisions of FSBs Key Attributes inasmuch as the Attributes only envisage co-operation and coordination between the resolution authorities rather than the resolution authorities questioning the effectiveness of the supervisory authorities efforts to nurse the stressed institutions back to health. We apprehend that the above provision has the potential to create a conflict between the regulatory authorities and the Resolution Corporation on the risk to viability classifications. This may adversely affect the supervisory authorities recovery/restoration plans.

    We believe that the Resolution Corporation should add value to the financial sector stability by seeking efficient resolution of the financial firms in the most cost effective manner keeping in view the interests of all the stakeholders, rather than acting as an additional 'watchdog'. This can be achieved if the Resolution Corporation intervenes (including conducting independent inspection or assessment) only when the CSP is classified by the regulators as having 'imminent risk to viability'. The intervention by the Resolution Corporation at 'material risk to viability' stage may also not be necessary as the resolution would start only in the 'critical risk to viability' stage and taking control of the CSP at the 'imminent risk to viability' stage would allow the Resolution Corporation sufficient time to prepare for the resolution. The concern of some other members of the Committee that the Resolution Corporation should not remain unaware of the impending crisis in the institution could be addressed by specifying necessary sharing of information by the regulatory authorities with the Resolution Corporation when the CSP is classified as having 'material risk to viability.'

We also believe that expecting or requiring the regulatory authorities to provide supervisory or other information relating to the CSPs regardless of their risk to viability status would burden CSPs, the regulators and the Resolution Corporation with unnecessary information overload without commensurate benefits. Therefore, in our view the sharing of information should not be required in respect of the CSPs including SIFIs that are classified as having low or moderate risk to viability.

– *Criteria for risk to viability classifications:* While we agree with the classification scheme and the criteria provided in the Draft Bill, we are concerned that it would create potential for a conflict and divergent risk assessments, one under the risk to viability framework, and the other under RBIs risk-based supervision. Such divergent classifications could not only result in conflicting directions to the CSPs by the two authorities, but could also potentially obstruct the application and effectiveness of the RBIs PCA regime which is based on RBIs supervisory risk classification.

  We are of the view that the risk to viability criteria for banks should be determined by RBI so that the PCA framework is aligned with the risk to viability classifications in such a way that the institutions are not transferred to the resolution authority when they are still under restoration.

– *Designation of certain FSPs as Systemically Important Financial Institutions (SIFIs):* The Bill provides for designation of certain

FSPs as Systemically Important Financial Institutions (SIFIs) based on the criteria to be determined by the Central Government. While recognising the need for paying special attention to the SIFIs for the purpose of restoration and resolution, RBI believes that designation of a FSP as a SIFI is primarily driven by regulatory and supervisory considerations, and consequently, such identification does not need intervention at the level of Central Government. Even the determination of G-SIBs is done by an international committee of regulators (Basel Committee on Banking Supervision). Typically, the national level financial sector oversight committees focus more on formulation of policies on systemic risk oversight rather than identification of SIFIs. Therefore, we are of the view that the identification of individual entities that are considered as systemically important as SIFI, or the identification of financial groups that have entities considered systemically important on solo basis as SIFIs should be left to the appropriate regulators. However, identification as SIFI of the financial conglomerates with no entity that would be treated as SIFI on solo basis, but having entities that are collectively considered systemically important, could be done by Central Government in consultation with the appropriate regulators as proposed in the Bill.

Further, we believe that the criteria for identification of financial conglomerates including the D-SIBs that RBI has developed based on years of supervisory experience could form the basis of identification of SIFIs as well. We also do not agree with the need for the RC to carry out, in the case of SIFIs, joint inspections with the regulators during all stages of risk to viability and independent inspection in material risk to viability stage. The joint or independent inspections should be confined to imminent risk and critical risk to viability categories, though the RC officers could be associated with the RBI inspection teams as observers if the SIFI is classified under material risk to viability category.

- *Voluntary amalgamation of the CSPs:* RBI's representative stated that Regulators should not be restrained from exercising their powers under their laws to sanction schemes for voluntary amalgamation proposed by a covered service provider with another, even when that covered service provider is in imminent or critical stages of risk to viability. He stated that such schemes of amalgamations are required to be approved by the shareholders of both the entities concerned with requisite majority and the Regulator sanctions such schemes taking into consideration the interest of all stake holders. Restraining such voluntary schemes at imminent or critical stages of risk to viability would not only increase resolution cost, but may also not be in the interest of the covered service provider and its stakeholders

- **PFRDA's views:** The Committee had deliberated in several meetings whether to include the Pension Funds in the covered service provider. Some of the earlier drafts even included the Pension funds as covered service provider. The PFRDA had explained in the meetings that in their current form, Pension funds , when they were only handling NPS (a DC Scheme), are only a pass through, being resolved through under the PF regulations by transfer of assets to another PF. This aspect needs to be qualified with the fact that a float of a couple of days is always available to the Pension Funds and also they have access to the funds parked in the money market and hence at any point in time the seven Pension Funds have access to about Rs 1000 crores between themselves (about 1% of the AUM).

  Further, in case the Minimum Guarantee Scheme, as mandated by the PFRDA Act , is also implemented, then the Pension Funds would also need to be resolved like say an insurance company. Hence Pension Funds should not be excluded from the purview of the Covered service provider totally. In the last meeting, the Committee was of the view that an enabling provision in the Schedule 2 may be built in to allow such situations to be handled. But pension funds need not be included in the Schedule 2 at this juncture. AMCs running Mutual funds were also not included in schedule 2. Vidhi also reiterated that the Global practise is also to exclude the Pension funds from the purview of resolution Corporation.

  Hence, PFRDA recommends that the following enabling clause to be included in the Schedule 2:

  > Any pension fund regulated by Pension Fund Regulatory and Development Authority, as may be classified as covered service provider by the said Authority

  This is also essential in view of the fact that the EPFO and several superannuation funds may face a risk to viability and hence should ideally be included in the Schedule 2. The proposal to include superannuation funds under the regulatory perimeter of PFRDA is already under consideration of the DFS, Ministry of finance, under Section 12 (1) (b) of the PFRDA Act 2013.

- **IRDAI's views:** Placed below are the comments of the Authority (IRDAI) on the run-off provisions in the FRDI Bill.

  1. On being identified by the FRDIC as an entity for run-off, the concerned insurer shall draw a scheme for run-off and furnish the same to the FRDIC within 60 days. FRDIC in consultation with the Appropriate Regulator shall consider and approve the same with modifications, if required. The scheme, as approved by the FRDIC, shall be binding on all the stakeholders, which include the insurer, policyholders and other claimants.

  2. The FRDIC shall appoint an Administrator to oversee the affairs of the insurer that has been placed under run-off. The Administrator shall ensure that all the investments of the insurer and the payments of claims of policyholders are as per the scheme approved by the FRDIC. Other rights, powers and duties of such Administrator shall be the same as that of the Administrator appointed under Section 60 of this Act.

  3. The Administrator shall furnish a report in the specified format to the FRDIC and the Appropriate Regulator on a monthly basis indicating inter-alia, the status of all the policy liabilities outstanding at the beginning and those settled during the month and outstanding at the end of the month.

  4. The policyholders shall have exclusive rights over the policyholders funds and no other entity/ entities shall be entitled to claim any part of the proceeds out of policyholders funds, till such time as all the liabilities of policyholders are fully discharged. Sums due to direct policyholders/ beneficiaries shall be given priority over those due to a cedant (reinsured). The shortfall towards other liabilities shall be distributed across the claims of other creditors and shareholders while maintaining the hierarchy of claims.

  5. Once the run-off scheme is approved by the FRDIC, the same shall be suitably published or informed to all the stakeholders which would include the policyholders/ beneficiaries and other claimants. If any party is aggrieved by such scheme, it should be provided an opportunity to represent or appeal before a suitable forum. The other issue was regarding the priority of ranking in the distribution of assets upon the liquidation of an insurer. It is

suggested that the following proviso may be inserted after section 77 of the FRDI Bill which lays down the order for settlement of dues by an entity in liquidation: provided that the policyholders/ beneficiaries shall rank above all other types of claimants until such time as all the liabilities of policyholders are fully settled

There were discussions regarding the resolution tools to be applied to Branches of foreign insurers/ re-insurers in India. Both the RBI and the IRDAI had submitted that though the branches of banks and insurers in India are not separate legal entities, for all practical purposes, including the regulatory stipulations, they are treated as one. They are required to have earmarked capital and investments for the Indian operations. In the event that their parent is in trouble or resolution, the Indian operations need to be ring-fenced in order to protect the consumers/ clients in India. In order to safeguard the interests of Indian consumers of foreign entities having presence in India, the Appropriate Regulator and the FRDIC need to have powers to take control of the Indian operations of troubled foreign entities. Such action may be initiated if there is no cross-border arrangement or MOU with the country of the troubled foreign entity.

A suitable provision to incorporate the above may be included in the proposed FRDI Bill.

The proposed FRDI Bill states that a SIFI shall submit a resolution plan and restoration plan to the Corporation and appropriate regulator respectively. Sec 41 (1) (c) and (d) deal with the contents of a restoration plan and talk about the steps to be taken by the covered service provider to qualify for classification at Moderate risk to viability. Ordinarily, only those covered service providers are required to submit restoration and resolution plans, which are at Material risk or higher. It is suggested that the Sec 40 (2) may be amended suitably so that a SIFI does not automatically get designated at Material or higher risk category and required to submit all details that may be applicable to service providers classified at Material or higher risk.