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EXAMINING RBI'S POWERS FOR RESOLVING FAILED OR FAILING BANKS/FINANCIAL INSTITUTIONS AND SUGGESTING REFORMS FOR EMPOWERING RBI FOR THIS PURPOSE

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1. Introductory Note

As seen from the global financial crisis, failure of financial institutions can have a significant impact on the stability of the financial system. This makes it crucial for a national resolution authority to be able to intervene early when an institution is failing, identify performing assets and critical functions, and adopt a resolution strategy that maximises the value return of resolution and minimizes the cost of failure. Additionally, the resolution authority should have the capability to engage in "intensive coordination, cooperation and information sharing between the authorities", throughout the management of the resolution process.[1]

However, the resolution regime in India is severely lacking. First, there is no single resolution authority responsible for either deciding, overseeing or implementing resolutions across different segments of financial institutions. Second, multiple authorities have different powers in relation to resolution across an array of financial institutions, leading to incongruity and inconsistency. Third, authorities responsible for resolution have very limited tools to facilitate either "restructuring of the institution into a solvent, viable institution" or to carry speedy and uniform resolution of financial institutions that have to be allowed to be failed.[2]

The Financial Sector Legislative Reforms Commission in its 2013 report ("FSLRC") has recommended establishment of a unified Financial Resolution Corporation ("FRA"). FRA is a statutory body that will deal with resolution of the all "covered service providers", namely, banks, insurance companies, defined benefit pension funds, and financial market infrastructures ("**FMIs**") such as payment, settlement and clearing systems. FSLRC was guided by the core notion that in the absence of a formal resolution corporation, problems of failing private firms will be placed upon the customers, tax payers, and the shareholders of public sector financial firms.[3] The main objectives of the FRA should be to, first, protect the stability and resilience of the financial system, second, enhancing financial market efficiency through efficient pricing and allocation of risk; third, protecting consumers of covered obligations up to a reasonable limit; and finally, protecting public funds.[4]

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[1] Financial Stability Board, "Resolution of Systemically Important Financial Institutions", November 2012, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_121031aa.pdf?page_moved=1

[2] Dr Duvvuri Subbarao, "Role of deposit insurance in bank resolution framework – lessons from the financial crisis", International Association of Deposit Insurers and DICGC conference, November 2011.

[3] *The board of the resolution corporation will consist of executive, non-executive and nominee members, to be appointed by the Central Government: (a) the total number of members must not be more than nine; (b) the total number of non-executive members must be greater than the total number of executive members; and (c) three members will be nominee members. The executive members will include the chairperson of the corporation; and an administrative law member. The nominee members will consist of one nominee of the Reserve Bank; one nominee of the Unified Financial Authority; and one nominee of the Central Government*

[4] Id.

Three most prominent resolution tools available to the FRA. In deciding which prominent resolution tool to apply, the main principles would be minimising direct and financial costs to the system, providing protection to the consumers and minimising contagion risk. These tools are: first, sale to another institution where all or part of the business of a covered service provider is sold to a viable commercial purchaser; second, establishment of a bridge institution that restores asset quality and arranges for a suitable buyer and third, temporary public ownership, which will be applicable provided the other two tools have failed to work. FRA also has the authority to determine when a covered service provider is to be liquidated. However, the process of liquidation will be carried out in accordance with the law of incorporation of the covered service provider. The limited authority available to FRA (in relation to liquidation) is being appointed as the official liquidator by the court concerned, and be the creditor of the first priority.[5]

The Working Group on Resolution of Financial Institutions in its report dated January 2014 ("Working Group on Resolution") has echoed the recommendation of the FSLRC. Working Group on Resolution suggests that given that resolution requires very specific techniques and specialization that financial regulators are not likely to have, coupled with the moral hazard issues, there should be an independent resolution agency or FRA. In its opinion, there are several advantages of establishing an FRA. First, having a separate resolution authority would enable development of the expertise needed for such a function to be performed effectively, even for financial conglomerates. Second, given that FRA will have a single fund, this will standardize usage of funds across sectors and also reduce the likelihood of sectors relying on support of the government.[6]

Some specific recommendations related to the FRA are set out below. First, there should be a single FRA for all financial institutions and FMIs and any co-ordination with respective regulators, will be as "deemed necessary by the FRA". Second, FRA should be the sole authority responsible for operation and implementation of resolution, including selecting the appropriate resolution tools. Third, FRA should be empowered by the law to coordinate/cooperate with regulators and have information sharing arrangements. Finally, given that Deposit Insurance and Credit Guarantee Corporation ("**DICGC**") has some kind of expertise in resolving banks, especially pay-outs to depositors post-failure, the FRA can either be set up by transforming DICGC into FRA, or by subsuming DICGC within a new entity altogether. [7]

Despite FRA's benefits as a unified resolution authority, it is imperative to have interim arrangements for resolution. First, creation of a new financial resolution authority will require creation of a separate institutional infrastructure, developing the expertise required for conducting speedy and efficient resolution and an extensive legal framework of rules and regulations. In the words of the Working Group, this will be a time consuming affair. Given that this will require a

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[5] Reserve Bank of India, "Report of the Working Group on Resolution Regime for Financial Institutions", January 2014, *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1398147216563.pdf

[6] Id.

[7] Id.

comprehensive framework, in October 2013, Financial Stability and Development Committee (FSDC) decided to establish a Task Force to lay the roadmap for, *inter alia,* the setting up of the FRA. However, it will be difficult for FRA, even with its proposed composition, to understand the intricacies across financial institutions swiftly and efficiently. Applying similar standards to financial institutions as different as an NBFC and a clearing system will have the traditional fallacy of the "one size fits all approach". Therefore, it will require considerable investment in achieving the right balance for different institutions and also facilitate co-ordination with sector-specific regulatory agencies. Whilst these processes are carried out, in the interim the RBI (or an agency under the RBI) can be empowered to as the primary authority for facilitating efficient and speedy resolutions for banks and certain other financial institutions.

In light of the aforesaid limitations, the major objective of this study is to examine RBI's present powers in relation to resolution of financial institutions, explore its limitations and suggest reforms that empower RBI in this behalf. In the 1st part, a two-pronged approach has been undertaken to conduct a detailed evaluation of the existing resolution regime: first, an analysis of the multiplicity of control across different resolution frameworks and the limitations resulting from the incongruous and inconsistent framework and second, the limitations of powers available under the different frameworks. In the 2nd part, an assessment of international experience has been undertaken to better inform the process of a potential reform of India's resolution system. First, India's current performance on internationally laid standards for resolution of financial institutions has been examined. Second, experiences of UK, US and EU jurisdictions have been examined to understand best practices and how they can be adapted to the Indian resolution regime. In the 3rd part, the main recommendations of the study have been discussed through the lens of three primary questions- first, how can RBI be enabled to have greater powers in resolution across different financial institutions under the existing framework, second, how can the existing deposit insurance mechanism be strengthened and third, what are some of the additional resolution tools that RBI could resort to.

2. An evaluation of the existing resolution regime in India

A. Multiplicity of control across different resolution frameworks

One of the most important limitations of the resolution regime in India is the lack of single resolution authority responsible for either deciding, overseeing or implementing resolutions across different segments of financial institutions. The present section discusses the multiplicity of control spread across several legislations for different financial institutions, the extent of the problem and why it is important to address this.

1. Multiple authorities play a role in the resolution of commercial banks.

*Resolution of Banking Companies under the Banking Regulation Act, 1949 ("**BR Act**"):*

India has had only a limited experience in resolving failed commercial banks. In the past decade, while nine commercial banks were voluntarily amalgamated,[8] five commercial banks had to undergo compulsory amalgamation.[9] Moreover, apart from Bank of Karad in 1992, there have been no cases of liquidation of commercial banks in the past two decades.

Whilst several resolution powers and tools have been recognized under the BR Act, the powers are distributed across different authorities, leading to a complex, inconsistent and limiting regulatory framework. Set out below are the different resolution powers and the involvement of different authorities in this behalf.

The soft resolution powers usually lie with the RBI. In this behalf, the RBI is empowered to undertake the following activities: (i) remove any chairman, director, chief executive officer or other employee of the banking company, if it is satisfied that it is necessary to do so either in the public interest or preventing the affairs of a banking company being conducted in a manner detrimental to the interest of the depositors or securing its proper management;[10] (ii) directions to control advances; (iii) terminate contracts; and (iv) write down debts.

The central government has been assigned the primary powers in relation to acquisition of banking undertakings. First, if on a report from the RBI, if the central government is satisfied that

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[8] (i) IDBI Bank Ltd. merged with IDBI Ltd. on April 2, 2005; (ii) Bank of Punjab Ltd. merged with Centurion Bank Ltd. on October 1, 2005; (iii) Sangli Bank Ltd. merged with ICICI Bank Ltd. on April 19, 2007; (iv) Lord Krishna Bank Ltd. merged with Centurion Bank of Punjab Ltd. on August 29, 2007; (v) Centurion Bank of Punjab Ltd. merged with HDFC Bank Ltd. on May 23, 2008; (vi) Bank of Rajasthan Ltd. merged with ICICI Bank Ltd. on August 12, 2010; (vii) State Bank of Saurashtra merged with State Bank of India on August 2008; (viii) State Bank of Indore merged with State Bank of India in July 2010; and (ix) SBICI Ltd. merged with State Bank of India on July 2011.

[9] (i) Benares State Bank Ltd. (BSBL) amalgamated with Bank of Baroda on June 19, 2002; (ii) Nedungadi Bank Ltd. amalgamated with PNB on February1, 2003; (iii) Global Trust Bank merged with Oriental Bank of Commerce on August 14, 2004; (iv) Ganesh Bank of Kurundwad Ltd. amalgamated with the Federal Bank Ltd. on September 2, 2006; and (v) United Western Bank Ltd. amalgamated with IDBI Bank Ltd. on October 3, 2006.

[10] Section 36-AA, BR Act, 1949.

a banking company has failed to comply with the directions of the RBI or is being managed in a manner detrimental to the interests of its depositors, it may acquire the undertaking of the aforesaid banking company, after consultation with the RBI.[11] The undertaking, assets and liabilities of the acquired bank shall either vest in the central government, or any existing company or any company established for the purposes of the transfer of the undertaking ("**transferee bank**"). Second, the central government can make a scheme for the transfer of the undertaking of the acquired bank to the transferee bank, after a consultation with the transferee bank, providing for, inter alia, the capital, constitution, services, assets and liabilities.[12]

Powers relating to amalgamation are spread across multiple organizations, including, the RBI, the central government and the banking companies. First, banking companies are allowed to undertake voluntary amalgamations, after a scheme in this behalf has been placed before the shareholders of each of the banking companies and approved by a majority resolution representing two-thirds in value of the shareholders of each of the said companies.[13] After the approval, the scheme of amalgamation is required to be submitted to the RBI for its approval, and once such approval is granted, the aforesaid scheme is binding on the banking companies and the shareholders. The RBI may also direct that the banking company which has now ceased to function due to the amalgamation, will stand dissolved. Second, RBI can prepare a scheme for the reconstruction or amalgamation of the banking company, if it is satisfied that it is in public interest or in the interest of the depositors or to secure the proper management of the banking company, after which the scheme will be required to be approved by the central government.[14]

Two separate authorities have been granted the primary powers in relation to suspension of business of a banking undertaking. First, a banking company is allowed to make an application to the High Court requesting for a stay in the commencement or continuance of all actions and proceedings against the company, provided it is temporarily unable to meet its obligations. Any such application can be maintained only when it is either accompanied by a report of the RBI stating that the banking company will be able to pay its debts if the application is granted, or the aforesaid report is provided by the RBI after the grant of the relief.[15] Second, the RBI may apply to the central government for suspension of the business of a banking company, and the latter might make an order

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[11] Section 36-AE, BR Act, 1949.

[12] Section 36-AF, BR Act, 1949.

[13] Section 44A, BR Act, 1949.

[14] Section 45, BR Act, 1949; The scheme may, inter-alia, contain provisions for the capital, assets, powers, rights, interests, authorities and privileges, liabilities, duties and obligations of banking company on its reconstruction or of the transferee bank; terms & conditions of transfer of business, properties, assets and liabilities of a banking company to the transferee bank; any change or appointment in/of the board of directors; alteration of memorandum articles of association of banking company on its reconstruction or of the transferee bank; reduction of interests or rights of depositors and other creditors; allotment of shares to the members of the banking company on its reconstruction or in the transferee bank on amalgamation, etc.

[15] Section 37, BR Act, 1949.

of moratorium staying the commencement or continuance of all actions and proceedings against the company for a fixed period of time.[16]

As set out hereafter, the High Court has the primary powers in winding up of banking companies. RBI is entitled to make an application to the High Court for the winding up of the company in several cases. First, when a banking company has, *inter alia,*: (a) failed to comply with the requirements specified; (b) become disentitled to carry on banking business in India; and (c) has been prohibited from receiving fresh deposits by an order. Second, where in the opinion of the RBI: (a) a compromise or arrangement sanctioned by a court in respect of the banking company cannot be worked satisfactorily; (b) when the banking company is unable to pay its debts and; (c) when the continuance of the banking company is prejudicial to the interest of its depositors.[17] Further, the High Court is also entitled to order the winding up of a banking company if it is unable to pay its debts. A banking company is deemed to be unable to pay its debts, if it has failed to meet a lawful demand in the period prescribed therein and RBI certifies that the banking company is unable to pay. Whilst the central government is required to appoint a liquidator for the purpose of conducting all proceedings for the winding up of banking companies, if the RBI makes an application in this behalf, either the RBI or State Bank of India or any other bank notified by the central government will be appointed as the official liquidator of the banking company. [18]The liquidator is required to submit a preliminary report to the High Court within two months about, *inter alia*, assets in cash that are under his control and assets that can likely be collected in cash to make preferential payments and discharge other liabilities and obligations.[19] For the purpose of making an estimate of the debts and liabilities of the banking company, the liquidator will serve notices to preferential claimants, secured and unsecured creditors.

Resolution of nationalised banks:

Given that nationalised banks are governed by the statutes establishing them, central government is the primary authority for the purposes of determining the application of several resolution tools and RBI's authority is limited to consulting with the central government. For instance, under the State Bank of India Act, 1955, several powers have been provided to the central government: (a) supersede the central board in case it is satisfied that it is necessary to do so in the public interest, or for preventing the affairs of the SBI being conducted in a manner detrimental to the interest of the depositors or the SBI or for securing the proper management of the SBI, on the recommendation of RBI;[20] (b) appoint an administrator for such period as it may determine, in

[16] Section 45, BR Act, 1949.

[17] Section 37, BR Act, 1949.

[18] Section 39, BR Act, 1949.

[19] Section 41, BR Act, 1949.

[20] Section 24A, SBI Act, 1955.

consultation with the RBI[21]; (c) remove the chairman or the managing director of the SBI[22]; and (d) give an order to liquidate the SBI in a manner as it may direct.[23]

Further, the central government also has the power to make a scheme for the reconstruction of any nationalised bank into two or more corporations or amalgamation of such banks. Recently, the government has been considering consolidation of national banks, in order to bolster the weaker banking organizations and also to have two-three global sized banks, however, it has stressed that the consolidation would focus on regional synergies and aim to reduce its negative effects on competition. In the early 90's, there was a merger between two nationalised banks, when *Punjab National Bank* acquired *New Bank of India*.[24] Recently, whilst there have been informal suggestions from the central government on amalgamation of several state-run banks, including *IDBI Bank* and *United Bank of India*, nothing concrete has happened in this behalf. Moreover, SBI acquired board approval for the merger of its five associates, and has already amalgamated two of its subsidiaries, *State Bank of Saurashtra* and *State Bank of Indore*. Whilst RBI has limited authority in determining the issue of amalgamation of public sector banks, in its opinion, merger of a weak public sector bank with a strong bank, can lead to creation of unhealthy entities, not only as a result of the "bad loan-pile up", which can lead to a contagious effect on the overall balance-sheet of the acquiring bank, but also due to difficulties in integration, ranging from cultural differences, core areas of expertise and geographies, and different business systems.[25]

Interaction of several agencies and its impact on resolution:

International experience with financial institutions that are weak but solvent, suggests that "rapid and early" action is important to avoid a situation where the net worth of the institution becomes negative and substantial costs are placed on the taxpayer. Therefore, it is crucial to have a system where RBI has the authority to undertake early assessment and interventions in resolving financial institutions that are approaching failure, in order to maximize the value returns, minimize costs and avoid the "markets penalizing delay in decision making and uncertainty over the future of a failing institution". However, anecdotal evidence suggests that in the present system, requirement of interaction with several actors slows down the process of resolution, whether, it is adoption of a court-driven procedure for liquidation or the requirement for consulting with the central government,

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[21] Id.

[22] Section 24, SBI Act, 1955

[23] Section 45 of SBI Act, 1955 states, "Bar to liquidation of State Bank No provision of law relating to the winding up of companies shall apply to the State Bank, and the State Bank shall not be placed in liquidation save by order of the Central Government and in such manner as it may direct."

[24] "IDBI Bank, United Bank deny merger rumours" July 28, 2014, FIRSTPOST, *available at* http://m.firstbiz.firstpost.com/finance/idbi-bank-united-bank-deny-merger-rumours-92116.html?most-popular#

[25] Dinesh Unnikrishnan , "Rajan's advice to Jaitley: Merging weak PSU banks with strong ones is a recipe for disaster", FIRSTPOST, Aug 14, 2014, *available at* http://www.firstpost.com/business/finance/rajans-advice-to-jaitley-merging-weak-psu-banks-with-strong-ones-is-a-recipe-for-disaster-2-1983967.html

before taking even temporary measures of superseding BoD. It has been opined, "*The process of judicial liquidation can result in significant loss in the value of bank assets on account of delay*". Court driven liquidations have taken years at time to complete the process, which is unacceptably long for a financial institution, and can have significantly negative impact on financial stability.

2. Resolution of NBFCs is spread over multiple legislations.

Non-Banking Financial Companies ("NBFC") are an integral part of the growth story. NBFCs are seen as important financial intermediaries for the small-scale and retail sectors. NBFCs have proven to be growth engines- enhancing competition and diversification in the financial sector, diversifying risks and complementing the banking system at competitive prices. [26] They have also been instrumental in extending credit to retail customers in underserved areas and to previously unbanked customers. NBFCs pioneered retail asset-backed lending, lending against securities and microfinance.

However, a staggered and inefficient resolution framework for NBFCs can potentially raise systemic risks for financial stability. The NBFC sector is heterogeneous in terms of size, business, spread and ownership. This makes it extremely difficult for regulators to evolve standardised codes and common reporting norms.[27] Under the Reserve Bank of India Act, 1924 ("**RBI Act**"), RBI has very limited powers to deal with non-compliant and failing NBFCs. First, if deposit-taking NBFCs fail to comply with the order/directions given by the RBI, RBI has the authority to prohibit the non-banking financial company from accepting any deposit.[28] Second, if the RBI is satisfied that it is necessary to do so in the public interest, it may direct the aforesaid NBFC to additionally not sell, transfer, create charge, mortgage or deal in any manner with its property and assets without prior written permission of RBI.[29] Third, RBI has the power to cancel a certification of registration for the NBFC, if it, *inter alia*, ceases to carry on the business of a non-banking financial company, fails to comply with directions and fails to either maintain accounts or submit books of account for inspection[30]. Finally, RBI may file an application for the winding up of an NBFC under the Companies Act, 1956 ("**Companies Act**"), if it is satisfied that the NBFC is either unable to pay its debt or has become disqualified to conduct business or prohibited to receive deposits and finally, continuation of its business is detrimental to the public interest or to the interest of the depositors of the company.[31] Therefore, as evident from the above, not only is RBI not entitled to exercise any soft resolution

[26] Nidhi Kothari (et al.), "An overview of the Indian NBFC sector performance in 2010, prospects in 2011",Legal Updates, *available at* http://www.india-financing.com/An%20overview%20of%20the%20Indian%20NBFC%20Sector-%20Nidhi%20&%20Kamil.pdf

[27] "Transforming India's NBFCs", Economic Times, September 24, 2009.

[28] Section 45MB, RBI Act, 1924.

[29] Id.

[30] Section 45-IA, RBI Act, 1924.

[31] Section 45MC, RBI Act, 1924.

powers to regulate the functioning of failing NBFCs, apart from restrictions on deposit taking NBFCs, but even powers like liquidation, mergers, amalgamations and acquisitions of NBFCs are governed entirely by the Companies Act. As such, RBI's powers to resolve failing NBFCs are limited and strictly circumscribed by statute.[32] This problem becomes much bigger when the troubled NBFCs are systemically important. While the aforesaid NBFCs are subject to higher standards of prudential regulation, given the limitations of RBI in determining resolution techniques, the failure of systemically important NBFCs can have adverse effects on the stability of the financial system.

In practice, the resolution framework has proven to be unworkable. Anecdotal evidence suggests three primary issues: (a) while several petitions have been filed by the RBI for liquidation of NBFCs under the Companies Act, most petitions remain pending; (b) while RBI issues certain supervisory directions in instances of mergers and amalgamations, there are several acquisitions which are not subject to any monitoring despite being part of the NBFC group companies; and (c) there are several NBFCs which engage in trading and manufacturing as their principal business, and it will be difficult to bring them within the ambit of a financial regulator for the purposes of liquidation.

3. There is no legal framework to facilitate resolution of Regional Rural Banks ("RRBs").

RRBs were created to provide for the demand of institutional credit amongst economically and socially backward communities in rural areas. Despite significant geographic coverage and credit disbursement by other banks, access to credit had not penetrated the rural poor. After the recommendations of the Narasimham Working Group (1975), which proposed the establishment of RRBs, they were established under the RRB Act, 1976 ("**RRB Act**").[33] Over the years, RRBs have played a predominant role in rural institutional financing in terms of "geographical coverage, clientele outreach and business volume".

However, RRB's contribution to the promotion of banking in rural areas has not been an enduring phenomenon, given their ill financial health. In 2009, due to alarmingly low Capital to Risk weighted Assets Ratio (CRAR), on the recommendations of the K C Chakrabarty committee, it was approved that RRBs be capitalized. However, at the end of March 2011, 23 RRBs had reported accumulated losses and the Gross NPA was INR 3,712 crores. A number of reasons have been cited for the poor health of RRBs- these include low earning capacity due to target consumers, large number of default, high cost of operation, and lack of commercial orientation.[34] Therefore, it is important for the RRBs to have an appropriate restructuring strategy.

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[32] Reserve Bank of India, "Report of the Working Group on Resolution Regime for Financial Institutions", January 2014, *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1398147216563.pdf

[33] Biswa Swarup Misra, "The Performance of Regional Rural Banks (RRBs) in India: Has Past Anything to Suggest for Future?" Reserve Bank of India Occasional Papers, Vol. 27, No. 1 and 2, Summer and Monsoon 2006.

[34] Ministry of Finance, "Consolidated review of performance of regional rural banks as on 31 march 2013", http://financialservices.gov.in/banking/Consolidated%20Review%20RRB%202014.pdf

Several committees have recommended mergers/amalgamation/liquidation as appropriate restructuring strategies. Given multiple concerns relating to the financial viability of RRBs, the Thingalaya committee in 1997 recommended that extremely weak RRBs should be liquidated or merged with neighboring RRBs. In 2001, the Expert Committee on Rural Credit recommended that the RRBs be consolidated in their entirety, while the Group of CMDs of Select Public Sector Banks, 2004 recommended that RRBs be amalgamated into six commercial banks on a regional basis and recognized at the same time that mergers and liquidation might be other restructuring strategies. Finally, the A.V. Sardesai committee in 2005 recommended that a change in sponsorship of RRBs, might be preferable to merger/amalgamation. Subsequently, because of prevalent losses amongst RRB, RRBs have been undergoing a process of amalgamation, and from 133 RRBs in 2006, there are now 67 RRBs.[35]

However, the liquidation and amalgamation of RRBs are subject to predominant control of the central government and limited regulatory oversight by RBI. In discharge of its functions, RRB is guided by directions in matters involving public interest that are given by central government in consultation with RBI.[36] Therefore, RBI does not have any powers to provide any directions to the RRB on its own. Further, the amalgamation of RRBs is carried out by an order of the Central Government after consultation with the National Bank for Agriculture and Rural Development, state governments and the sponsor banks, with no opinion or consultation required from the RBI.[37] Further, there is no provision of merger of RRBs with their sponsor banks under the RRB Act. Finally, the RRB Act explicitly bars liquidation of RRBs by mandating that "*no provision of law relating to the winding up of companies shall apply to a RRB except by order of the Central Government and in such manner as it may direct*".[38] Therefore, despite several documented concerns with the RRBs and the need to address the same, RBI does not have any powers to resolve the banks including soft measures like stabilizing and imposing conditions on functioning, and the central government's powers are limited to either amalgamation or liquidation.

4. Duality of control makes resolution of co-operative banks difficult.

While urban co-operative banks ("UCBs") are important for the economy, failure amongst UCB is rampant. According to Manual on Financial and Banking Statistics, 2007 by RBI, urban co-operative banks account for about 5% of deposits and an almost equal proportion of advances of the banking system.[39] Despite their small share in business, they contribute significantly towards social and economic development, as an instrument of financial inclusion. However, while co-operative banks

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[35] Id.

[36] Section 24, RRB Act, 1976.

[37] Section 23A, RRB Act, 1976.

[38] Section 26, RRB Act, 1976.

[39] Gurpur, "Hapless depositors of urban-cooperative banks", MONEY LIFE, October 30, 2013, *available at* http://www.moneylife.in/article/hapless-depositors-of-urban-co-operative-banks/35086.html.

were established to primarily increase community participation and credit access in underserved areas, over a period of time, their financial health has declined significantly. While commercial banks account for 88% of the insurance premium collected by DICGC, co-operative banks only account for under 8%[40]. However, 100% of the payments made by DICGC to depositors in lieu of their insurance premium, can be accounted to co-operative banks. About 89 co-operative banks have failed in the last four years (2009-2013) forcing the DICGC to provide huge compensation to the depositors that helps them recover only part of their losses. In 2012-13, the DICGC paid as much as INR 160 crore to deposit holders of the 13 banks.[41]

Multiplicity of control is considered a significant factor in contributing to the continuing crisis in co-operative banking. Whilst the incorporation, management and winding up of primary-cooperative banks are regulated either by the authorities under State Cooperative Societies Acts (for banks operating in a single state) or the Multi-state Cooperative Societies Act, 2002 (for banks operating in multiple states), RBI's mandate is limited to regulating the banking business. According to the Madhav Rao Committee, "*Various Committees in the past, which went into working of the UCBs, have found that the multiplicity of command centers and the absence of clear-cut demarcation between the functions of State Governments and the Reserve Bank have been the most vexatious problems of urban cooperative banking movement. This duality of command is largely responsible for most of the difficulties in implementing regulatory measures with the required speed and urgency and impedes effective supervision*".[42]

RBI has introduced a revised supervisory action framework for urban co-operative banks in November 2014. RBI has introduced revised triggers for supervisory/regulatory actions that can help facilitate early intervention to address the irregularities/deficiencies of the banks. Among the self-corrective action by UCBs, the major triggers are: (a) Gross NPA exceeding 10% of advances or incremental gross NPAs of 3 percentage points each, where banks will be required to furnish an action plan for NPA recovery; (b) banks are required to take corrective action if the CD ratio exceeds 70%; (c) in case of losses for two consecutive years of losses or accumulated losses, banks are required to submit an action plan for making operations profitable- rationalize and close branches, contain expenses and launch drive to recover NPAs and (d) in capital goes below the regulatory capital of 9%, banks will be advised to submit an action plan for augmenting capital. Further, the RBI is empowered to undertake regulatory actions to facilitate early rectification and less disruptive exit, including, prohibiting premature withdrawal of deposits including by way of loans against deposits, imposition

[40]Tamal Bandopadhyaya, "How safe is your money with co-operative banks", LIVEMINT, August 9, 2014, available at "http://www.livemint.com/Opinion/fGmd3fJ0kILX7L1CExXMGI/How-safe-is-your-money-with-Coop-banks.html

[41]Why should depositors from better banks pay for cooperative banks' failure? MONEY LIFE, May 28, 2013, *available at* http://www.moneylife.in/article/why-should-depositors-from-better-banks-pay-for-cooperative-banks-failure/32898.html.

[42] K.D.Zacharias, "Legal and Regulatory Framework for Co-operatives", RBI QUARTERLY PUBLICATION, April 26, 2005, *available at* http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/62572.pdf

of all inclusive directions under Section 35 A of BR Act, 1949 (AACS) and issue of show cause notice for cancellation of license.[43]

However, resolution of UCBs is the mandate of the state governments. The regulation of banking and co-operatives are central and state subjects respectively. Accordingly, giving primacy to banking laws over co-operative laws can prove contentious, and accordingly state governments have powers over the resolution of these banks, by virtue of them being under the control of their respective Registrar of Co-operatives ("**Registrar**").[44] Under The Multi-State Cooperative Societies Act, 2002 ("**Multi State Act**"), the Registrar is appointed by the central government and has primary powers in relation to resolution of a co-operative bank that operates as a co-operative society in more than one state. First, whilst the multi-state co-operative bank is entitled to undertake amalgamation, transfer of assets and liabilities, or reorganization, by way of a resolution passed by a majority of its members, the Registrar is required to prepare a scheme of amalgamation or reorganization when an order for moratorium has been passed by the central government under the BR Act, after taking previous approval from the RBI.[45] Second, the Registrar can direct the winding up of the multi-state co-operative bank, after either an audit or inspection has been conducted or of his own motion. The Registrar is required compulsorily to make an order for the winding up, if so required by the RBI under the Deposit Insurance and Credit Guarantee Corporation Act, 1961 ("**DICGC Act**"), and the DICGC will be reimbursed by the liquidator, to the extent and in the manner provided in the DICGC Act.[46] However, the Registrar has the authority to operate and implement the winding up by appointing the liquidator, who is in charge of, *inter alia*, taking custody and control of all property, disposal of surplus assets and determining priority of contributions.[47] Finally, after a report from the liquidator, the Registrar is entitled to cancel the certification of registration.[48] Similarly for single-state co-operative banks, the RBI's power is limited to requiring the Registrar to make an order for winding up of a co-operative bank, who will then be in charge of the liquidation process.[49] Therefore, as evident from the above, for the limited purpose of providing deposit insurance, co-operative laws have been amended to give RBI the powers to direct the Registrars to make an order for winding of a co-operative bank. According to Dr Duvvuri Subbarao, former Governor of the RBI, because of the

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[43] RBI Notification on Supervisory Action Framework for Urban Co-operative Banks (UCBs) dated November 27, 2014, *available at* http://rbi.org.in/scripts/NotificationUser.aspx?Id=9364&Mode=0

[44]http://www.thehindu.com/business/Industry/13-cooperative-banks-go-belly-up-in-201213/article4756294.ece

[45] Section 13-14, Multi State Act, 2002

[46] Section 87, Multi State Act, 2002

[47] Section 88-92, Multi State Act, 2002

[48] Section 93, Multi State Act, 2002

[49] For instance- Section 110A, The Maharashtra Co-Operative Societies Act I960 states, "*An order for the winding up, or an order sanctioning a scheme of compromise or arrangement, or of amalgamation, or reconstruction (including division or re-organisation), of the bank may be made only with the previous sanction in committee, writing of the Reserve Bank of India*" ;

aforesaid dual control, delays are experienced in resolution of UCBs over several issues, including, *inter alia*, appointment of liquidators, gathering of information about depositors, depositor pay-outs and recovery of assets.[50] Further, in practice, the liquidators appointed by the state are usually not qualified and the settlement of claims and disbursement is extremely delayed and challenging.

RBI is devising innovative ways to regulate UCBs more closely, however, challenges remain. Within the existing legal framework, Memorandum of Understandings ("**MoU**") have been entered into by RBI with all the State Governments powers for supervision of co-operative banks as far as banking regulations are concerned. A Task Force on Urban Co-operative Banks ("**TAFCUB**") has been constituted in all States comprising of representatives from RBI and the State Governments with a mandate to find revival path for the viable urban co-operative banks and non-disruptive exit for the non-viable entities.[51] However anecdotal evidence suggests that it is problematic that these TAFCUBs have no legal backing. Whilst TAFCUBs have had minor successes in improving the health of co-operative banks, their processes remain cumbersome and time-consuming, subject to political pulls and pressures and prevent the RBI from taking timely unilateral action as it is able to in the case of commercial banks.

RBI has limited powers to assess the merger and transfer of assets & liabilities of urban co-operative banks. While the BR Act does not empower RBI to formulate merger or amalgamation schemes, state governments under local co-operatives acts require a sanction from RBI for approval of the scheme. However, RBI is only concerned with the merits of the scheme of merger or amalgamation, and any due process and compliance is to be done by the Registrars.[52] However, the merger route is voluntary in nature and requires consent from the banks as a pre-condition, which is often not forthcoming. In a recent circular, RBI now requires that acquiring bank should not incur any loss arising out of the said merger or transfer of assets and liabilities of cooperative banks, which implies that depositors in failed co-operatives will have to sacrifice a portion of their deposits. [53] Despite this restriction and burden on customers of co-operative banks, no solution has been formulated to streamline the resolution of co-operative banks.

[50] Inaugural address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the IADI-DICGC International Conference - Role of Deposit Insurance in Bank Resolution Framework – Lessons from the Financial Crisis - November 14, 2011, *available at* http://www.dicgc.org.in/english/pdf/Speeches/Gov-speech.pdf

[51] RBI, " Draft Vision Document on Urban-Cooperative Banks", *available at* http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/1521010.pdf

[52] RBI Notification on Guidelines for transfer of assets and liabilities of Urban Cooperative Banks to commercial banks dated February 24, 2010 *available at* http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=5511&Mode=0

[53] RBI Notification on Guidelines for transfer of assets and liabilities of Urban Cooperative Banks to commercial banks dated September 3, 2014 *available at* http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=9209

B. Limitation of powers under different regulatory frameworks

"The existing resolution powers available with the regulators, i.e., imposing moratorium and facilitating voluntary and/or compulsory mergers with stronger financial institutions, have served the purpose so far but are not equipped to deal with the failure of a large and complex institution and in a cross-border context.

- *Report of the Working Group on Resolution Regime for Financial Institutions, 2014*

An analysis of the resolution processes and mechanisms across different legislations demonstrates several limitations in the existing regulatory regime. First, different authorities have different powers in relation to resolution of different financial institutions, leading to incongruity and inconsistency. For instance- while RBI is required to apply to central government for preparing a scheme of amalgamation of a private sector commercial bank, central government is required to frame a similar scheme for nationalised banks, in consultation with the RBI. Second, the powers of different regulatory authorities in charge of resolving financial institutions are limited to identifying failed institutions, finding merger partners, cancelling license and requesting courts to liquidate. For instance- while RBI has no powers for resolution of RRBs and nationalized banks, central government can only exercise liquidation and amalgamations as the primary resolution tools for the aforesaid financial institutions. Third, the existing legal framework does not provide for new resolution tools that have gained prominence since the global financial crisis. Fourth, no powers have been given either to the RBI or to the central government to ensure continuity of essential services and functions of failing financial institutions. To sum up, as evident from the financial crisis, while resolution is an integral aspect of regulation of banking business and crucial to promoting financial stability, RBI has been granted very limited powers to facilitate a resolution regime that is cost-effective, speedy and uniform.

Except for commercial banks, there is no mechanism to enable early intervention or trigger resolution for a troubled financial institution. As part of the prompt corrective action ("**PCA**") framework, capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA) have been identified as the parameters on which resolution can be triggered. The RBI has specified certain regulatory trigger points, as a part of prompt corrective action (PCA) Framework, in terms of three parameters, i.e. capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA), for initiation of certain structured and discretionary actions in respect of banks hitting such trigger points. The PCA framework is applicable only to commercial banks and not extended to co-operative banks, non-banking financial companies (NBFCs) and FMIs. This framework is to essentially bring about timely corrective action in times of banks' failure to meet prudential requirements, or regulatory violations or the depositors' interest is threatened in any other way. Further, RBI also mandates that the trigger event for a non-viable bank, a bank that may no longer remain a going concern is the earlier of: (a) a decision that a conversion or temporary/permanent write-off, without which the firm would become non-viable, is necessary, as determined by the RBI; and (b) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.[54] However, not only do these triggers have no bearing in relation to initiation of a resolution action for private sector commercial banks, but for other banks (UCBs, RRBs), even the trigger points have not been made applicable. Further, more significantly, there is minimal framework for early detection and intervention to address concerns that occur at the holding company level and can have potential group wide-ramifications.[55] An inability to resolve the group wide distress can potentially jeopardise the stability of the larger financial system, given the likelihood of cross-defaults and intra-group funding stresses.

3. International experience in resolution of Financial Institutions

A. Key attributes framework of FSB and India's performance

Following the global financial crisis, a number of countries have adopted laws to strengthen their resolution regimes. The Financial Stability Board ("**FSB**") adopted the Key Attributes of Effective Resolution Regimes for Financial Institutions in November 2011 ("**Key Attributes**"). The Key Attributes represent a new international standard that set out the core elements of effective resolution regimes and that FSB considers. The Key Attributes listed by the FSB are: scope of resolution regime (KA 1), existence, mandate and governance of resolution authorities (KA 2), resolution powers (KA 3), legal framework governing set-off rights, contractual netting, collateralisation arrangements, and segregation of client assets (KA 4), existence of safeguards (KA 5), funding arrangements to support resolution (KA 6), legal framework for cross-border cooperation (KA 7), Crisis Management Groups (KA 8), Institution-specific cross-border cooperation agreements (KA 9), resolvability assessments (KA 10), recovery and resolution planning (KA 11) and access to information and information sharing (KA 12). Of these, the Key Attributes relating to resolution authorities (KA 2) and resolution powers (KA 3) are discussed in greater detail below.[56]

[54] Reserve Bank of India, "Report of the Working Group on Resolution Regime for Financial Institutions", January 2014, *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1398147216563.pdf; Saugata Bhattacharya and Urjit R. Patel, "Reform Strategies In The Indian Financial Sector", Conference on India's and China's Experience with Reform and Growth International Monetary Fund and National Council of Applied Economic Research New Delhi, November 15-16, 2003, *available at* https://www.imf.org/external/np/apd/seminars/2003/newdelhi/patel.pdf

[55] Id.

[56] Financial Stability Board, "Key Attributes of Effective Resolution Regimes

Set out hereafter are main requirements on the Key Attributes relating to resolution authorities and resolution powers. The Key Attribute on resolution authorities states that jurisdictions should have a designated resolution authority that is operationally independent and adequately resourced. Where there is more than one resolution authority in a jurisdiction, their roles should be clearly defined and coordinated, and the resolution regime should identify a lead authority to coordinate resolution of a multi-sector financial group within that jurisdiction. Such resolution authorities should pursue financial stability, protect depositors, insurance policy holders and investors; avoid unnecessary destruction of value; and consider the potential impact of their actions on financial stability in other jurisdictions. While resolution measures may be implemented by an administrator that is appointed and supervised by a court, the objectives of all such authorities must also be in line with those set out in the Key Attribute. The Key Attribute on resolution powers sets out the range of powers that should be available in resolution regimes.[57] These include the power to transfer assets, rights, liabilities or shares of a failing institution to a purchaser, bridge institution or asset management company; the power to write down and convert debt of failing institution; the power to appoint an administrator, to operate the firm in resolution and take actions necessary to restructure or wind down its operations. Resolution should be triggered when a firm is, or is likely to be no longer viable, and before it is balance-sheet insolvent and the equity has been fully wiped out.

Based upon the Key Attributes, the FSB conducted a review of countries to ascertain the degree to which they met these attributes and flag areas for further reforms. India too was part of this review process. The review process found that while India did have a single resolution authority in the form of the RBI, it had very limited powers, including, replacing firm management, operating, resolving the firm and appointing an administrator without shareholder or creditor consent, all of which have to be carried out in consultation with other actors, including the central government. Moreover, it lacked the following resolution powers that were included in the Key Attribute on resolution powers: the power to require group companies to provide services, the power to transfer assets and liabilities of banks, the power to establish a bridge institution (i.e. a temporary acquirer of a failing bank pending a final sale), the power to bail-in within resolution, the power to establish an asset management company and the power to impose temporary stay on early termination rights.[58]

B. The resolution framework in United Kingdom

The Bank of England ("BoE"), the central bank of UK, has the powers to operate and implement resolution tools for financial institutions. Based on the principle that appropriate interventions in managing failure of financial institutions are crucial to its mission of maintaining financial stability,

for Financial Institutions", October 15, 2014, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

57 Id.

58 Financial Stability Board, "Thematic Review on Resolution Regimes: Peer Review Report", April 11, 2013, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_130411a.pdf?page_moved=1

BoE has been given the powers of operating and implementing the special resolution regime ("**SRR**") under The Banking Act, 2009 ("**BA 2009**"). Other authorities like the Prudential Regulation Authority ("**PRA**") and the Financial Conduct Authority ("**FCA**"), which were earlier Financial Services Authority ("**FSA**") , and Her Majesty's Treasury ("**HMT**") have responsibilities including inter alia, making the determination that a banking institution is failing, or is likely to fail, and making decisions with implications for usage of public funds respectively.[59]

BoE has the authority to implement three primary resolution tools for a financial institution. Under the BA 2009, BoE has the authority to exercise three primary stabilisation options for a financial institution that is failing, or likely to fail. First, in the case of bank or a building society, BoE has the authority to transfer either the banking institution, or some or all of its business to a private purchaser. Second, in the case of a bank or a building society, BoE could transfer some or all of its business to a bridge bank. Third, in case of a bank, building society or holding company of a bank, BoE has the authority to transfer the treasury of the institution into temporary public ownership. Per the Code of Practice for SRR, 2010, these options are achieved through effecting the transfer of shares and other securities or property, rights and liabilities, by operation of law. Additionally, the amended Banking Act also grants the prudential supervisor (PRA, or in the case of investment firms, FCA) , BoE and Financial Services Compensation Scheme ("**FSCS**") the authority to apply to the court for a bank insolvency order to wind up a banking institution, and to enable payments to eligible depositors or assist with transfers to other banking institutions. [60]

Suitable checks and balances to restrain BoE's unfettered powers are provided. Under the Banking Act, BoE has the authority to exercise its stabilisation powers if it is satisfied that exercise of the power is necessary with regard to public interest in, first, the stability of the financial systems of the United Kingdom, second, maintenance of public confidence in the stability of the banking systems of the UK or third, the protection of depositors. However, according to the Code of Practice BoE is required to consult the prudential supervisor (PRA, or in the case of investment firms, FCA) and HMT before making the aforesaid decision or proceeding with the bank insolvency procedure, with the prudential supervisor determining that the threshold conditions for exercising stabilization powers are satisfied. These threshold conditions include, first, a determination that the institution is failing, or likely to fail and second, it is not reasonably likely that relevant action will be taken by the institution.[61]

The resolution regime in UK is constantly evolving to reflect international standards. In order to comply with the international standards for resolution regimes established by the Financial Stability

[59] The Bank of England, "The Bank of England's approach to resolution", October 2014, *available at* www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf

[60] "Regulation Outlook: Compendium on bank resolution regimes: from the FSB to the EU and US frameworks", BBVA Research, June 2014, *available at* https://www.bbvaresearch.com/wp-content/uploads/2014/06/Regulation-Outlook.pdf

[61] Supra note 59.

Board ("**FSB**") in 2011 and the EU Bank Recovery and Resolution Directive ("**BRRD**"), UK has established a new resolution regime that is applicable from January 1, 2015 ("**New Regime**"). Under the New Regime, BoE has been designated the UK resolution authority. BoE is proposed to be allocated a number of additional powers and responsibilities, including, inter alia, requiring information from financial institutions for resolution planning, assessing their resolvability and removing barriers to the same, setting minimum requirements for own funds and eligible liabilities and finally, assessing that there is no reasonable likelihood that a financial institution will no longer be failing or likely to fail.[62]

The New Regime provides BoE with additional tools to resolve financial institutions. An additional stabilization tool, 'bail-in', is proposed to be introduced. Bail-in implies a tool where post- absorption of losses, the institution is recapitalized from its own resources and the claims of the shareholders and unsecured creditors are written down and/or converted into equity to restore solvency. Further, three additional tools have been introduced for the components of the institutions that need to be wound down in a controlled manner. First, the asset separation tool allows assets and liabilities of the failed firm to be transferred to and managed by a separate asset management vehicle which is wholly or partially owned by public authorities. Second, administration procedure, which facilitates the necessary administration of the portion of a failed institution, which has not been transferred to the bridge or the private sector purchaser under the SRR. A third tool, public equity support tool that equips member states with the power to contribute to the recapitalisation of firms, is controlled by the HM Treasury.[63]

C. The resolution framework in the US

FDIC is the primary authority for supervising the liquidation of failing banks. Whilst FDIC does not have the authority to decide on the closure of bank, a function typically performed by the appropriate authorities depending on the charter of the depository institution, it plays the primary role in supervising and implementing the resolution process. For federal savings institutions and national banks, the Office of Thrift Supervision and the Office of the Comptroller of the Currency determine when a failing institution is to be closed and FDIC be appointed as the receiver, while for state chartered savings and loan associations or banks, the state regulatory authorities determine the same. In certain limited cases, FDIC has the authority to appoint itself a receiver for a state chartered insured depository institution.[64] FDIC undertakes a resolution process comprising of two different stages. First, the resolution stage, where FDIC values the assets of the institution, solicits bids for

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[62] Id.

[63] Id.

[64] PWC, "New Resolution Planning- New Guidance, More time, no Specificity", FS Regulatory Brief", April 2013, http://www.pwc.com/us/en/financial-services/regulatory-services/publications/resolution-planning-new-guidance.jhtml http://www.davispolk.com/sites/default/files/files/Publication/e8ee04a0-d98c-46ea-a1a5-58afb664f2bc/Preview/PublicationAttachment/06c22352-4914-465a-a966-6a333bf78209/rguynn.jdouglas.

the sale, evaluates bids to determine which one is the least expensive for the insurance fund and ensures payment to an acquiring or agent institution that is equivalent to the liabilities assumed or payment of insured deposits in the event there is no acquirer. Second, the liquidation stage, where FDIC liquidates the assets of the institution and distributes the proceeds to unsecured depositors, general creditors and the shareholders, in the aforesaid order of preference.

FDIC has two alternatives for executing the resolution. First alternative is a closed bank transaction where the failing institution doesn't survive and includes two tools, purchased and assumption transaction, where the assets of failing bank are acquired by a healthy bank (P&A) and deposits pay-off, where the appropriate authority closes the bank and FDIC pays the insured deposits to the failing institution's depositors. Second alternative is an open bank transaction where the failing institutions is kept "alive" through support loans, guarantees and capital injections.[65]

Purchase and assumption is the most common resolution tool in the US. In terms of the P&A resolution method, the acquiring institution purchases assets of a failed institution and assumes some of its liabilities. The most widely used P&A tools are loss-sharing transactions and bridge banks. As part of the loss-sharing transaction, FDIC absorbs a significant component of credit losses on shared loss assets, in order to help acquiring banks continue to hold the commercial loan and commercial real estate portfolios of the failing institutions. Whilst this mechanism allows FDIC to still receive a premium for the failing institution's deposit franchise, it also helps "induce rational and responsible credit management behavior" in the acquiring institution. During the shared loss period, FDIC reimburses the acquiring institution for 80% of the shared-loss assets, while during the recovery period, the acquiring institution pays the FDIC 80% of recoveries. As part of the bridge bank solution, FDIC acts temporarily as the acquirer, taking control of the business while it determines an appropriate permanent resolution or has sufficient flexibility to reorganize the failing institution. FDIC continues to accept deposits, make limited loans and honor commitments that do not create additional losses, while ensuring that the performing loans are retained and problematic assets are transferred to the receivership. Eventually, the bridge bank is resolved in a manner similar to other banks, through different processes involving a P&A transaction, merger, or a stock sale.[66]

Deposit pay-off is executed only when FDIC does not receive a P&A bid. Under the method, when the appropriate authority closes the bank, FDIC makes payment of the insured deposits to failed bank's depositors and liquidates the assets. There are two primary ways of deposit pay-off, first, straight deposit pay-off where FDIC liquidates the failed bank's assets and assumes the costs of compensating the insured depositors and second, insured deposit transfer, where insured deposits

[65] "Regulation Outlook: Compendium on bank resolution regimes: from the FSB to the EU and US frameworks", BBVA Research, June 2014, *available at* https://www.bbvaresearch.com/wp-content/uploads/2014/06/Regulation-Outlook.pdf

[66] Id; International Monetary Fund, "Cross-Border Bank Resolution: Recent Developments", June 2014, *available at* http://www.imf.org/external/np/pp/eng/2014/060214.pdf

are transferred to another bank, which acts as the FDIC agent, and the depositors have the authority to either seek to withdraw the same or use the services of the new bank.[67]

FDIC has been given significant powers to avoid interference from other agencies. In order to expedite and maximize the cost-effectiveness of the liquidation process to maintain stability of the financial system, FDIC has been given additional powers and responsibilities than available to a normal bankruptcy trustee under US laws. Most significantly, FDIC is not subject to court supervision, in executing its receivership responsibilities of managing the assets and liabilities of a failed institution, and its decisions cannot be reviewed except under limited circumstances. Further, the FDIC is not subject to the direction or supervision of any other executive agency or department while operating the receivership, including determining the resolution tool that should be applied to a failing institution.[68]

A new resolution process is envisaged for systemically important financial institutions ("SIFIs") under Dodd-Frank Act. Given the lack of authority to FDIC to resolve either the holding companies or non-deposit taking institutions, the financial crisis witnessed a number of bail-outs and disorganized bankruptcy proceedings. In terms of Title II of the Dodd Frank Act, SIFIs can be put under the FDIC receivership process if first, there is no viable private sector alternative to prevent default and second, if adoption of normal bankruptcy proceedings will have "serious adverse effects" on the stability of the financial system. There are two separate stages to this process, first, the pre-resolution phase where a regime for early remediation of financial distress of SIFIs has been provided and second, a resolution phase where a large, complex financial company is quickly and efficiently liquidated by appointing FDIC as the receiver. As part of the pre-resolution phase, SIFI is required to comply with several levels of intermediation relating to risk based capital and leverage requirements, and a failure can trigger a resolution assessment where the Federal Board can recommend to the Treasury Department and the FDIC that the SIFI be resolved under the Orderly Liquidation Authority in the Title II of the Dodd-Frank Act, depending on whether it is in default, danger of default and poses a risk to the stability of the US financial system.[69] Under the resolution phase, Title II of Dodd Frank that mandates speedy and efficient resolution of a large, complex financial company in order to avoid a significant risk to the financial stability. As part of this phase, four main steps are important. First, a financial company is to be placed in receivership only if the bank is in default or danger of default, the failure will have serious adverse effects on financial stability and no alternative is available to prevent the default. Second, as the receiver, FDIC is directed to liquidate the company through sale of assets, merger and transfer of any asset or liability, payment of obligations to the extent that funds are available, ensuring that shareholders and unsecured creditors bear losses, maximizing return from any sale or disposition and minimize losses and finally ensuring priority of

[67] Id.

[68] FDIC, "FDIC's role as receiver", *available at* https://www.fdic.gov/bank/historical/reshandbook/ch7recvr.pdf

[69] Supra note 65.

claims and similar treatment of similarly placed creditors. Third, the treasury creates an orderly liquidation fund ("**OLF**") in order to make financing available for FDIC to conduct its receivership operations effectively. Fourth, failure and significant losses of banks would always be assumed by the holding company, therefore, FDIC will be appointed receiver of only the parent holding company under the single point entry ("**SPE**") scheme and organize a bridge financial company, to which it will transfer assets from the receivership, leaving the liabilities behind. [70]

D. The resolution framework in the EU

The Bank Recovery and Resolution Directive (BRRD) is the single legal framework for resolution in EU. On 15 April 2014, the European Parliament approved the BRRD. The BRRD will be enforced from 1 January 2015 onwards. The goal of the BRRD is to achieve a common framework to guide intervention by EU member states in a banking crisis. The BRRD is based on three main pillars: *preparation and prevention* which requires banks to blueprint recovery plans while resolution authorities must plan for the continuity of critical functions; *early intervention* by the regulator if a bank fails to meet regulatory capital requirements or appears likely to breach them; and *resolution* which involves the taking over of control of a failing institution and ensuring a resolution of the crisis through a range of measures. The BRRD covers all credit institutions and investment firms established in the European Union including EU financial institutions, parent financial holding companies in a member state, and branches of institutions that are established outside the European Union.[71]

While Eurozone will have a single resolution authority, EU member states are required to designate national authorities to serve as resolution authorities. The BRRD provides for operational independence of the resolution and supervisory activities to prevent conflicts. The European Banking Authority is required to co-ordinate cross-border recovery and resolution plans and mediate between relevant national authorities for resolution planning and group recovery. In addition, the EU has also created a Single Resolution Authority ("**SRA**") for the Eurozone which includes only 18 participating countries that agreed to have such a common resolution authority. For these countries, all resolution activities are carried out by the SRA. [72]

A Single Resolution Authority has been created to streamline implementation of the BRRD for Eurozone. The SRA which becomes operative from January 2016 onwards was conceptualized to meet two objectives: (a) preservation of the level playing field by ensuring a uniform implementation of the BRRD; and (b) provision of an effective cross border resolution framework to ensure financial stability. Under the SRA route, bank resolution is to be conducted by a new Single Resolution Board

[70] Anne Sibert, "Draft Briefing Note on Bank Resolution Regimes", Directorate General For Internal Policies Policy Department, European Parliament *available at* http://www.europarl.europa.eu/document/activities/cont/201103/20110316ATT15696/20110316ATT15696EN.pdf

[71] Id.

[72] Id.

("**SRB**") which will comprise a Chair, a Vice-chair, three independent members (appointed by the EU Council) and representatives of the national authorities of the participating member states. Although decisions of the SRB can be vetoed by the EU Commission ("**EC**") and the EU Council, a veto is required to be exercised within 24 hours and must be based upon pre-established conditions. The SRB is to have the power to directly resolve significant banks, cross border EU banks and all banks whose resolution required the use of the Single Resolution Fund which has been established with a capacity of Euro 55 billion. The remaining banks are to be resolved by national authorities although the SRA retains the power to step in at any time.[73]

Specific resolution triggers have been identified under the BRRD. The BRRD has established resolution triggers for the application of resolution tools. These triggers are known as the point of non-viability i.e. the stage at which an authority determines that an institution is insolvent or so close to insolvency that it will become insolvent in the foreseeable future. A determination that a point of non-viability has been reached operates as a trigger for a resolution to be effected by the resolution authority. The following circumstances trigger resolution under the BRRD: (a) A determination that the institution is failing or likely to fail; (b) A determination that there is no reasonable prospect for any alternative private sector measures to prevent a failure of the institution within a reasonable timeframe; (c) A determination that a resolution action is necessary in the public interest.[74]

Both national resolution authorities and SRA have been granted a uniform set of resolution tools to resolve failing banks. Resolution authorities are provided with the following resolution tools to resolve an institution when a resolution is triggered. The *sale of business tool* involves the sale of the bank or a whole or part of its business on without shareholders' consent or other procedural requirements. The *Bridge institution tool* involves the transfer of all or part of the bank's business to a "bridge bank," (which is wholly owned by a public authority). This is usually a temporary measure pending a final sale of the bank to another private player. The *Asset separation tool* involves the transfer of the institution's high-risk assets to an asset management vehicle which would be owned by a public authority. The *Bail-in tool* involves a write-down of the claims of unsecured creditors or the conversion of the creditors' debt claims into equity. Finally, in extraordinary circumstances when there is a threat of a systemic crisis, resolution authorities may also seek funding from alternative financing sources and use public funds.[75]

[73] "Regulation Outlook: Compendium on bank resolution regimes: from the FSB to the EU and US frameworks", BBVA Research, June 2014, *available at* https://www.bbvaresearch.com/wp-content/uploads/2014/06/Regulation-Outlook.pdf; Dirk Schoenmaker, **"Banking Supervision and Resolution: The European Dimension**," DSF Policy Paper Series, available at http://www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-19-Banking-Supervision-and-Resolultion-The-European-Dimension-Jan-2012.pdf

[74] Id.

[75] Id.

The Resolution mechanism by under the SRA route. SRA is required to obtain EC approval for its resolution plan. Once resolution is triggered the SRB is required to draw up a resolution plan and communicate this to the EC. If no objection is raised by either the EU Council or the EC within 24 hours, the SRB's plan is deemed to be adopted. On the other hand, EC can, within 12 hours, ask the EU Council to either veto the plan or materially change the amount of money that would be charged to the Single Resolution Fund. The EU Council gets 12 hours to decide upon the EC's proposal. If the EU Council decides to amend the resolution plan (as against vetoing it), it gets an additional 8 hours to make necessary amendments to the resolution plan.[76]

4. Recommendations for reforming the resolution framework

In view of the issues and concerns listed above, it is imperative that the existing resolution framework of financial institutions be reformed as an interim measure, while the FRA framework is sought to be established. This section aims to discuss (a) how RBI can be enabled to have greater powers, (b) the strengthening of deposit insurance mechanism, and (c) the additional resolution tools that RBI should be enabled to exercise.

A. How can RBI be enabled to have greater powers of resolution?

Keeping in mind the international experience, RBI should be designated as the interim national resolution authority for banks and non-banking financial institutions. The resolution regime in India should be suitably amended to reflect RBI as the primary resolution authority to ensure compliance with the FSB standards. While EU has created a single resolution authority, it has only been done for Eurozone states with about 18 participating countries, given the higher significance of cross-border resolution in lieu of a common currency. For the rest of the EU member states, they are required to designate their national authorities to serve as resolution authorities. Also, as seen in the resolution regimes of UK and US, existing authorities (BoE and FDIC) that were playing a primary role in the operation and implementation of resolution of financial institutions before financial crisis, have been designated as the national resolution authorities and granted greater powers to facilitate speedy and efficient resolution. It is submitted that in line with international experience, RBI should be given primacy as the national resolution authority, given its prior experience and powers in operating and implementing resolution tools. This can be adopted as an interim measure until the FRA system becomes operational. This will also be compliant with FSB, which has given RBI, the de facto status of resolution authority. This section discusses ways in which the same can be enabled.

1. Resolution framework could potentially be re-modelled along the lines of the resolution framework in UK.

As depicted in the figure below and discussed in the previous section, whilst BOE is designated the primary resolution authority of UK, the PRA, which is technically a part of BOE, but operates

[76] Id.

independently in matters of resolution, plays a significant role in determining how the resolution framework is to be applied.

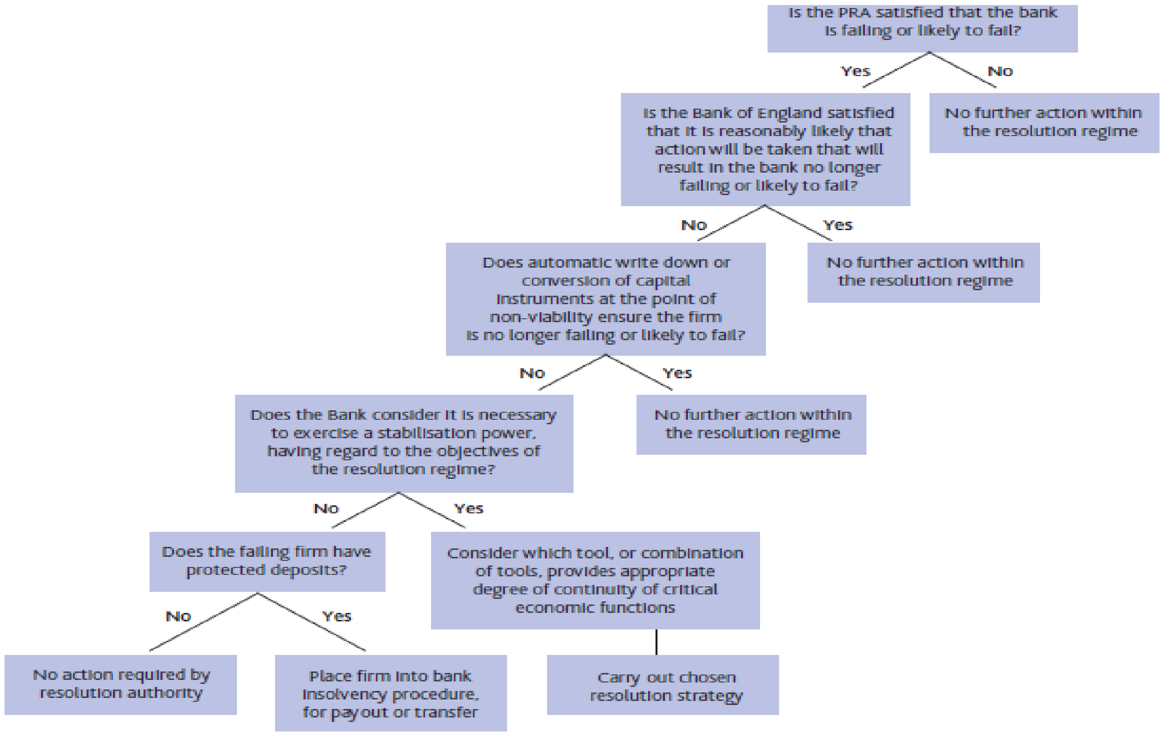

Figure 1: Decision tree for a bank entering resolution in the UK[77]

To reiterate the role of PRA and BOE in the resolution framework, set out below are their different responsibilities: (a) *Pre-resolution:* PRA-regulated financial institutions are required to provide information to the PRA relating to their recovery and resolution plans. For instance- they are required to provide resolution packs to the PRA containing information on their financial, legal and operational structure, as well as their critical economic functions. This information can be used to identify an appropriate resolution strategy, even before an institution has encountered difficulties. As the difficulties of a financial institution increase, it is subjected to heightened supervision and regulation by the PRA. For instance- as part of PRA's proactive intervention framework, which supervises how close an institution is to failure, PRA will expect it to take actions to help it reduce the likelihood of failure.[78] (b) *Triggering the resolution:* Before a financial institution can be put in resolution, as a first step, it is required to prove that the firm is either failing, or likely to fail. This would require that the institution is not able to satisfy the threshold conditions, including, having an appropriate amount and quality of capital and liquidity, having appropriate resources to measure, monitor and manage risk, to be fit and proper and to conduct their business prudently. This determination is required to be made by the PRA. In the second step, BOE is required to make an

[77] The Bank of England, "The Bank of England's approach to resolution", October 2014, *available at* www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf

[78] PRA (2014), 'The Prudential Regulation Authority's approach to banking supervision', *available at* www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf

assessment on consultation with the PRA that it is not reasonably likely that action will be taken outside the resolution regime that will result in the firm no longer failing or likely to fail; [79]and (c) *Conducting the resolution:* In the first phase of resolution or stabilisation, the provision of critical economic functions is assured, either through bail-in or recapitalisation. In the second phase, the restructuring, changes are made to the business model and organization of the financial institutions to address the reasons for failure. In the second phase, exit from resolution, BOE's involvement as a resolution authority is concluded. Whilst BOE is authorized to conduct the resolution process, it is required to decide the appropriate tools and strategy for resolution in consultation with the PRA. Further, in cases of transfer of business, acquirer would be required to demonstrate that the threshold conditions (capital requirements, for instance) as laid down by the PRA, for the acquired or merged business are complied with. Similarly, in case of a bail-in, the firm in resolution will continue to be authorised and regulated by the PRA.[80]

A similar framework can be formulated to empower RBI as the primary resolution authority by introducing an amendment to the BR Act. While the Working Group on Resolution has cautioned against RBI being the resolution authority on grounds of moral hazard, suitable checks and balances can be introduced to facilitate a collaborative process, where consent of other authorities will be material in determining whether a bank or a financial institution is failing and whether there is a reasonable likelihood that there is any other suitable alternative to address the failure, than resolve the bank/financial institution. Similar to UK, an authority similar to the PRA can be created within the domain of the RBI, which will be entrusted with first setting standards or policies that are important for promoting the safety and soundness of financial institutions, coupled with assessing risks in institutions that might threaten the stability of the financial system, and taking appropriate actions to remedy them. As part of its responsibilities, such an authority will be required to ensure that firms create recovery and resolution plans in compliance with the FSB standards, and also make an initial determination of when a firm is in trouble and requires application of heightened supervisory standards, whether initial trigger requirements for resolution has been complied with, and finally, assist RBI in making a determination of which are the appropriate resolution tools and strategies that might be deployed for a particular financial institution. The aforesaid authority will also be in charge of ensuring that the newly created businesses as a result of applying different resolution tools, are compliant with its regulatory requirements. Such authority may also be bestowed with new powers as envisaged under the New Regime (discussed above) in the UK. Set out below is a figure depicting what the aforesaid potential structure might look like.

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[79] The Bank of England, "The Bank of England's approach to resolution", October 2014, *available at* www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf

[80] Id.

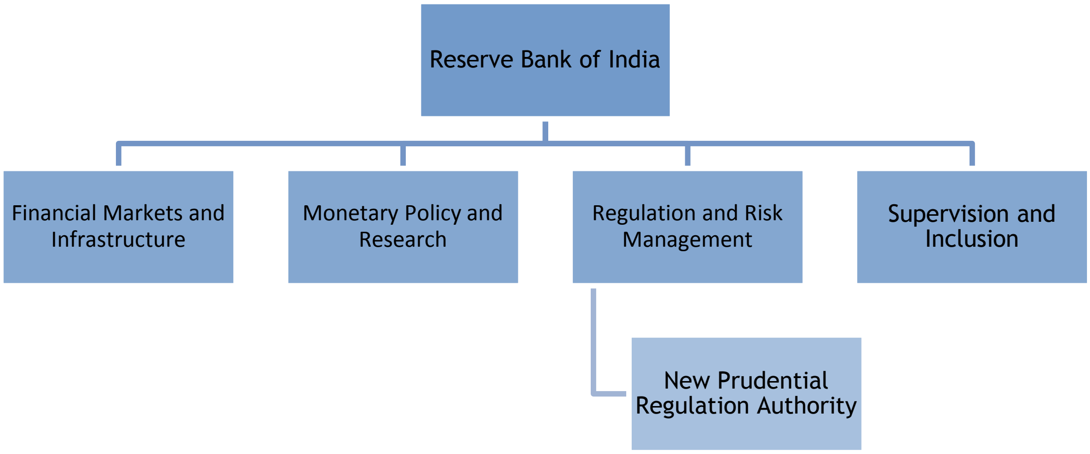

Figure 2: Potential structure of RBI with a prudential regulation authority

2. Several institution-specific reforms need to be undertaken in the present framework to facilitate greater powers for the RBI.

Co-operative Banks:

Given that co-operative banks fail frequently and absorb 100% of the payouts by DICGC, it is important that they be resolved in an orderly manner to cause least disruption to consumers and the financial system. This will require the examination of the constitutional question of whether giving greater power to RBI/Central Government in the resolution of co-operative banks is permissible.

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 co-operative societies and vests exclusive legislative competence in the States in this matter. Hence, conflicting legislative entries in List I, List II and List III assume importance in this discussion, all of which have been enumerated hereunder.

Entry 45, List I – Banking.

Entry 32, List II - Incorporation, regulation and winding up of corporations, other than those corporations which find mention in List I, and universities; unincorporated trading, literary, scientific, religious and other societies and associations; cooperative societies.

Entry 9, List III – Bankruptcy and insolvency.

The Supreme Court has recognised the competence to legislate on co-operative societies to vest in the State, irrespective of whether such power incidentally trenches on matters over which the State does not have legislative competence. In *Greater Bombay Co-operative Bank Ltd., v. United Yarn Tex (P) Ltd. and others*[81] the Court held,

"Co-operative Banks constituted under the Co-operative Societies Acts enacted by the respective States would be covered by co- operative societies by Entry 32 of List II of Seventh Schedule of the Constitution of India."[82]

Explaining this rationale while upholding the legislative competence of the state to enact the Uttar Pradesh Co-operative Societies Act, 1965, the Supreme Court held,

"[W]e do not have the slightest doubt that in pith and substance the Act deals with 'Cooperative Societies'. That it trenches upon banking incidentally does not take it beyond the competence of the State Legislature. It is obvious that for the proper financing and effective functioning of Cooperative Societies there must also be Cooperative Societies which do banking business to facilitate the working of other Cooperative Societies. Merely because they do banking business such Cooperative Societies do not cease to be Cooperative Societies, when otherwise they are registered under the Cooperative Societies Act and are subject to the duties, liabilities and control of the provisions of the Cooperative Societies Act. We do not think that the question deserves any more consideration and, we, therefore, hold that the UP. Cooperative Societies Act was within the competence of the State Legislature."[83]

It is thus established that states have the power to legislate pertaining to co-operative banks flowing from their exclusive power to legislate on co-operative societies, contained in Entry 32 List II. This is notwithstanding the fact that such laws trench on to matters pertaining to banking which fall under Entry 45, List I and thereby under the exclusive competence of the Union.

The question that confronts us now is however the converse:

[81] (2007) 6 SCC 236.

[82] Ibid., para 98.

[83] *Virendra Pal Singh v. District Assistant Registrar, Co-operative Societies, Etah and another,* (1980) 4 SCC 109, at para 10.

1. Does the Union have the competence to enact a provision in pursuance of its powers under Article 246 read with Lists I and III of the Seventh Schedule, irrespective of whether it trenches on a subject in List II?
2. Following on from (1), is a provision pertaining to insolvency of co-operative banks an instance of such a provision?

The answer to the first question follows from the decisions extracted above. If states have the power to legislate on a matter within their competence irrespective of whether it trenches on matters where it does not possess such competence, then the reverse should also be true, i.e. <u>the Centre should have analogous competence in matters where it has the power to legislate irrespective of whether it trenches on matters where it does not possess such competence. This principle is well-established and has been upheld in several cases.</u>[84] Pertinently, this principle has been used by the Central Government to enact laws that relate to co-operative banks.

In fact, implementation of this principle is evident from the amendment made to the BR Act *vide* Section 14 of the Banking Regulation (Amendment) Act, 1965. This amendment introduced Part V of the BR Act providing for the application of this Act to co-operative banks, subject to certain modifications.[85] By insertion of Part V (specifically Section 56) into the BR Act, co-operative banking activity was brought within the supervisory power of the RBI, by means of an amendment to a law enacted by Parliament.[86] Thus Chapter V of the BR Act is an example of Parliament having legislated on certain aspects pertaining to co-operative banks despite such banks being regulated focally by respective state legislations. Till date, there is no reported challenge to the constitutional validity of this Part. The power of the Central Government to enact a provision within its competence (i.e. in Lists I or III) that incidentally affects a matter in List II is thus incontrovertible.

The key question is how once can ascertain as to which legislative entry, a particular law or provision of law *primarily* relates, i.e. 'its true nature and character"[87]. Under the principles of constitutional law, the doctrine of pith and substance is used to make such a determination when two seemingly overlapping entries in different Lists can be invoked to justify competence.[88]

The doctrine of pith and substance gives the concerned legislature the power to not only enact a law, but also to insert provisions in an existing legislation which may incidentally touch upon a subject in another list. This doctrine can, and has also be applied to test the constitutional validity of

[84] *Subrahmanyan Chettiar v. Mutuswami Goundan*, AIR 1941 FC 47; *Prafulla Kumar Mukherjee and Others v. Bank of Commerce, Limited, Khulna*, AIR 1947 PC 60; *Kerala State Electricity Board v. Indian Aluminium Co.*, (1976) 1 SCC 466; *Premchand Jain v. RK Chhabra,* (1984) 2 SCC 302; *Special Reference No. 1 of 2001,* (2004) 4 SCC 489.

[85] *Bharat Co-operative Bank (Mumbai) Ltd. v. Co-operative Bank Employees Union* (2007) 4 SCC 685.

[86] *Janata Sahakari Bank Ltd. and Anr. v. State of Maharashtra and Ors.* AIR 1993 Bom 252.

[87] *Citizens Insurance Company of Canada v. Parsons,* 1881 7 App. Cas. 96 (Supreme Court of Canada)

[88]Durga Das Basu, 'Shorter Constitution of India', Vol. 2, 14thedn. (Lexis Nexis, 2013), p. 2331.

amendments made to existing Acts, which may be challenged for incidentally entrenching upon subject-matters which the concerned legislature is incompetent to legislate upon.[89]

In order to ascertain its pith and substance, the Act must be seen as a whole, its objects, scope and effect fully considered. Further, the entries themselves to which the Act or provision could plausibly relate to must be carefully considered. While the general principle is that entries will have to be construed broadly to preserve legislative competence, the import of a broad entry might have to be circumscribed in view of a specific entry on the subject and entries must be read so as to not obliterate either. This is known as the principle of harmonious construction.

On the basis of the aforesaid principles, we can now turn to the second question posed above. Our proposed suggestion is to amend the BR Act to include provisions for insolvency resolution of banks and certain other financial institutions, including cooperative banks through a Prudential Regulation Authority. If the pith and substance of this provision is ascertained, then in our view, though the provision deals both with banks as well as co-operative banks, as discussed in 'Section 1' above, its true nature and character is that of an insolvency resolution mechanism.

By virtue of Article 246(2) and Entry 9 of List III, Parliament is competent to make laws with respect to bankruptcy and insolvency. The Supreme Court held in *In re Special Courts Bill, 1978*[90] that by virtue of Article 246(2), Parliament undoubtedly has the power to make laws with respect to matters under List III. No power of the State Government under List II affects this. This is in accordance with the general principle that when entries in the three lists are in conflict, List I has priority over Lists II and III and List III has priority over List II.[91] Thus the power of the State Legislatures under Entry 32 of List II does not, in any matter whatsoever, affect the Parliament's power to enact a law under Entry 9 of List III.

The inference of Union competence in this regard is reaffirmed if the general entry on co-operative societies is to be read harmoniously with the specific entry pertaining to insolvency. For all other matters related to co-operative banks, except insolvency which is a specialised provision, the respective State Co-operative Acts will be resorted to. There are instances where specific provisions of legislations enacted by the Parliament have been used for specific matters relating to co-operative banks. For instance, the mechanism under the DICGC Act contains provisions for registration of every existing banking company, including co-operative banks, as an insured bank. Registration of co-operative banks with the DICGC is to be carried out under a law enacted by Parliament, and this provision exists harmoniously along with the State Co-operative Society Acts. There are other instances too when Parliament has enacted specific laws which apply to co-operative banks, notwithstanding the exclusive power of the states to legislate on co-operative societies—The

[89] *See, Raghunathrao Ganpatrao v. Union of India* 1994 Supp (1) SCC 191; *Bajinath Kadio v. State of Bihar* [1970] 2 SCR 100 for an analysis of the pith and substance of amendments made to existing laws.

[90] (1979) 1 SCC 380.

[91] *Prafulla Kumar Mukherjee and Others v. Bank of Commerce, Limited, Khulna,* AIR 1947 PC 60.

Agricultural Refinance and Development Corporation Act, 1963 the Prevention of Money Laundering Act, 2002, the Payment and Settlement Systems Act, 2007, are a few examples. It is thus clear from precedent and an application of the principle of harmonious construction that the Union possesses the competence to make specific provisions within its own competence on matters relating to co-operative banks notwithstanding that the focal competence in this regard lies with the States.

If the pith and substance of the BR Act itself (rather than the proposed amendment itself) is to be ascertained once the proposed amendment is made, taking into account the constitutional principles above, it is our view that it would be a law that in its true nature and character regulates all banking activity in India. To the extent that co-operative banks, the Exim Bank, IRBI, Regional Rural Banks, NABARD etc. all of which are set up under different statutes require to be within the framework of banking regulation, such banks are regulated. Banking, as stated aforesaid, is Entry 45 of List I. Thus a law in relation to banking is within the exclusive competence of the Union.

The suggested provision is essential for all insolvency resolution of banks and financial institutions to proceed in a systematic and orderly fashion. **Even if the proposed authority is not set up, there is an equally arguable case, on the basis of the principles above, that all provisions in the BR Act that relate to insolvency resolution (including provisions relating to framing of schemes under Section 45) can also be applied to co-operative banks within the existing constitutional framework as long as such powers are limited to resolution of insolvency.**

The proposed solution addresses the problem of dual control by State Governments and the RBI more optimally than the suggestion to transfer "cooperation" (sic) from List II to List I.[92] This suggestion, made earlier in the Report of the High-Power Committee on Urban Cooperative Banks, marks a major transformation for our federal polity, requiring more than half of the state legislatures besides Parliament to approve it. This is highly unlikely. The proposed suggestion of an amending legislation to the BR Act that empowers the RBI for governing all matters relating to insolvency resolution of co-operative banks serves the same purpose in a more achievable, realistic and constitutional manner. Hence we recommend its enactment.

Resolution of NBFCs:

The new Companies Act, 2013 ("**CA 2013**") permits the RBI to make a reference to the National Company Law Tribunal ("**NCLT**") for declaring the company to be a sick company if it has sufficient reasons to believe that a company has become sick.[93] After a company is declared 'sick', Chapter XIX of CA 2013 provides for a detailed mechanism for rescuing or rehabilitating a sick company through a scheme which may include financial reconstruction, change of management, amalgamation, sale of business, rationalization of workforce, rescheduling of debt and any other preventive or remedial

[92]Reserve Bank of India, 'Legislative Reforms in Statutes', 7 December 1999, available at <http://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=137>.

[92]1970 (3) SCR 530.

[93] Section 253(5), CA 2013.

measures. The proposed regime also provides for takeover of the company's management by a private insolvency practitioner (on directions of the NCLT) who is also empowered to engage the services of experts for running the business. It may be noted that even where an application is filed by the RBI, the process for rehabilitation will be driven by the creditors. The RBI may consider making an appropriate representation to the Government to provide for greater involvement of the RBI under CA 2013 for schemes of rehabilitation involving NBFCs (especially at the time of formulation of a scheme). If a scheme is not approved by the requisite majority of creditors, the company is required to be liquidated under chapter XX of CA 2013. However, Chapters XIX and XX of CA 2013 have not been notified for commencement yet as the operationalization of NCLT is entangled in a litigation before the Supreme Court. The Bankruptcy Law Reform Committee appointed by the Government in August 2014 is proposing certain measures which may facilitate early operationalization of the NCLT. Alternatively, the Committee is also proposing that if the NCLT cannot be operationalized anytime soon, Chapters XIX and XX of CA 2013 could be operationalized through existing company courts at the High Courts. After the said provisions are brought into effect, they may provide for a useful insolvency resolution regime for NBFCs. However, like any other court/tribunal driven bankruptcy procedure, the proceedings under CA 2013 may not be as swift as desirable. Therefore, it is recommended that at least the systematically important NBFCs should be subject to a separate resolution framework (through the proposed Prudential Regulation Authority as discussed in 'Section 1' above).

RRBs, State Banks and Other Nationalised Banks:

Provisions of individual acts (RRB Act, 1976 and State Bank of India Act, 1955) that exclude the applicability of general corporate and financial laws, for instance, the absolute bar on liquidation except in a manner provided by the central government, should be amended so that the proposed resolution authority is empowered to apply its resolution tools, as and when the need be. An amendment to this effect should also reflect in the Reserve Bank of India Act, 1934. Further, the amalgamation of RRBs should not be the exclusive mandate of the central government and RBI should be empowered to prepare the scheme of, and operate such scheme of amalgamation.

3. Judicial intervention in resolution needs to be minimised.

The resolution regime for banks and other financial institutions should be suitably amended to minimize the intervention from courts. Ensuring that that there is no systemic risk from failure of a large, complex financial institution is crucial and achieving this requires speedy and cost-efficient resolution of banks/financial institutions. Along the lines of FDIC, which is not subject to court supervision in managing the assets and liabilities of a failed institution, the resolution regime in India should seek to minimize this role as well. In order to avoid further delays to the resolution process through instances including the shareholders challenging the authority of the regulator to resolve the bank, a 'stay of litigation' power could be granted to the proposed authority, similar to powers available to FDIC in the US. It is also crucial to limit the roles of other executive agencies and departments, while the RBI implements and operates the resolution process. In terms of Section 11(d)

(12) of the Federal Deposit Insurance Act, after the FDIC is appointed as a receiver or conservator of a failed bank, it is allowed to request a stay in any judicial action, or administrative proceeding, that the bank is a party to, or becomes a party to, for a maximum period of 90 days. Whilst FDIC must apply to the appropriate court for the stay, in the case of Praxis Properties, *Inc. v. Colonial Savings Bank S.L.A*,[94] it was held that a court is mandatorily required to grant the stay, and the stay will apply to all parties in the proceeding. The main aim of the provision is to give FDIC the power and ability to "assess and evaluate the facts of each case".[95] The power to suspend or stay litigation is not limited to matters that are filed before the creation of the receivership or conservatorship, but also extend to any litigation filed after the institution's failure.[96] Additionally, FDIC is also entitled to a stay of 60 days for any action (e.g. judicial foreclosure proceeding) in which the FDIC is a successor party of a failed bank.[97] Further, in terms of Section 13(C)(i), a party to a contract with a failed bank is prohibited from exercising its right to terminate, accelerate, or declare a default under the contract, or otherwise affect any contractual rights of the failed bank during the period of the receivership or conservatorship, unless a prior consent is obtained. [98] The proposed authority should be given powers to apply to courts for stays **which should become operational automatically upon filing**.

This recommendation has also been reiterated by the Working Group on Resolution in 2014. While adopting certain resolution tools (transferring assets to a private-sector purchaser, for instance), the solvency and recapitalization of the new entity is required to be ensured. It is likely that in order to achieve this, the value of the assets transferred will be greater than the value of the liabilities transferred. Whilst this will mean that certain depositors and creditors whose claims are transferred to the new entity will have a greater benefit, this should not result in other affected parties undermining the process of resolution through judicial actions. To this end, the Working Group recommends that "*the rights to judicial review of resolution actions and available remedies should be framed in a way that does not undermine effective resolution and the necessary legal certainty of resolution actions. However, legal remedies should be available for improper decision or action by the FRA, in the form of monetary compensation for the loss suffered by the stakeholders.*" The

[94] 947 F.2d 49, 60 USLW 2270; Also see Wachovia Bank, N.A. v. Michael Taylor, 2007 U.S. Dist. LEXIS 83793, at *5 (W.D. Mich. Nov. 13, 2007) ("a stay is mandatory and must be granted").

[95] Gibson, Dunn and Crutcher LLP, "Overview of the FDIC as Conservator or Receiver", September 26, 2008, *available at* http://www.gibsondunn.com/publications/Documents/092608-Overview-FDICasConvervator-Receiver.pdf

[96] Id.

[97] Richard M. Hynes and Steven D. Walt "Why Banks Are Not Allowed in Bankruptcy", 67 WASH. & LEE L. REV. 985 (2010)

[98] Stanley V. Ragalevsky and Sarah J. Ricardi, "Anatomy of a Bank Failure", The Banking Law Journal, December 2009, *available at* http://www.klgates.com/files/Publication/75c34466-1733-4cee-ac60-70a3faf13402/Presentation/PublicationAttachment/38ad8050-02a6-4bde-acda-752a232c299d/Banking_Law_Journal.pdf.

actions of the proposed Prudential Regulation Authority should be insulated from such challenges and review on merits by the higher courts.

B. Strengthening the Deposit Insurance mechanism

Depositor confidence is critical for a financially stable economy and the same can be provided by formulation of a sound financial safety net. The essential components of a financial safety net are prudential regulation, supervision, resolution, lender of last resort and deposit insurance. A harmonization in the functioning of all these components is the ultimate aim of all the financial regulations and policies across the globe. Deposit insurance is a proven critical tool for maintaining the depositor's confidence during bank runs or for in fact, preventing bank runs in the first place. Bank runs may occur due to panic based events wherein small unsophisticated depositors, who do not understand the banking and financial risks fully, may panic on rumours regarding a bank's insolvency, and in the absence of a credible deposit insurance scheme, withdraw their deposits prematurely if they expect others to do the same for a first come first basis advantage, and the banks have to liquidate their long terms assets and thus they fail[99]. On the other hand, bank runs may also occur due to other events i.e. due to an economic downturn. The objective of deposit insurance is largely to pre-empt such panic based bank runs and other events by the announcement of a credible deposit insurance scheme which such depositors understand and take confidence in. Additionally, deposit insurance also improves the competitive efficiency of small banks vis-à-vis large banks as it inspires the confidence of depositors in all banks equally, irrespective of its size, and it also hedges the financial economy from a systemic failure.

The financial crisis that started in 2007 brought about a large number of changes in the financial systems across the globe and deposit insurance regime was one of them. Various countries reacted differently to the crisis in respect of their existing deposit insurance regimes by expanding the coverage of the deposit insurance arrangements, adopting explicit deposit insurance schemes where such schemes were not in place, general guarantee schemes etc. Though India remained largely buffered from the said crisis and did not evidently bring about any changes in its deposit insurance regime[100], this does not absolve it from the reality that the deposit insurance regime in India requires an overhaul from various perspectives as has been observed by several financial working groups and committees over the past few decades to align it with the international best practices.

[99] Frank Allen et al, *Deposit insurance and risk taking*, Oxford Review of Economic Policy, Vol 27 Number 13, 2011 pg. 464-478.

[100] Asli Demirguc-Kunt et al, *IMF Working Paper on Deposit Insurance Database*, July 2014.

1. Depository insurance in India is the function of a singular entity.

Under the Indian law, the DICGC established under the DICGC Act is the only entity responsible for the insurance of deposits[101] deposited with certain banks. The scheme of the DICGC Act is such that the banks (i.e. all commercial banks including branches of foreign banks functioning in India, local area banks and regional rural banks, and all urban co-operative banks[102]) are the insured entities and each depositor in a bank is insured up to a statutory cover of INR 1,00,000/- for both principal and interest amount held by him in the same capacity and same right[103] as on the date of liquidation/cancellation of bank's licence or the date on which the scheme of amalgamation/merger/reconstruction comes into force. All banks have to compulsorily take the insurance cover from the DICGC and are not permitted to withdraw from the scheme. The DICGC does not provide the insurance to the depositors directly, but through liquidators, in the case of liquidation of a bank, and through the transferee bank in the case of amalgamation/merger/reconstruction, within two months from the date of receipt of claim list from the liquidator / transferee bank. The DICGC is entitled to re-imbursement of the insurance cover expended by it under the DICGC Act. The DICGC collects a flat insurance premium from insured banks for administration of the deposit insurance system, which currently stands at 0.1% per annum, which is borne by the banks themselves and is not passed on to the depositors. The premium to be paid by the insured banks are computed on the basis of their assessable deposits. Insured banks pay advance insurance premium to the DICGC semi-annually within two months from the beginning of each financial half year, based on their deposits as at the end of previous half year. A deposit insurance fund is maintained by the DICGC which is credited with amounts *inter alia* from the insurance premium, the re-imbursements made to it by the insured banks, the investment income received from the central government securities etc., however, no statutory limit for the said fund is provided for. The RBI may also advance certain sums of money (up to a maximum of INR 5 crore) for the purposes of the deposit insurance fund. The said funds are utilized for the settlements of claims of depositors of banks taken into liquidation/ reconstruction/amalgamation etc.

2. Several reforms are required to the domestic framework on deposit insurance.

Several ingredients of the deposit insurance regime require consideration on the basis of reports of the financial committees or international best practices (more specifically the IADI[104] Core Principles

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[101]Savings, fixed, current, recurring deposits etc. except the following types of deposits - (i) Deposits of foreign Governments; (ii) Deposits of Central/State Governments; (iii) Inter-bank deposits; (iv) Deposits of the State Land Development Banks with the State co-operative bank; (v) Any amount due on account of any deposit received outside India (vi) Any amount, which has been specifically exempted by the corporation with the previous approval of Reserve Bank of India.

[102] Except primary co-operative societies.

[103] As explained in http://www.rbi.org.in/scripts/FAQView.aspx?Id=64.

[104] International Association of Deposit Insurers is an international body which was formed in May 2002 to enhance the effectiveness of deposit insurance systems by promoting guidance and international cooperation.

for effective deposit insurance systems[105] (the "**Core Principles**")). Some of them are discussed below.

The adequacy of the insurance coverage limit needs to be examined. The current statutory insurance coverage limit under the DICGC Act is INR 1,00,000/- which was last revised in the year 1993. Prima facie it appears to be on the lower side, especially when compared to other jurisdictions across the world, where countries like the UK and US have insurance coverage limits of $1,39,978 and $2,50,000 respectively.[106] Thereafter, it was suggested by the Jagdish Capoor Working Group Report on Reforms in Deposit Insurance in India[107] in the year 1999 ("**Jagdish Capoor Working Group**") that no revision was required, although it suggested the introduction of a limited co-insurance[108].However, later, the Damodaran Committee Report on Customer Services[109] suggested that the deposit insurance cover should be raised to INR 5,00,000/- so as to encourage individuals to keep all their deposits in a bank convenient for them.

The Core Principles state that whilst the coverage should be limited, credible and cover the large majority of depositors, it should leave a substantial amount of deposits exposed to market discipline. This has been recommended to sufficiently protect a majority of depositors, who do not have an incentive to pre-emptively withdraw their deposits, while keeping a meaningful percentage uninsured in order to provide an incentive to larger depositors to monitor the risk-taking activities of the financial institution.[110] Although a low insurance coverage may result in disorderly bank runs, establishing a high insurance coverage may lead to a greater possibility of moral hazard[111] and hence it is necessary to strike a balance. There are two approaches which have been utilized for the

[105] The International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS) issued the *Core Principles for Effective Deposit Insurance Systems* in June 2009 which have been updated as on November, 2014. A *Compliance Assessment Methodology for the Core Principles* was completed in December 2010. The Core Principles and their compliance assessment methodology are used by jurisdictions as a benchmark for assessing the quality of their deposit insurance systems and for identifying gaps in their deposit insurance practices and measures to address them. They are also used by the International Monetary Fund (IMF) and the World Bank, in the context of the Financial Sector Assessment Program (FSAP), to assess the effectiveness of jurisdictions' deposit insurance systems and practices.

[106] Table 2 (Coverage of Explicit Deposit Insurance Schemes Around the World, end-2013), Asli Demirguc-Kunt et al, *IMF Working Paper on Deposit Insurance Database*, July 2014.

[107]Dated 4th November, 1999, *available at* http://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?FromDate=11/04/99&SECID=12&SUBSECID=2

[108] Co-insurance in terms of deposit insurance means that a certain amount of the insurance cover has to be borne by the depositor himself, and the remaining portion is insured by the insurer, in the event of a bank failure. The Core Principle 8 states than as essential criteria for the deposit insurer is to not incorporate co-insurance, and during the financial crisis in 2007 and thereafter, co-insurance was abolished by majority of the countries as it was feared it might jeopardize depositor confidence and financial stability generally. Post the crisis it was not reinstated as it had lost credibility by then.

[109] Dated 3rd August, 2011, Available at http://rbi.org.in/scripts/PublicationReportDetails.aspx?ID=645.

[110]IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage, dated March, 2013.

[111] Moral hazard arises when parties have incentives to accept more risk because the costs that arise from the risk are borne, in whole or in part, by others.

purposes of determining the optimal coverage limit – (i) the early approach of using GDP as the basis and typically one or two times the per capita GDP was considered appropriate[112], and in practice it averages to about twice the GDP (though there is a wide range around that average)[113] (“**Approach 1**”); (ii) a more robust approach where a limit that covers at least 80 percent of depositors and 20–40 percent of total deposits is generally considered adequate[114] (**Approach 2**”). Approach 1 is not preferred as the per capita GDP distribution of one country cannot be easily compared with another country as they may not share the same characteristics with respect to their financial systems and the objective of their deposit insurance systems may be different. In view of this, a standard level of insurance coverage on the basis of per capita GDP cannot be set.[115] Approach 2 is considered to be more feasible for jurisdictions where the aim is to protect small depositors and where deposits are distributed between large number of relatively small deposits and small number of large deposits.[116] Approach 2 has also been used by the European Commission for the purposes of revising the coverage limit under the EU Directives on deposit insurance, from EUR 20,000 (which covered about 65% of the eligible deposits) to EUR 50,000 (which covered about 80% of the eligible deposits)[117] and ultimately to EUR 100,000 (which would cover 95% of eligible deposits, 7% more than before the crisis).[118]

As per the Annual Report 2013-14 of the DICGC[119], it was able to fully protect 92.4 percent of the deposit accounts as on March 31, 2013, as against the international benchmark of 80 percent. Amount wise, 31.2 percent of the assessable deposits were protected by the deposit insurance cover, as against the international benchmark of 20-40 percent. Therefore theoretically, there does not appear to be an immediate need for the revision of the insurance coverage limit (as also has been reiterated by the DICGC, on the basis of the same rationale and the figures applicable at that time[120]) however,

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[112] International Monetary Fund (IMF) Working Paper, *Deposit Insurance: Actual and Good practices*, Gillian G.H. Garcia (1999)

[113] IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems:Deposit Insurance Coverage, dated March, 2013; IMF Country Report on European Union: Publication of Financial Sector Assessment Program Documentation—Technical Note on Deposit Insurance, dated March 2013

[114] Rule of thumb accepted at the First Annual Conference of the International Association of Deposit Insurers (IADI) in Basel, Switzerland, May 2002.

[115]Draft IADI Deposit Insurance Coverage Discussion Paper, dated August 2009; IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems :Deposit Insurance Coverage, dated March, 2013

[116] Draft IADI Deposit Insurance Coverage Discussion Paper, dated August 2009; IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems :Deposit Insurance Coverage, dated March, 2013

[117] Explanatory Memorandum to the **Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on Deposit Guarantee Schemes as regards the coverage level and the payout delay, October, 2008**

[118] Commission proposes package to boost consumer protection and confidence in financial services, July 2010, Available athttp://europa.eu/rapid/press-release_IP-10-918_en.htm?locale=fr ; http://europa.eu/rapid/press-release_MEMO-10-318_en.htm?locale=EN

[119] Available at http://www.dicgc.org.in/English/pdf/AR2013-14.pdf

[120] Core Principles for Effective Deposit Insurance Systems – Position in the Indian Context, February 2008, Available at http://www.dicgc.org.in/english/Pub_Report-Research2.html#9

the Core Principles specifically state that the level and scope of coverage should be reviewed periodically e.g. at least every five years to ensure that it meets the public policy objectives of the deposit insurance system. For instance, the Article 6 of the recast EU Directives[121] mandate that the coverage limit has to be reviewed *periodically* by the European Commission and at least once every five years taking account in particular of developments in the banking sector and the economic and monetary situation in the European Union, and a specific provision has been made for adjusting of the coverage limit in accordance with inflation in the European Union on the basis of changes in the harmonized index of consumer prices published by the European Commission since the previous adjustment. The last review in the Indian scenario having being undertaken as long back as in 1993 i.e. almost 25 years ago (with revisions prior to 1993 being undertaken in quick succession[122]), it appears that a revision is long due.[123] Coverage limits may need to be reviewed and when necessary adjusted because of factors such as: inflation, the growth of real income, the composition and size of deposits, stakeholder expectations, the development of new deposit products, additional funding requirements, and other factors that could affect the public-policy objectives of the deposit insurance system.[124]

The IADI lays down a four step iterative process[125] that can be used to determine the appropriate coverage limit where the relevant financial data is available – First, the coverage level that fully protects most retail depositors is determined and this may range upwards from 90–95 percent of the number of total depositors; second, two things are to be estimated (i) the value of deposits at risk of loss and (ii) the likelihood of failure. The estimation methods may be technical (such as, value at risk or probabilities of bank failure) or more straightforward (such as, covering a given number of small and medium-sized banks); third, funding requirements to support coverage limits are examined to ensure that adequate funding for a typical loss is available, whether from an ex-ante deposit insurance fund or secured ex-post funding arrangements; and fourth, if the resulting funding requirements are not realistic and the resources cannot be made available, coverage limits will need to be modified. Therefore, by following the said iterative approach, it may be conclusively determined whether the insurance coverage limit as it stands today is adequate in reality, and accordingly, appropriate revisions may be made to the coverage limit.

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[121] Directive 2014/49/EU of the European Parliament and of the Council on deposit guarantee schemes (16 April 2014)

[122] The amount of Rs. 1,500 raised to Rs. 5,000 w.e.f. January 1, 1968; Rs. 10,000 w.e.f. April 1, 1970; Rs. 20,000 w.e.f. January 1, 1976; Rs. 30,000 w.e.f. July 1, 1980; and Rs. 1,00,000 w.e.f. May 1, 1993.

[123] Address by Chairman (Shri Subir V. Gokarn), Deposit Insurance and Credit Guarantee Corporation Golden Jubilee Year (2011), Available at http://www.dicgc.org.in/english/pdf/Speeches/Address_by_Chairman.pdf

[124] IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage, dated March, 2013

[125] Please see IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage, dated March, 2013.

The premium rate required to be paid by depository institution needs to be re-examined. Under the DICGC Act, the insured banks are required to pay a flat premium of 10 paise per INR 100 assessable deposits per annum to the DICGC. Such a flat premium rate materializes into a uniform rate of premium payable by all banks, irrespective of the level of risk that a bank poses to the deposit insurance system and its rating and can be perceived as unfair.[126] Therefore, when the premium rate was hiked in 2005 from 0.05% to 0.08%, several strong banks opposed it on the basis that an increased premium rate which is flat amounted to their penalization. The Narsimhan Committee Report[127] suggested the need to shift from a flat rate premium to a risk based premium such that institutions which have riskier portfolios or which have lower ratings should pay higher premium. This recommendation was accepted by the Jagdish Capoor Working Group as it would minimize moral hazard, however, it was suggested that the risk-based pricing should be high enough to cover the expected reimbursement in the event of a failure. DICGC in its report on the Core Principles in 2008 argued that a risk-adjusted premium system was not introduced, given the prevalence of non-competing categories of banks with different prudential norms for regulation and lack of supervisory rating system for banks other than commercial banks. Dr. Subbarao, ex-Governor of RBI, has also suggested that risk based premium is not necessarily optimal in the Indian context as it would adversely affect the stock price of already weak bank and a clearer assessment of the trade-off between minimizing moral hazard and placing additional burden on already weak banks is required and yet serve an important function of financial inclusion.[128] However, none of the reasons provide any clarity as to how the flat premium system is fair in a financial system where the risk profile and the ratings of the banks vary tremendously and go against the government's recommendation of adopting a risk based premium system. Thus the possibility of introducing risk based premium should be explored.

The deposit insurance fund needs to be strengthened. Public confidence in deposit insurance is largely determined by whether the public believes that the deposit fund is large enough to meet its commitments. The DICGC Act does not provide for any statutory limit on the amount that is required to be maintained in the deposit insurance fund. Any shortfall shall be taken care by the RBI as it shall advance certain sums of money (upto a maximum of INR 5 crore) for the purposes of the deposit insurance fund. By the end of March 2014, the size of DIF stood at INR 406,179 million including surplus of INR 50,683 million (up from INR 361,203 million as on March 31, 2013) implying a Reserve Ratio (ratio of Deposit Insurance Fund to Insured Deposits) of 1.7 per cent[129] as against the

[126] IADA General Guidance for Developing Differential Premium Systems, October, 2011

[127] Committee on Banking Sector Reforms (Narsimhan Committee II) – Action taken on the recommendations, *available at* http://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=251,

[128] Inaugural address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the IADI-DICGC International Conference - Role of Deposit Insurance in Bank Resolution Framework – Lessons from the Financial Crisis - organized as part of DICGC's Golden Jubilee celebrations; Jodhpur, India, November 14, 2011, *available at* http://www.dicgc.org.in/english/pdf/Speeches/Gov-speech.pdf

[129] Annual Report 2013-14 of the DIC, available at http://www.dicgc.org.in/English/pdf/AR2013-14.pdf

international benchmark of 1.25%. However, the situation was starkly different in 2008 when the Reserve Ratio stood at 0.85% and at that time, the DICGC had recommended amendment of the DICGC Act to provide for unlimited collateralised borrowing from RBI[130]as the amount of INR 5 crore may be insignificant in the time of need. Also in 2004, there were multiple co-operative bank failures which drained out the deposit insurance fund, it was being contemplated that the RBI would re-capitalize the fund on the basis of an executive order. The Jagdish Capoor Working Group had recommended the deposit insurance fund to be maintained at a level of 2% of the insured deposits. Therefore, to provide for future contingencies which may not be predictable now, and to be ready to deal with widespread financial crisis and extraordinary situation of systemic failure of banks so as to ensure readily available funds for prompt re-imbursement to depositors, a certain statutory limit may be prescribed for the maintenance of the deposit insurance fund and the backstop support from the RBI may be increased significantly or made unlimited with a quick approval process[131]. It has to be also borne in mind that strengthening the deposit insurance fund of the DICGC is a critical pre-requisite to increasing the insurance coverage limit.

The possibility of DICGC exercising an enhanced role in resolution of financial institutions. Under the DICGC Act, the role of the DICGC is limited to a "*paybox*" or an entity that only pays insurance premiums to depositors at the failure of banks and does not have additional responsibilities. For this reason, deposit insurers have often been left out of discussions about maintaining financial stability or in reviewing resolution options.[132] It has been suggested that the role of the DICGC be expanded to "paybox plus" such that it plays a more pro-active role in regulatory frameworks in terms of early detection of and timely intervention of troubled banks before banks become non-viable, and also failure resolution. It has been suggested that though the DICGC should be made 'paybox plus', but it may not be necessary to have a separate supervisory machinery in DICGC independent of the RBI as is the practice in some other jurisdictions, notably the United States[133], and thus this reflects development of a limited 'paybox plus system'. As per the Core Principle 14, the failure resolution includes not only re-imbursement of the depositors' money, but also powers to replace and remove senior management, terminate contracts, transfer and sell assets and liabilities, write down or convert debt to equity and/or establish a temporary bridge institution, resolution by a least cost mechanism etc. The involvement of deposit insurers in the prudential supervision as well as in the resolution procedures of financial institutions increases the credibility of the insurance scheme and

[130] http://www.dicgc.org.in/English/Pub_Report-Research2.html#10

[131] Valedictory Address by Dr. K.C. Chakrabarty, Deputy Governor, RBI at the International Conference on Role of Deposit Insurance in Bank Resolution Framework – Lessons from the Financial Crisis delivered on Nov 15, 2011 at Jodhpur.

[132] IADA Guidance Paper on Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage, dated March, 2013

[133] Subbarao for sweeping changes in DICGC, 19th January, 2010, *available at* http://archive.indianexpress.com/news/subbarao-for-sweeping-changes-in-dicgc/568961/ ; Report of the Jagdish Capoor Working Group on Reforms in Deposit Insurance in India

the resilience of the financial system.[134] Hence, it may be possible to transform the DICGC from a 'paybox' to 'paybox plus' as an alternative to the proposed Prudential Regulation Authority, however to do so, a detailed analysis of the relevant laws and a complete overhaul of the DICGC Act is required, and also, it has to be ensured that the deposit insurer has the operational independence and sufficient resources to exercise its enhanced powers in such modified role.

The re-imbursement of deposits has to be expedited. It has been observed that however generous and however much confidence the depositors have in eventually getting back their deposits, the prospect of losing access to their fund for more than a few days can initiate a bank run[135], and also, asymmetric and missing information in relation to the deposits can cause significant delays in the entire process of resolving bank insolvencies. [136] In the context of the UK regime, it had been suggested that even if the UK deposit insurer, Financial Services Compensation Scheme ("**FSCS**"), has a limited role in the liquidation process, it should have early access to the relevant data on deposits in a failed bank which is necessary to prepare prompt payouts.[137] To this effect, the 'single customer view' information system has been developed and operationalized in the UK which is defined as "a single, consistent view of an eligible claimant's aggregate protected deposits with a deposit taker".[138] It requires all deposit takers to maintain single customer view files ("**SCV file**") in an electronic format containing all the information set out in COMP 17.2.8R.[139] The deposit takers should be able to provide the FSCS with a single customer view for each eligible claimant[140] within

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[134] Frank Allen et al, *Deposit insurance and risk taking*, Oxford Review of Economic Policy, Vol 27 Number 13, 2011 pg. 464-478

[135] Treasury Committee Seventeenth Report dated 22nd July, 2008, Available at http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/1008/100808.htm#a20

[136] Robert DeYoung et al, *A theory of failed bank resolution: Technological change and political economics*, Journal of Financial Stability (2011)

[137] Konrad Szelag, *Recent Reforms of the Deposit Insurance System in the United States: Reasons, Results, and Recommendations for the European Union*, National Bank of Poland Working Paper (May 2009)

[138] FSA Policy Statement 09/18 on Financial Services Compensation Scheme reform Single customer view – Verification, Available at http://www.fsa.gov.uk/pubs/policy/ps09_18.pdf

[139] Prudential Regulatory Authority Handbook, COMP 17.2 Core systems and information requirements, Available at http://fshandbook.info/FS/html/PRA/COMP/17/2

[140] Except accounts under HMT sanction, dormant accounts as defined by the Dormant Bank and Building Society Accounts Act 2008, legally disputed claims and beneficiary accounts in which the beneficiary is not immediately identifiable. Such excluded accounts may be entitled to compensation after further investigation by the FSCS and/or the insolvency practioner.

72 hours of request from FSCS.[141] However, there is a threshold[142] below which an electronic submission of the SCV files is not required, but a notification in this regard (that they fall below the threshold level and chose not to comply with the electronic requirements) has to be given to the FSCS. Having said that, they are still required to provide the relevant information to FSCS within the prescribed time limit.[143] The SCV records within the SCV file which are marked / flagged as *inter alia* having no valid address of the deposit holder, or where the account holder is deceased and probate needs to be carried out or if they are marked for fraud, dispute, money laundering etc. are to be tagged as "not fit for straight through reimbursement" and are payable within 20 days of the bank failure whereas the SCV records tagged as "fit for straight through reimbursement" are payable within 7 days of the bank failure (or to be more precise, after the determination by the competent authority or a judge that deposits are unavailable). In this context it is important to note that the recast EU directives[144] require the payout deadline to be brought down from 20 days to 7 days in a phased manner.[145]

Other associated reforms which have been brought about to assist in faster re-imbursement of the deposits are[146] – (i) the BA 2009 enables the FSA to collect from banks all information that the FSCS requires, and share it with the FSCS before default and the legislation also allows the FSCS to obtain information directly from banks as soon as a bank is declared in default[147] , helping FSCS in the execution of its duties; (ii) gross payout is mandated to speed the payout process and thus the depositor's debts are not set-off against any positive balances held with the same authorized deposit taker; (iii) the FSCS has an automatic right to pay compensation to eligible claimants without requiring them to make an application; (iv) it is a fundamental requirement for the FSCS to have funds available and for this purpose it is allowed to borrow from the National Loan Funds.[148]

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[141] As a part of the implementation process, the SCV file verification was outsourced to a company named Experian and the verification involved a number of data checks including reviewing the data to ensure the compensation limit has been applied, the required data fields have been completed, the aggregated accounts add up to the compensable balance and that the file is secure and can be run through the verification system. All firms with electronic SCV solutions were required to submit a sample SCV file, containing a representative sample of 10 per cent of their records or 10,000 records, whichever is less, to the FSCS by January 31, 2011. FSCS and Experian ran the sample SCV files through the verification solution to ensure the SCV file is fit for use. (IADI General Guidance for Developing Effective Reimbursement Systems and Processes (October 2012))

[142] Deposit takers which hold less than 5000 accounts

[143] http://www.fscs.org.uk/uploaded_files/faster_payout_qa_update_-_full_v4_2.pdf

[144] Directive 2014/49/EU of the European Parliament and of the Council on deposit guarantee schemes (16 April 2014)

[145] 20 working days until 31 December, 2018 , 15 working days as from 1 January 2019, 10 working days as from 1 January 2021, and eventually 7 working days as from 1 January 2024

[146] IADI General Guidance for Developing Effective Reimbursement Systems and Processes (October 2012)

[147] Konrad Szelag, *Recent Reforms of the Deposit Insurance System in the United States: Reasons, Results, and Recommendations for the European Union*, National Bank of Poland Working Paper (May 2009)

[148] Section 223B, FSMA 2000

At present, in India, the DICGC Act provides for a time of three months to the liquidator to submit the claim list to the DICGC and thereafter a time of two months to the DICGC to pay to the depositors. However, the international best practice requires the settlement of claims in a period of 7 days[149], and thus, a drastic reduction is required to be brought about in the time required for the settlement of claims. Digitalization of the records of the depositors, records of the insured banks and electronic preparation / filing / processing of claims, as is undertaken in the UK system, will expedite the claim settlement process. We understand that the process for operationalizing such a mechanism was under consideration under the Integrated Claims Management System[150] ("**ICMS**"), the main objectives of which were - (i) establishment of a process for the minimization of time and visual checking / reconciliation of the depositors' list for arrival at the deposit claim amount; (ii) to provide technical support to liquidated banks to prepare error free claims list; (iii) maintain historical data for depositors; (iv) develop capability to make payments through physical and electronic mode; (v) to arrive at the size of insured deposits, likely liability on a particular date and other relevant statistical data etc. It is submitted if such a system is not already operationalized, it should be done as soon as possible and upgraded in line with the best practices discussed above. Further, the DICGC Act should be amended to provide for earlier settlement of deposits.

C. Other resolutions tools that the RBI could resort to

Several strategies have been proposed in the wake of the 2008 financial crisis aiming to avoid another protracted and chaotic insolvency of large financial institutions ("**FI**") together with all the attendant negative impacts on the wider economy. This section discusses some such strategies which could be introduced within the existing legal framework.

1. Bail-in mechanism as a strategy for resolution:

The primary aim of the bail-in strategy is to attempt to force an internalization of the costs of FI failure by making equity holders and debt holders in the failing FI bear the losses in the first instance prior to looking for external sources of funds. During the 2008 financial crisis, regulators in the US and the UK had to commit billions of dollars in bailout funding to distressed FIs. This was done as emergency funding in order to prop up the financial system and avoid contagion effects spreading through to other sectors of the economy from distressed FIs such as Lehman Brothers and AIG. However, an implication of such "bail-out" measures was that the original financial stakeholders in a failing FI, i.e., the equity and debt holders would escape (to a certain extent) without suffering losses. Assuming that as a result of the bail-out, the distressed institution continues operations and returns to solvency or profitability (as was the case in AIG, RBS etc.) there would have been a pure

[149] Core Principle 15

[150] Invitation for Expression of Interest for the development, supply and implementation of ICMS dated 27th February, 2009, Available at http://www.dicgc.org.in/hindi/docs/dicgc-icms-eoi-27feb09.pdf

transfer of wealth from the taxpayer (the government) to the equity and debt holders in the failing institution. Apart from being viewed as inherently unfair, such a transfer also has the effect of entirely insulating the equity and debt holders from losses in their investments, thereby encouraging more irresponsible and risky investments ex ante by the stakeholders in systemically important FIs. Bail-outs cause the twin economic problems of negative externalities (the costs and risks of insolvency not being fully borne ex post by the relevant risk-takers) and moral hazard (the negative externalities leading to more aggressive risk taking ex ante by the risk takers).

In order to address these concerns, regulators have proposed the introduction and application of the "bail-in" power in the event of the failure of a systemically important financial institution. The use of such bail-in powers would entail the losses in the FI being first absorbed by the equity and debt holders of the FI prior to resorting to "external" sources of financing to rescue the FI. That is, equity and debt instruments in the FI would be required to absorb losses to a certain threshold prior to infusing taxpayer money in the form of a bail out of the FI. The way these bail-in powers have been introduced – either by regulatory mandate or by incentivizing their use through favourable regulatory capital treatment – has varied from country to country, however, the rational underlying the introduction of such powers has been the same. One approach has been to mandatorily require a certain portion of the FI's capital structure to be made up of "bail-in bonds" (i.e., bonds which on their terms will either be converted to equity or be completely written off in value at a point prior to the point of complete non-viability of the FI) and if such requirement is not met, subject the recalcitrant FI to punitive capital charges. Another approach has been to incentivize the issue of bail-in bonds, by providing them with more favourable regulatory capital treatment than non-bail-in bonds. This section will consider briefly the international regulatory approach to bail-in requirements by considering a few significant jurisdictions. We will also briefly look at the profile and incentives of investors in such bail-in instruments.

International Regulatory approach to Bail-in

The first post-2008 regulatory proposal to introduce bail-in came from the Basel Committee for Banking Supervision ("Basel" or "BCBS") in 2011 which introduced minimum loss absorption requirements for instruments which intended to qualify for tier 1 and tier 2 capital treatments. The January 2011 BCBS requirements meant that in order to qualify for favourable capital treatment, such instruments were required to contain provisions which allowed the instruments to be converted into equity or written off entirely at the point that the institution becomes non-viable. These measures were aimed at addressing concerns that pre-2008 instruments which purported to be "additional tier 1" capital instruments and contained similar write-off/conversion features specified the "point of non-viability" ("**PONV**") at such a late stage in the timeline of ruin of an FI that it was all but a necessity for the state to step in – meaning that the conversion/write off triggers were in practice never met.[151] The January 2011 BCBS requirements meant that the PONV had to be drafted

[151] Bank for International Settlement, "Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee," January 13, 2011, *available at* http://www.bis.org/press/p110113.htm

in such a manner so as to kick in at a relatively early stage of an FI's financial decline. The January 2011 BCBS requirements also contemplated bail-in provisions being introduced by regulation or legislation rather than through the inclusion of provisions in contractual documentation.[152] The requirements regarding contractual provisions did not apply if the home jurisdiction of the FI contained rules which required the compulsory write off/conversion of tier 1 and tier 2 instruments in this situation.

The FSB Key Attributes (discussed above) specify that the power to conduct "Bail-in within resolution" is one of the key attributes of an effective resolution regime for FIs. The Key Attributes require that the bail-in power should "enable resolution authorities to convert or write down any contingent convertible or contractual bail in **<u>instruments whose terms had not been triggered prior to entry into resolution</u>**." This is in addition to requiring that the bail-in power permit a "write down of equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses; convert into equity or other instruments of ownership of the firm under resolution all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation."

Bail-in has proved an extremely popular tool in Europe. The EC Recovery and Resolution Directive ("RRD") introduced bail-in as a regulatory power in the European context. By far the most far ranging bail-in proposals implemented, the RRD specifies that investors and creditors representing 8% of an FI's total balance sheet will have to be bailed-in prior to resolution authorities being able to access other forms of stabilization funding. The RRD also requires greater clarity from banks on where bail-in capital is held and about the contractual terms governing conversion. The regulatory power to bail-in is broadly worded and affords significant discretion to regulators. FIs will be required to meet a minimum requirement of own funds and eligible liabilities capable of being bailed in. The percentage will be equal to a percentage (to be set by the relevant national authorities on an FI by FI basis) of total liabilities and own funds of the FI. The RRD is currently undergoing the process of national implementation by the member states of the European Union.[153]

While the Unites States has not formally enacted bail-in powers in federal legislation, there are several indications that it may choose to adopt broadly similar powers. In several significant recent speeches by members of the Federal Reserve, it has been noted that the United States is preparing a proposal to require systemically important banks to issue 'bail-in able' long term debt that will enable insolvent banks to recapitalize themselves in resolution without calling on government funding – this cushion known as the "gone-concern buffer".[154] The Vice-Chairman of the Federal Reserve has

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[152] Id.

[153] Freshfields Bruckhaus Deringer, "Key points from the EU Recovery and Resolution Directive", *available at* http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/RRP/EU%20Directive%20key%20points.pdf

[154] Louis Cammarosano, "The U.S. Plans To Bail-In The Banks – Federal Reserve Vice Chairman", August 12 2014, available at https://smaulgld.com/u-s-plans-to-bail-in-the-banks/

noted in a speech that the United States is preparing a detailed bail-in proposal. While such a power could be implied from the bar under the Dodd-Frank Act against using public funds to bail out a failing FI, it appears officials in the United States are in the process of issuing detailed rules and processes around any future exercise of bail-in powers – similar to those enacted under the RRD in Europe.[155]

Several other jurisdictions are also currently in the process of enacting similar bail in powers. It is likely that over the next couple of years most sophisticated financial jurisdictions will have a power analogous to bail in enacted in their local regulations/legislation. For instance- Japan, under its Deposit Insurance Act has also required the write down or conversions of an FI's capital instruments under certain conditions and Japan's Financial Services Agency is in the process of drafting detailed rules and processes governing the exercise of the bail-in power by authorities.[156]

In addition to regulators, banks and financial institutions themselves are beginning to utilize bail-in bonds innovatively. UBS, for instance has announced plans to pay bonuses to its key managerial staff in bail-in bonds in order to align the incentives of senior management with the long-term success of the firm. By paying bonuses using bail-in bonds, UBS seeks to ensure that senior management personnel who are often responsible for the excessive risk taking that exposes the FI to failure absorb such losses on their interests in the FI received over the years as bonus – the theory being that this will disincentivise them from excessive risk taking and encourage more prudent behavior. [157]

The Bail-in Bond Market

The introduction of the wide ranging powers entailed by the bail-in tool greatly adds to the uncertainty faced by investors in the debt and other instruments issued by FIs. In this context, it may be queried whether there will be any takers for such "bail-in" instruments where investors potentially face the prospect of seeing their holdings converted into equity or indeed being completely written off. However, since the 2008 crisis, there has developed a healthy market in bail-in debt issued by FIs especially in Europe. According to Bloomberg, Banks have sold close to USD 63 billion of contingent capital instruments or "CoCos" to meet the 2019 Basel deadline and according to certain estimations banks will need to issue as much as 500 billion Euros in additional qualifying debt in order to meet the new requirements.[158] Though it is impossible to say with certainty who the underlying investors in the largely anonymous international bond markets (where the interests are held through clearing systems such as Euroclear and Clearstream) are, the primary targets of

[155] "Fed Vice Chair Fischer On U.S. Bailin "Proposals", December 8, 2014, *available at* http://www.zerohedge.com/node/492827

[156] "Japan: GLAC and the bail-in mechanism", September 23, 2014, *available at* http://www.iflr.com/Article/3383571/Japan-GLAC-and-the-bail-in-mechanism.html

[157] Philip Adrick, "UBS bonuses to be part-paid as 'bail-in bonds", THE TELEGRAPH, Feb 5, 2013, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9851258/UBS-bonuses-to-be-part-paid-as-bail-in-bonds.html

[158] Frances Schwartzkopff, "Bank Bail-In Extras Alarm Investors as Danske Eyes Debt", BLOOMBERG, December 8, 2014, *available at* http://www.bloomberg.com/news/2014-12-07/bank-bail-in-extras-alarm-investors-as-danske-explores-new-debt.html

marketing by investment banks selling CoCos appear to be institutional investors such as pension funds etc. who are long term real value investors and who are usually looking to hold the debt to maturity. The primary attraction of bail-in debt such as CoCos over non-bail-in debt issued by the same financial institution is the higher returns that bail-in debt can command – a higher return which such institutional investors evidently feel is not outweighed by the added risks that such bail-in/convertible instruments entail. Returns on bail-in debt roughly lie between equity and simple debt – as theory would predict.

The most recent issuances of bail-in debt in Europe which have all taken place after the new requirements under the RRD have received a lukewarm response from institutional investors who appear to be worried by the increasing uncertainties placed on their investments by far-reaching regulations. Credit rating agencies have also explicitly warned institutional investors that bail-in debt is riskier than appreciated by market participants.[159] Two instances in Europe – (i) in respect of SNS REAAL N.V, a financial services firm in Netherlands where the Dutch government nationalized the firm and (ii) in respect of the Co-operative Bank Plc in the UK which was forced to implement a recapitalization programme – both, being instances which triggered the bail-in bonds issued by the respective entities, brought home to investors, the underlying risks in investing in bail-in bonds, especially those issued by second tier financial services firms. However, despite the concerns around regulatory changes, it must be said that a relatively robust and deep market for bank bail-in bonds primarily involving real money long term value investors such as pension funds etc. has developed in Europe with such participants primarily motivated by the higher yields obtained on such debt and the relatively remote risk of bail-in powers ever being exercised.

We understand that the banking community in India does find investors for debt instruments issued to meet the Tier II capital requirements in spite of the possibility of a write-off. Therefore, if the RBI was to make the issuance of 'bail in able' bonds mandatory (either as a pure debt instrument convertible into equity or as perpetual preference shares convertible into equity shares – it may be noted that non-cumulative preference shares may be more viable for banks), arguably it would be a more attractive instrument for the investors than the instruments currently being issued for meeting the Tier II capital requirements. Such bonds will be convertible into equity shares at the discretion of the RBI/concerned resolution authority upon entry into insolvency or such other insolvency linked trigger events as the RBI/resolution authority may prescribe. Once the 'bail in able' instrument in converted into equity, the holders of such instruments will rank below creditors at the time of liquidation. Further, if the holders of such instruments are banks, the present investment/cross-holding limits applicable to investments in banks should also be relaxed for conversion of such bonds into equity upon the happening of insolvency related events.

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[159] John Greenwood, "Bail-in bonds riskier than previously thought: S&P warns", Feb 7, 2014, *available at* http://business.financialpost.com/2014/02/07/bail-in-bonds-riskier-than-previously-thought-sp-warns/

2. Adoption of recovery and resolution plans by financial institutions

The Financial Stability Board in its Key Attributes sets out 'recovery and resolution planning' as a core measure. As part of this measure, global jurisdictions are required to have "robust and credible" recovery and resolution plans ("**RRPs**") for all systemically important financial institutions. The RRPs should reflect the nature of the institution, complexity, interconnectedness, level of substitutability and size. [160]

Individual supervisory and resolution authorities are required to ensure that the aforesaid financial institutions maintain a recovery plan. Recovery plans primarily identify ways in which a systemically important financial institution is required to restore its financial strength and viability in times of financial and operational distress. According to FSB, the aforesaid plans will include: (a) credible options that address different situations including, *inter alia*, idiosyncratic and market wide stress; (b) situations that address capital shortfalls and liquidity pressures; and (c) systems and processes that ensure implementation of recovery options in times of distress. [161]

In addition to the recovery plan, a resolution plan is also required. Resolution plans help allow resolution of financial institutions in an orderly manner without taxpayer exposure to loss from solvency support. A resolution plan, is required to include both a substantive strategy and an operational plan, including, *inter alia*: (a) financial and economic functions for which continuity is critical; (b) suitable resolution options to preserve the aforesaid functions or wind them down orderly; (c) relevant data on the financial institution's business operations, structures, and systemically important functions; (d) potential barriers to effective resolution and actions that help mitigate the aforesaid; (e) actions to protect insured depositors and insurance policy holders and ensure the rapid return of segregated client assets; and (f) option or principles to help facilitate an exit from the resolution process. Further financial institutions are required to maintain key service level agreements that, *inter alia*, prevent termination on recovery or resolution and also help transfer the contract to third party acquirers. For global institutions, the home resolution authority will lead the process of developing the resolution plans, however, host authorities are allowed to maintain their own resolution plans for the firm's operations in their jurisdictions.[162]

RRPs are also required to be reviewed and updated regularly. Either annually, or when there are material changes to a financial institution's business or structure, the substantive resolution strategy for each financial institution should be subject to a review by both the home and the host supervisory and resolution authorities. In case the resolution authorities are not satisfied with a financial institution's RRP, the authorities should mandate them to undertake appropriate measures to address the deficiencies.

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[160] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions", October 15, 2014, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

[161] Id.

[162] Id.

In 2012, FSB conducted a review of the progress in implementation of RRPs. FSB recommended implementing several other components of the Key Attributes that depend on a preparation of effective resolution plans by systemically important financial institutions: (a) establishing an appropriate crisis management group ("**CMG**") for each global institution; (b) implementation of resolvability assessments to test resolution plans; (c) implementation of institution-specific co-operation agreements to facilitate cooperation among the supervisory and resolution authorities; and (d) cross-border cooperation protocols among the members of each institutions CMG and non-CMG member host authorities. Given the aforesaid measures required adoption of RRPs, FSB suggested that the delay in adopting such plans was the most serious impediment to improving financial stability. Additionally, FSB was working to extend the resolution-planning framework to each G20 member's domestic SIFIs, systemically important insurers, and nonbank SIFIs.[163]

In November 2014, FSB submitted a report on the progress in reform of resolution planning for global systemically important financial institutions ("G-SIFIs"). FSB identifies that CMGs and recovery plans for all the identified G-SIBs have been developed along with high-level resolution strategies and operational plans for implementation of these strategies. These strategies or resolution mechanisms would dictate how global banks restructure themselves and ensure that crucial banking functions are not disrupted, notwithstanding the failure of the larger group.[164] Whilst most host authorities participating in the CMGs, preferred a single point of entry strategy to resolution where resolution powers are applied at the top holding or parent company level by a single resolution authority alternative approaches to resolution were being explored. One of these approaches is a multiple point of entry strategy, where in case of a failure, the bankrupt component of the business of a financial institution is isolated for special treatment.[165] FSB also conducted an initial resolvability assessment process in order to promote robust and continuing reporting on the resolvability of each G-SIFI, and also determine steps that should be taken to address material recurring issues with respect to resolvability. While initial results demonstrate sufficient progress in resolution planning, however, a number of factors and circumstances affecting the feasibility and credibility of resolution of firms were identified.[166]

In the US, living wills are in the process of implementation. In terms of the Dodd-Frank Wall Street Reform and Consumer Protection Act, bank holding companies with total consolidated assets of $50 billion or more and non-bank financial companies designated as systemically important are required

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[163] "Better Late Than Never – FSB Reports Regulatory Reform Is Advancing … But Slowly", *available at* http://financial-reform.weil.com/credit-rating-agencies/late-fsb-reports-regulatory-reform-advancing-slowly/#ixzz3P9ELq03X

[164] Brooke Masters, "Banks Living wills start to take shape", FINANCIAL TIMES, August 5, 2013, available at http://www.ft.com/cms/s/0/41be5e44-f2ae-11e2-a203-00144feabdc0.html#ixzz3P6SiCBuY

[165] Financial Stability Board, "Towards full implementation of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions", November 12, 2014, *available at* http://www.financialstabilityboard.org/wp-content/uploads/Resolution-Progress-Report-to-G20.pdf

[166] Id.

to submit resolution plans ("**Living Wills**") periodically to the Federal Reserve and the Federal Deposit Insurance Corporation. Living Wills are required to articulate a strategy for rapid and orderly resolution in the event of either a significant financial distress, or failure of the financial institution. In November 2011, FRB and FDIC issued the regulations that enunciated the requirements for living wills in indicating how a financial institution can be acquired, broken up or wound down quickly and effectively without jeopardizing systemic financial stability. Living wills are required to include, *inter alia*, the following: (a) a description of how resolution planning is incorporated in the firm's corporate governance structure; (b) a description of the group's overall organizational structure, including a list of all material entities, jurisdictional and ownership information, and mapping of core business lines and critical operations into corporate entities; (c) description of management information systems that support the financial institution and its material entities; (d) description of interconnections and interdependencies among a financial institution and its material entities; and (e) identification of supervisory authorities and regulators that oversee the company.[167] The rule also provides that a living will has to be credible, implying that its strategies for resolution are well-founded and based on observable and verifiable information. In a case where a living will plan submitted by a financial institution, is determined to be 'not credible' by FRB and FDIC, and a credible plan is not resubmitted within two years, the regulatory authorities are permitted to restrict the growth, activities or divest certain assets and operations of the bank as necessary to facilitate orderly resolution. [168]

In August 2014, FDIC deemed the living wills submitted by eleven major financial institutions, 'not credible'. The aforesaid institutions had submitted revised plans in October 2013, after they had failed to convince regulators about the viability of their original plans, and envisioned shareholders absorbing losses, laying off executive staff and selling assets as the primary ways to ensure an orderly and effective resolution.[169] In August, FDIC officially deemed the living wills as not credible and mandated that the financial institutions are required to develop a "less complex legal structure" and revise financial contracts by 2015, in order to provide regulators more time to resolve a failing institution, failing which changes including higher capital and leverage requirements, restrictions on growth and forcible divestitures might be enforced.[170] Some of the most important concerns raised about the living wills primarily related to, *inter alia*, potential actions of foreign regulators in case of winding up or liquidation (ring fencing, for instance), likelihood of counterparties exercising their right to unwind contracts, potential barrier to clearing and posting collateral in cases

[167]Jacopo Carmassi Richard John Herring , (2013),"Living wills and cross-border resolution of systemically important banks", Journal of Financial Economic Policy, Vol. 5 Iss 4 pp. 361 - 387

[168] Clay R. Costner, Living Wills: Can a Flexible Approach to Rulemaking Address Key Concerns Surrounding Dodd-Frank's Resolution Plans? 16 N.C. BANKING INST. 133, 133 (2012).

[169]Jesse Hamilton , "Banks File Living Wills Outlining Plans to Dismantle", BLOOMBERG, Oct 4, 2013, *available at* http://www.bloomberg.com/news/2013-10-03/banks-file-living-wills-outlining-plans-to-dismantle.html

[170] Jesse Hamilton , "Big Banks' 'Living Wills' Get Failing Grade", BLOOMBERG, Aug 6, 2014, available at http://www.bloomberg.com/news/2014-08-05/biggest-u-s-banks-told-to-simplify-their-living-wills-.html

of impending resolution and internal systems capable of providing crucial information.[171] However, the action of FDIC and Fed was criticized on several grounds, including, first, lack of access to the discount window diminishes the role of government as the lender of the last resort[172], second, no clear guidelines have been issued around framing of living wills and how future reactions of counterparties have to be taken into account, and third, no formal systems and processes for co-operation amongst different regulators for cross-border failures have been agreed upon.

In 2011, all UK deposit taking and large investment firms were asked to draft their living wills. Whilst the bigger banks were already working on their recovery and resolution plans, the FSA extended the requirement to a much larger umbrella of financial institutions. The plans require financial groups, to first, detail the measures required to be undertaken to prevent a failure, and second, for preserving key economic functions in case of a failure.[173] As part of the recovery plan which will be reviewed by the PRA and updated regularly, there are certain triggers to decide when the recovery plan will be carried out. These include, first, invoking of the firm's contingency funding plan, second, negative market sentiment or opinion towards the firm measured by liquid market-based indicators, third, an expected drop in a firm's credit rating; and finally, use of a firm's capital planning buffers. Further, while UK regulatory authorities are required to prepare a resolution plan to facilitate orderly and effective resolution of financial institutions, the institutions are required to provide a '*resolution pack'* to the PRA. The pack must include details of significant entities in the group, key structural and operational issues, a critical function contingency analysis covering separation and controlled wind-down for a firm, and plans to overcome barriers to resolution, for instance- reducing the risk profile of a firm, such as simplification of intra-group relationships, changes in contractual arrangements etc.[174]

However, there is very little clarity on when a recovery or resolution plan will be triggered and who will decide this. In UK, it has been opined by the governor of BOE that a recovery regime should be triggered when there is no "reasonable prospect" of complying with the regulatory criteria, however, this has been criticized on grounds of bring considerable uncertainty in the process. Despite the triggers provided for this purpose, as discussed above, deciding to activate either of these plans also might require a clear indication of the true state of a financial institution, however, this is not always easy, especially in times of a financial crisis. The concern is accentuated by the problem of contagion, as failure of an interconnected institution or competitor might trigger market pressures

[171] Victoria Mcgrane "Banks' Failure on 'Living Wills' Frays Relations With Regulators", THE WALL STREET JOURNAL, Aug. 6, 2014, *available at* http://www.wsj.com/articles/regulators-banks-optimism-killed-living-wills-1407367909

[172] Gina Chon, "*Fed Blow to Banks over living wills*", Financial Times, August 17, 2014, *available at* http://www.ft.com/intl/cms/s/0/617d442c-24c4-11e4-ae78-00144feabdc0.html

[173] Brooke Masters, "Banks Living wills start to take shape", FINANCIAL TIMES, August 5, 2013, available at http://www.ft.com/cms/s/0/41be5e44-f2ae-11e2-a203-00144feabdc0.html#ixzz3P6SiCBuY

[174] Jerome Walker and SNR Denton, " UK and U.S. Comparison of Living Wills Requirements for Banks in the UK and U.S. - Part II," *available at* http://www.bna.com/uk-and-us-comparison-of-living-wills-for-banks/

that are agnostic of the state of the institution. Further, there is no consensus around who should decide to activate the recovery or resolution plan, the board of directors of the institution or the supervisors. It has been stated that in practice, "the decision to pull the trigger will be collaborative, with the resolution authority having the final say".[175]

The concept of living wills has also found favor in the EU. In October 2010, the EU framework for crisis management framework communique was issued, which comprised of, *inter alia*, preparatory and preventative measures such as a requirement for recovery and resolution plans in addition to powers to regulatory authorities to require financial institutions to make changes to their structure and business organization to ensure orderly and effective resolution.[176] In 2013, EU mandated thirty-nine financial institutions to present their living wills by the end of the year to demonstrate how the banks would be wound down in case of severe financial distress, without affecting systemic stability.[177]

However, financial regulators in Asia, including India, have been criticized for their inaction. Slow efforts by prominent Asian economies in determining how to implement measures to protect taxpayers from failures of systemically important financial institutions has hampered the pace of global reforms. In case of living wills, financial institutions that operate in several jurisdictions, have struggled to finalize their recovery and resolution plans, owing to lack of regulations on how Asian governments will act in the event of a failure.[178]

3. Section 35A of BR Act might facilitate the additional resolution tools under the present framework.

RBI has wide powers under Section 35A of the BR Act. Section 35A of the BR Act allows the RBI to issue directions to banks in public interest, in the interest of banking policy, in the interests of depositors or in the interests of the bank itself. The RBI may exercise its power under Section 35A either when called upon to do so or of its own motion. Finally, Section 35A also empowers the RBI to modify or cancel its own directions and in doing so, issue binding pre-conditions on the bank in question. As may be evident, RBI's power under Section 35A is sweeping and as subsequent sections show, judicial precedents have construed its ambit widely. The actual text of Section 35A reads as follows:

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[175] Vincent O'Sullivan and Stephen Kinsella, ""Living Wills" for Banks Sound Good, But Would They Work?", HARVARD BUSINESS REVIEW, September 14, 2012, *available at* https://hbr.org/2012/09/living-wills-for-banks-sound-g

[176] Thomas F. Huertas and Rosa M. Lastra , "Living Wills", Banco De España Estabilidad Financiera, *available at* http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/11/ref0221%20.pdf

[177] Huw Jones, "Top EU banks told to write "living will", REUTERS, Jan 23, 2013, available at http://www.reuters.com/article/2013/01/23/us-banks-eu-eba-idUSBRE90M0RE20130123

[178] Michelle Price, "Asian foot-dragging leaves taxpayers on hook for bank bail-outs" , REUTERS, Dec 8, 2014, *available at* http://www.reuters.com/article/2014/12/08/asia-regulations-idUSL3N0T92D420141208

(1) Where the Reserve Bank is satisfied that—(a) in the public interest; or (aa) in the interest of banking policy; or (b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or(c) to secure the proper management of any banking company generally, it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

Directions under Section 35A are binding and enjoy statutory force. In *Bank of India Finance Ltd v Custodian*, the Supreme Court held that any directions issued by the RBI under Section 35A would be binding.[179] This is because such directions are statutory in nature as opposed to being mere policy statements.[180] Thus the actions of banks that contravene directions of the RBI under Section 35A are reviewable and remediable by courts. In *Central Bank v Ravindra*[181] for example, the Supreme Court drew a distinction between its power to interfere in cases where the interest rate being charged by banks was excessive under the general law of India and where it exceeded the mandatory rate fixed by the RBI under Section 35A. In the latter case, the Court held, it would be in a position to review with the bank's actions and strike down the excessive rate of interest because the RBI's directions under Section 35A were statutory and binding in nature:

"The power conferred by Section 21 and 35A of the Banking Regulation Act, 1935 is coupled with duty to act. Reserve Bank of India is prime banking institution of the country entrusted with a supervisory role over banking institution of the country and conferred with the authority of issuing binding directions, having statutory force, in the interest of public in general and preventing banking affairs from deterioration and prejudice as also to secure the proper management of any banking company generally. Reserve Bank of India is one of the watchdogs of finance and economy of the nation."

Courts cannot ordinarily review directions issued by the RBI under Section 35A. Courts have time and again held that they would not interfere with or review on merits, the directions issued by the RBI under Section 35A for two reasons. *First,* because courts do not ordinarily question the motivations behind any legislation and since the RBI's directions under Section 35A enjoy statutory force, courts will not review and question the substance of the directions although they may look at the reasons behind the issuance of certain directions to understand its context.[182] *Second*, courts lack the expertise to substantively review decisions involving fiscal policy made by high-ranking

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[179] *Bank of India Finance Ltd v Custodian*, AIR 1997 SC 1952; *Durga Hotel Complex v RBI*, AIR 2007 SC 1467; *Surendra Kambli v Bhandari Cooperative Bank Ltd*, Writ Petition No. 8393 of 2012 before the Bombay High Court.

[180] *Canara Bank v Upadhyaya*, AIR 1998 SC 3000; *Durga Hotel Complex v RBI*, AIR 2007 SC 1467.

[181] AIR 2001 SC 3095.

[182] *Corporation Bank v Gowda*, (1994) 5 SCC 213; *Janata Sahkari Bank Ltd v Maharashtra*, AIR 1993 Bom 252.

statutory bodies such as the RBI.[183] In *Holystar Natural Resources Pvt. Ltd. v India*, the Supreme Court explained this approach by stating: *"In fiscal matters and/or where discretion is conferred on high ranking statutory authorities, Courts don't ordinarily interfere in exercise of power of judicial review."*[184]

RBI can act against failing banks under Section 35A. Having explained the breadth and range of the RBI's power under Section 35A, this section looks to the RBI's power to act against failing banks. In particular, it analyzes whether the RBI can act against failing banks under Section 35A. Section 35A empowers the RBI to issue directions to further the interests of four [classes]: the general public, India's banking policy, a bank's depositors and the bank itself. Of these, "banking policy" is defined in Section 5(ca) of the Banking Regulation Act to mean *"any policy which is specified from time to time by the Reserve Bank in the interest of the banking system or in the interest of monetary stability or sound economic growth, having due regard to the interests of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources."* The definition of 'banking company' allows the RBI to frame a policy in the interest of the banking system, monetary stability and economic growth provided that the RBI takes into account the interests of depositors and the need to equitably distribute deposits. By itself, the definition is wide enough to allow the RBI to act as it deems fit against failing banks. Judicial decisions appear to support this view. In *Janata Sahkari Bank Ltd v Maharashtra*[185] the Bombay High Court found that that 'banking policy' and 'banking' were "*co-ordinating subjects and both are covered within the supervisory powers of the Reserve Bank of India within the meaning of S. 35A*". In *Indian Bank v Godhara Nagrik Cooperative Credit Society Ltd*[186] the Supreme Court held that RBI could issue directions for initiating an enquiry into the affairs of the banks.

Specifically, in *Kambli v Bhandari Co-operative Bank Ltd*, the RBI had cancelled the license of a failing bank under Section 22(4) of the BR Act. In the context of the RBI's power to do so, the Bombay High Court found that the RBI's power under Section 22(4) overlapped with its powers under Section 35A and the RBI could legitimately act under either provision:

"At the outset, it may be noted that the powers of the Reserve Bank under Sections 22(4) and 35A are distinct and separate. If the Reserve Bank is satisfied that any of the conditions stipulated in Section 35A exists, and it is necessary to issue directions, generally or to any banking company in particular, the Reserve Bank may issue such directions and the banking companies generally, or the particular banking company, as the case may be, are or is bound to comply with such directions. On the other hand, if any of the conditions provided in sub-section (3) of Section 22 of the BR Act is not fulfilled, the Reserve Bank may cancel the banking licence issued to any banking company. It may

[183] *Shri Mulraj Jayantilal Sheth v RBI Governor*, AIR 2003 Bom 318; *Holystar Natural Resources Pvt. Ltd. v India*, AIR 2014 Delhi 60.

[184] AIR 2014 Delhi 60.

[185] AIR 1993 Bom 252.

[186] AIR 2005 SC 2585.

well be that there is an overlap in a given case between the jurisdictional facts provided in Section 35A and Section 22(3) for the Reserve Bank to act. In such a case, the Reserve Bank has an option to act under either or both the provisions. The action under one cannot be faulted on the ground of recourse to the other provision."[187]

RBI's power to resolve failing banks under Section 35A is not conclusive. The aforesaid cases appear to establish that the RBI's powers under Section 35A include the power to act against failing banks. However, it must also be noted that the BR Act also contains a number of other provisions that deal with the liquidation of such banks and measures that the RBI can take after obtaining approval of the government. It is a salutary principle of law that a provision of law must be construed in a way that does not reduce any other provision to a nullity. Accordingly, were the RBI to take over a failing bank under Section 35A and were such an action to be tested in court, it is possible for a court to conclude that the RBI lacks the power to take over a bank given that another provision establishes a clearly laid down framework in this behalf. However, given the wide powers of Section 35A, its statutory binding nature and limited review by Courts, it might be open for the RBI to exercise resolution tools **that are not provided for in the BR Act**, for instance- those relating to bail-in, recovery and resolution plans, and different stabilization powers that are currently being implemented in other jurisdictions (at least for such banks, the insolvency resolution of which squarely falls within RBI's competence under the present framework). However, in order to avoid legal challenges, it would be advisable to empower the RBI to use such tools through a new prudential regulation authority created (by introducing an amendment to the BR Act).

D. Emergency Resolution Fund

Another tool that could be utilized for resolving banks and other systemically important financial institutions while reducing the moral hazard associated with bail-outs out of public funds is creation of an 'emergency resolution fund' (independent of the deposit insurance fund) that can be established under a statute and ramped up with a special 'cess' collected from specified financial institutions. It may be noted that the CA 2013 proposes a Rehabilitation and Insolvency Fund ("**Fund**") for the purpose of rehabilitation, revival and liquidation of sick companies.[188] CA 2013 provides that the Fund will be managed by an administrator to be appointed by the Central Government. The provision envisages following contributions to the Fund: (a) grants made by the Central Government and other sources; (b) amounts deposited by companies, and (c) any investment income of the Fund. However, the contributions to be made by companies to the Fund do not appear to be mandatory.

It is submitted that a similar fund may be created under the BR Act (or the legislation operationalizing the Resolution Corporation) for the purpose of resolving failed or failing financial institutions (of a

[187] *Surendra Kambli v Bhandari Cooperative Bank Ltd*, Writ Petition No. 8393 of 2012 before the Bombay High Court.

[188] Section 269, CA 2013 – not operationalised yet.

size beyond a specified value) which albeit solvent at the time of making such contribution can benefit from a drawdown upon entry into insolvency/resolution procedure or where such insolvency is imminent – a solvent 'going concern' bank would not be allowed to benefit from the fund. Further, all specified financial institutions should be mandatorily required to contribute to the fund (as an emergency resolution cess). There should be no other contributories to the fund. In order to prevent moral hazard/forbearance issues, drawdown from the fund should be possible only at the discretion of the authority managing the fund and in limited circumstances during a financial crisis. Rules can be developed to determine the trigger events for drawdown, the extent of drawdown permitted and the purposes for which such amounts can be utilized (including the costs of the resolution proceedings). The proposed fund should be managed and administrated by the proposed Prudential Regulation Authority or the Resolution Corporation, as the case may be.

Although ramping up such a fund may take a significant amount of time, once established, it may go a long way in protecting the interest of the markets without perpetuating a moral hazard. The establishment of such a fund will empower the RBI/Resolution Corporation to make large-scale emergency interventions to protect the financial system in times of financial distress without the need to 'nationalise the financial sector'.[189] Closing down large financial institutions may have to be avoided in many cases where a close-down could have spillover effects on the macro-economy. In other words, notwithstanding the moral hazard argument, it may not be easy to rule out bail-outs of financial institutions whenever the next financial crisis strikes. In such a situation, an 'emergency resolution fund' may provide a useful alternative to bail-outs funded by public money.

[189] Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund, Jeffrey N. Gordon and Christopher Muller (2010).