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Need for a special resolution regime for financial institutions

This paper examines the need for a separate resolution regime for distressed financial institutions in India. It provides an overview of extant statutory provisions on the subject and notes that the law as it currently exists is inadequate and fragmented that leaves India ill-prepared for dealing with a financial crisis. This paper also examines the recommendations of the Financial Sector Legislative Reforms Commission and the Committee to draft a Code on Resolution of Financial Firms that propose large scale reforms to address the situation. The recommended measures are a step in the right direction and can go a long way in ensuring a robust resolution regime for protecting India's financial stability.

After the global financial crisis of 2007-09, jurisdictions across the world adopted initiatives to strengthen the ability of financial institutions (**"FIs"**) to withstand systemic shocks. Some of these were oriented towards promoting prudential management in FIs and have included measures like adoption of new capital and liquidity requirements[1], harmonisation of accounting and

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data collection standards[2] and prescription of principles of sound compensation practices for managers[3] etc. Some others were driven by the recognition that FIs are prone to failure despite superior regulation and that inadequate management of such failures could cause enormous financial and social losses.[4] A consensus seems to have emerged that specialized regimes are needed for managing failing FIs and several jurisdictions have enacted such regimes into law.[5]

Čihák and Nier note that in the early days of the crisis, regulators facing imminent failures of FIs in their jurisdictions were left with two choices – either to let FIs fail and file for insolvency or to bail them out through injection of public funds.[6] Subsequent experience demonstrated that both these choices resulted in sub-optimal outcomes. In the US, the Lehman Brothers insolvency filing led to a fall in global bank equity prices, rise in interbank spreads and creditor runs, compromising cash flows to corporate debtors.[7] Furthermore, the financial contagion lead to the disruption of key payment and settlement services causing further systemic instability.[8]

The alternative to insolvency were bail-outs which required infusion of enormous sums of public funds into the failing FIs. Such bail-outs resulted in significant fiscal outlays amounting to several trillion dollars in 2008-09 in the US alone.[9] Aside from the impact on the sovereign balance sheets, such bail-outs also brought into focus moral hazard concerns. It has been suggested that problems of moral hazard were a real contributing cause of the crisis and FIs emboldened by the implicit assurance of governmental support

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1 Stijn Claessens & Laura Kodres, *The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions* 8-9 (IMF, Working Paper-WP/14/46), https://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf.

2 See e.g., Financial Stability Board & IMF, *Financial Crisis and Information Gaps-Report to the G-20 Finance Ministers and Central Bank Governors* (2009), http://www.fsb.org/wp-content/uploads/r_091029.pdf.

3 *See* e.g., Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2009), http://www.fsb.org/wp-content/uploads/r_0904b.pdf?page_moved=1.

4 Financial Services and the Treasury Bureau, The Hong Kong Monetary Authority & The Securities and Futures Commission and the Insurance Authority, *An Effective Resolution Regime for Financial Institutions in Hong Kong* 7 (Jan. 2014), http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/RR_Consultation_Paper.pdf.

5 *See* e.g., Financial Stability Board, *Effective Resolution of Systemically Important Financial Institutions-Recommendations and Timelines* (2011), http://www.fsb.org/wp-content/uploads/r_110719.pdf.

6 Martin Čihák & Erlend Nier, *The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union* 4 (IMF, Working Paper, WP/09/200), https://www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf.

7 *Id.*

8 *Id.*

9 John Armour, *Making Bank Resolution Credible, in* THE OXFORD HANDBOOK OF FINANCIAL REGULATION 457 (Moloney et.al. eds., 2015).

made making risky investments knowing that they would be bailed out in the event of a collapse.[10] The experience during the crisis showed unsuitability of the aforesaid mechanisms to deal with distress in FIs. The difficulty seemed to lie in the inability of these mechanisms to maintain financial stability at an acceptable fiscal cost.[11]

The first section of the article explains why there is a need for a separate regime for FIs. The subsequent section discusses the current regime in India concerning FIs. The third section deals with the proposed reforms to this regime, while the last section concludes by analysing the interaction of these positive reforms with the Insolvency and Bankruptcy Code of 2016.

REASONS FOR A SEPARATE REGIME FOR FIS.

- Unique position of FIs: The financial sector is characterised by the structural fragility and inter-connectedness of various actors operating in the sector.[12] This makes these institutions vulnerable to contagions whereby, distress in one FI can potentially generate negative externalities extending beyond losses to the institution's immediate creditors. Additionally, some FIs may be responsible for carrying out critical functions which are fundamental to the economy. These may include activities like provision of credit, acceptance of deposits, and operation of systems of "clearing, settlement and recording of monetary and other financial transactions, such as payments, securities and derivative contracts."[13] All this, puts FIs in a unique position vis-à-vis other corporate actors which may not share the characteristics of FIs.

- Inadequacy of 'ordinary' insolvency regimes in resolving financial sector distress: Armour notes that ordinary insolvency frameworks are inadequate for managing distress in FIs owing to the time-consuming nature of the proceedings (generating unacceptable levels of risk for the creditors) and the non-appreciation of concerns of systemic stability during such proceedings.[14] Such mechanisms can further

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[10] *Id.* at 458-59. See also, Mike Mariathasan et.al., *Bailouts and Moral Hazard: How Implicit Government Guarantees Affect Financial Stability* (2014), https://gdrenice2015.sciencesconf.org/52277/document.

[11] Čihák and Nier, *supra* note 6, at 5.

[12] Armour, *supra note* 9.

[13] Reserve Bank of India, *Report of the Working Group on Resolution Regime for Financial* Institutions 76-77, http://www.sebi.gov.in/sebi_data/attachdocs/1398147216563.pdf.

[14] Armour, *supra note* 9 at 459 ["First, bankruptcy procedures take time to complete. A pay-out is not usually made to creditors until it is determined how much money will be available to do so. Consequently, creditors must bear liquidity risk associated with delay

aggravate systemic risks by "interrupting critical services, disrupting key financial relationships, and freezing financial markets [thereby] destroying value and harming the real economy."[15] The aftermath of the failure of Lehman Brothers (noted above) is a representative instance of the negative externalities generated by the application of such regimes to distressed FIs.

- Drawbacks of bail-outs: Despite their extensive use during the 2007-09 crisis, bail-outs have a number of limitations as mechanisms of addressing distress in the financial sector. Aside from the hefty costs they impose on the exchequer, frequent bail-outs can translate into implicit governmental guarantees of the continued viability of FIs. This can promote reckless behaviour by FIs and creditors and further compromise the integrity of the financial system. Furthermore, bail-outs provide authorities, limited powers to influence the functioning of the distressed institution (such as powers of replacing the management, cancellation of dividends, determination of executive compensation etc.).[16] This prevents the overhaul of institutional policies and practices which were responsible for the distress in the first place.

EXTANT REGIME IN INDIA

The financial sector in India consists of a range of functionaries.[17] It must be noted that no unified legislative framework or regulator exists in relation to the management of financial sector distress in the Indian context.[18] The following part examines the extant regime in relation to banks, insurance companies, pension funds and Non-Banking Financial Institutions (**"NBFCs"**).

in the proceedings, even if funds are eventually paid. Second, wholesale liquidation of a financial firm's assets can depress the value of these assets generally, harming the balance sheets of any other firm also holding those assets. Third, speculation about where losses will fall during the period before final accounts are prepared can lead to runs by creditors of institutions who are believed to be exposed to the failed bank."].

15 Fed. Deposit Insurance Corp. & Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions* 2 (2012), https://www.fdic.gov/about/srac/2012/gsifi.pdf.

16 Čihák and Nier, *supra* note 6, at 6-7.

17 These include banks (commercial banks, regional rural banks, and co-operative banks); non-banking financial institutions; primary dealers; development financial institutions; insurance companies (including life insurance companies, general insurance companies and reinsurer companies), securities market functionaries (including merchant bankers, venture capital funds, stock exchanges, depositories, depository participants, qualified depository participants, stock brokers, sub-brokers, debenture trustees and credit rating agencies), provident and pension funds, housing finance companies and financial market infrastructures.

18 Reserve Bank of India, *supra* note 13, at 43.

- Banks: Multiple legislations prescribe mechanisms which may be used for the management of financial distress in commercial banks (i.e., banking companies, foreign bank branches and public sector banks), regional rural banks ("**RRBs**") and cooperatives.

Commercial Banks

S No.	Legislations	Mechanism
1.	[Banking Regulation Act 1949, SBI Act 1955, SBI (Subsidiary Banks) Act 1959, Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][19]	Power to appoint and remove directors in cases when directors are not deemed fit and proper, or in interests of public, banking policy or to secure proper management.
2.	[Banking Regulation Act 1949][20]	Power to issue directions and prohibitions from entering a particular business
3.	[Banking Regulation Act 1949][21]	Power to acquire/transfer or sell assets and liabilities, legal rights and obligations

[19] Banking Regulation Act 1949, §10(B)(6)[RBI's power remove Chairman/Managing Director when an appointed person is not regarded fit or suitable for the post by the RBI], §36AA [RBI's power to remove managerial or other persons and appoint suitable persons in that place in public interests or in interests of depositors or securing the proper management of the company] and §36AB [RBIs power to appoint additional directors in interests of banking policy, public interest or depositors' interests]; SBI Act 1955, §19 [appointment of chairman/managing directors by Central Government ("CG") in consultation with RBI], §19B [power of RBI to appoint additional directors in interests of public or banking policy or depositors of SBI], §24 [power of CG to remove chairman/managing directors]; SBI (Subsidiary Banks) Act 1959, §25A [RBI's power to remove a director when deemed not fit and proper], §25B [RBI's power to appoint additional directors in interests of banking policy or public or depositors or subsidiary bank], §31 [CG's and SBI's power to remove a director for sufficient reason]; Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980, §9(3)(a) [appointment of whole time directors by CG], §9A[appointment of additional directors by RBI in interests of banking policy, public interest or new bank], §9(3B) [removal of directors by RBI for non-fulfilment of legislative criterion].

[20] Banking Regulation Act 1949, §35A [RBI's power to give directions in public interest, depositors' interests or to secure the proper management of the banking company or in interests of banking policy] and §36(1) [RBI's power to caution or prohibit banking companies from entering into particular transactions].

[21] Banking Regulation Act 1949, §36AE [relating to power of CG to acquire undertakings of banking companies in cases when the banking company is non-compliant with directions of CG or is being managed to the detriment of depositors or in interests of baking policy etc.], §36AF [relating to power of power of CG to make schemes in relation to acquired banks].

S No.	Legislations	Mechanism
4.	[Banking Regulation Act 1949, SBI Act 1955, SBI (Subsidiary Banks) Act 1959, Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][22]	Power to supersede board of directors in interests of public or to secure proper management.
5.	[Banking Regulation Act 1949; Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][23]	Power to apply for moratorium and prepare scheme of amalgamation
6.	[Banking Regulation Act 1949, SBI Act 1955, SBI (Subsidiary Banks) Act 1959, Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][24]	Liquidation and appointment of liquidators.

Regional Rural Banks and Cooperatives- Central Government (**"CG"**) after consultation with the National Bank, concerned State Government and Sponsor Bank is empowered to amalgamate RRBs, on grounds of public interest, in the interests of the development of the area served by RRBs or RRBs themselves.[25] CG has the power to liquidate a RRB, in furtherance of a notification of amalgamation.[26] RBI is empowered to supersede the boards of multi-state cooperative banks in interests of public, depositors and for securing proper management[27] and apply to CG for suspension of business and issue of order of moratorium.[28] The Central Registrar of cooperative

[22] Banking Regulation Act 1949, §36 ACA [relating supersession of Board of Directors to further interests of depositors or secure proper management of the company]; SBI Act 1955, §24A [relating to supersession of Central Board in interests of public, depositors or to secure proper management of SBI]; SBI (Subsidiary Banks) Act 1959, §35A [ditto]; Banking Companies (Acquisition and Transfer of Undertakings) Acts 1970/1980, §18A [ditto].

[23] Banking Regulation Act 1949, §37 [relating to grant of moratorium by high court when a banking company is temporarily unable to meets its obligations], §45 [relating to suspension of business of banking company and preparation of scheme of amalgamation]; Banking Companies (Acquisition and Transfer of Undertakings) Acts 1970/1980, §9(2)(c) [power of CG to sanction schemes of reconstruction and grant moratorium].

[24] Banking Regulation Act 1949, §38 [liquidation by High Court], §39 [appointment of RBI as liquidator]; SBI Act 1955, §45 [Bar on liquidation except by order of CG]; SBI (Subsidiary Banks) Act 1959, §57 [Bar on liquidation except by order of CG]; Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980, §18 [Bar on liquidation except by order of CG].

[25] Regional Rural Banks Act 1976, §23A.

[26] Regional Rural Banks Act 1976, §23D.

[27] Banking Regulation Act 1949, §36AAA.

[28] Banking Regulation Act 1949, §45(2).

societies has powers to prepare scheme of amalgamation in such cases.[29] RBI also has the power to direct the winding up of a multi-state cooperative bank[30] and CG has the power to appoint a liquidator.[31]

- Insurance Companies: Under the Insurance Act, 1938, IRDA has the powers of formulating and sanctioning a scheme of amalgamation and transfer, appointment of an administrator for the management of insurance business and cancellation, reduction or variation of contracts and agreements.[32] High Court/National Company Law Tribunal has the power to wind up an insurance company in cases of its insolvency, non-compliance with the Insurance Act or when its continued operation is prejudicial to policy holders.[33] Also, insurance companies can be voluntarily wound-up for effecting amalgamation or reconstruction or in cases when it cannot continue its business on account of its liabilities.[34] As per the General Insurance Business (Nationalisation) Act 1972, the CG has the power to frame schemes for the efficient management of insurance business and provide for inter alia, transfer of undertakings and alterations of conditions of service of employees.[35] The CG by order may dissolve the General Insurance Corporation of India. Such dissolution cannot be effected by any other means.[36] Pursuant to the Life Insurance Corporation ("**LIC**") Act 1956, the LIC may only be liquidated by an order of CG.[37]

- Pension Funds: Under the Pension Fund Regulatory and Development Authority ("**PFRDA**") Act 2013, CG has the power to supersede PFRDA in cases when the authority is unable to discharge its functions, is non-compliant with the directives of CG or in cases when such supersession is justified in public interest.[38] CG is also empowered to appoint an administrator when it has a reason to believe that a pension fund or central record keeping agency is functioning in a manner prejudicial to the subscriber's interests.[39]

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29 Multi-State Cooperative Societies Act, 2002, §18.

30 Multi-State Cooperative Societies Act, 2002, §87. This power can be exercised in cases specified under §13D of the Deposit Insurance and Credit Guarantee Corporation Act, 1961.

31 Multi-State Cooperative Societies Act, 2002, §89.

32 Insurance Act 1938, §35-37A, §52A, §52C respectively.

33 Insurance Act 1938, §53.

34 Insurance Act 1938, §54.

35 General Insurance Business (Nationalisation) Act 1972, §16.

36 General Insurance Business (Nationalisation) Act 1972, §33.

37 Life Insurance Corporation Act 1956, §38.

38 Pension Fund Regulatory and Development Authority ("PFRDA") Act 2013, §44.

39 PFRDA Act 2013, §19.

- NBFCs: RBI is empowered to file winding up petitions in relation to NBFCs inter alia in cases when such entities are unable to meet their debts or when their continuance is not in public interest.[40]

Proposed Reforms

Several law reform commissions and working groups have recommended changes to the extant regime of distress management in the Indian financial sector. The proposal of two such bodies has led to the drafting of a new law on resolution of financial institutions in India. As of the date of writing this article, the proposed law, called the Financial Resolution and Deposit Insurance Bill, 2017 ("**Bill**") has been approved by the Union Cabinet and is ready to be introduced in the Parliament. Although the contents of the final Bill are not publicly available yet, the recommendations of the two bodies that seem to have shaped the Bill are as follows:

- Recommendations of the FSLRC[41]: The FSLRC noted that failure of financial firms is a part of the regenerative process of market economies. However, on account of disruptive effect of such failures on the economy, adequate mechanisms have to be instituted to allow smooth exit of failing firms. The Commission recommended the institution of a resolution corporation ("**RC**") which would allow speedy resolution of financial firms like banks, insurance companies, defined benefit pension funds, and payment systems. FSLRC envisioned that RC would have representation from across the financial regulatory architecture and would carry out the resolution process in the interests of protecting the stability and resilience of the financial system, enhancing financial market efficiency through efficient pricing and allocation of risk.

- Recommendations of the Committee to draft a Code on Resolution of Financial Firms ("**Committee**"):[42] The Committee recommends the constitution of a RC to be manned by representatives from RBI, SEBI, IRDAI and PFRDA, Central Government and independent members. The RC shall have jurisdiction over banks, insurance companies, financial market infrastructures, payment systems, and other finan-

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[40] Reserve Bank of India Act 1934, §45MC.

[41] Financial Sector Legislative Reforms Commission. See, *Report of the FSLRC*, *Vol. I: Analysis and Recommendations*, http://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf.

[42] Ministry of Finance, Dept. of Economic Affairs, *Report of Committee to Draft Code on Resolution of Financial Firms* (2016), http://dea.gov.in/sites/default/files/report_rc_sept21_1.pdf.

cial service providers (excluding individuals and partnership firms) ("**FSPs**"). The Committee recommends classification of financial service providers into five categories of 'risk to viability', namely, low, moderate, material, imminent and critical. The criteria for designating a financial service provider in a particular 'risk to viability' category or stage will be determined by the RC in consultation with the relevant financial sector regulator. The Committee envisages that the resolution process will be triggered only if an FSP is designated to be in the category of 'critical' risk to viability. The Committee also recommends measures such as submission of resolution and restoration plans at earlier stages of 'risk to viability' such that the RC is better prepared to resolve or restore FSPs in the event of a crisis. As far as the resolution tools are concerned, the Committee recommends use of globally accepted measures like 'bail-in', such that existing shareholders and creditors (other than insured depositors) bear the losses before the Government is called upon to bail an FSP out. It is also envisaged that the RC will collect a resolution fee from FSPs at earlier stages of 'risk to viability', which may be used to resolve them if they ever reach the 'critical' stage. Such recommendations seem to be targeted at inculcating discipline in FSPs and reducing dependence on public funds for managing distress. In addition to proposing a new law for resolution, the Committee has recommended amendments and repeals to many financial sector laws to harmonize the fragmented regime outlined in the previous section. It has also been recommended that the RC takeover the deposit insurance functions from the 'Deposit Insurance and Credit Guarantee Corporation' for all insured bank deposits in India to protect insured depositors in the event of RC being required to invoke its resolution powers against a banking institution.

INTERACTION WITH THE BANKRUPTCY CODE

It may be noted that the Insolvency and Bankruptcy Code, 2016 ("**IBC**"), enacted by the Parliament last year, is targeted at resolving insolvencies in non-financial entities. Although IBC excludes FSPs from its purview, it provides some flexibility to the Government to notify some FSPs to be covered by it under Section 227. This power may have been retained at the time of the enactment of the IBC due to the uncertainty of future enactment of any law governing FSPs, and the scope of such a law. In view thereof, it is possible that some FSPs that are notified to be covered under the IBC will not get covered by the Bill. Going by international best practices, only systemically important FSPs, large banks, insurance companies and market infrastructure providers should be covered under the special resolution regime envisaged by the Committee. Once the Bill is enacted, it will be interesting to see how the IBC and the new resolution regime for financial entities interact with each other. The successful implementation of the two laws will be important for securing India's financial stability in future. Regardless of how this interaction between the two codes may play out, what can be said without doubt is that the proposed reforms are indeed a step in the right direction. The Bill is a massive improvement over the existing scattered regulatory structure, and seeks to maintain a fine balance between assistance to critical FIs and minimization of negative externalities. One can only hope that is passed without much ado and implemented in the right spirit.