

# CHAPTER 1

## Introduction

### Background

**1.1** The recent global financial crisis demonstrated the shortcomings of the frameworks to handle the failure of large and systemically important financial institutions, also known as “Too-Big-To-Fail” (TBTF) institutions<sup>1</sup>. There were no effective tools to deal with problems at an early stage, nor were there effective solutions to be applied once problems became acute. Majority of the G20 jurisdictions had some form of bank insolvency procedure for exercising resolution measures for problem banks but it was not extended to large and complex institutions and non-banks. Such measures may have worked for resolution of smaller and domestically oriented banks without public bailouts and without catastrophic systemic consequences, but proved inadequate for resolving TBTF institutions.

**1.2** The jurisdictions lacked in effective resolution mechanism for financial institutions with sufficient powers and tools. The legislative framework for resolution was ill-suited to deal with the failures of financial institutions of a large scale and interconnectedness especially when they operated across borders. The extent resolution toolkits were also not specially designed to take into account the special and unique nature of financial institutions.

**1.3** The problem became more acute in jurisdictions where there was higher concentration of banking assets among few top banks, for example the United Kingdom where the combined assets of the top 5 banks represented 446% of gross domestic product (GDP) at the end of 2009, Netherlands (464%), Sweden (409%), or France (334%)<sup>2</sup>. In order to contain the contagion effect that could seriously undermine the financial stability, the authorities had to intervene and provide support with an unprecedented range of measures, including takeover, blanket guarantee, liquidity infusion and expanded deposit insurance, together termed as government-funded bailouts. In some cases, authorities used corporate

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<sup>1</sup>The term TBTF, though old in usage, assumed its significance from the recent actions of European as well as US authorities in 2008 in rescuing financial institutions as diverse as AIG, Dexia, Fortis, Hypo Real Estate, Icelandic banks, Washington Mutual, to name a few, as well as the consequences of the failure to rescue Lehman Brothers in September 2008. TBTF firms are institutions of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences.

<sup>2</sup>Patrick Kenadjian (2011) – Cross Border Resolution of Bank Failures.

insolvency procedures leading to disorderly collapse, which undermined public confidence. The amount of direct and indirect public support<sup>1</sup>, estimated to be about 25% of GDP, to financial institutions during the crisis raised concerns about moral hazard.

**1.4** The global financial crisis highlighted the urgent need to improve resolution framework for large and complex financial firms so as to enable authorities to have more effective tools, powers, capacity and information and accordingly resolve problem institutions quickly without destabilising the financial system or exposing taxpayers to loss. An effective resolution framework would not only provide the tools and the financial means to take appropriate action, but it will also empower the resolution authority to orderly resolve a financial institution in difficulty, while ensuring continuity of critical and important functions.

**1.5** A wide variety of policy proposals to address the moral hazard problem have been put forward. The reform agenda has been driven by the need to reduce the likelihood of crisis of such dimensions by strengthening prudential regulations, making financial infrastructure more robust, improving macro-prudential oversight and by developing a framework for resolving systemically important financial institutions (SIFIs). Post-crisis, the global initiatives to strengthen the financial regulatory system are driven by the G20 under the auspices of the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), to address, among others, the moral hazard posed by the TBTF institutions.

**1.6** In November 2008, G20 leaders called for a “review of resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border institutions”. At the G20 summit at Pittsburgh in September 2009, they called on FSB to propose possible measures to address the TBTF problems associated with the SIFIs. They also committed to act together to “...create more powerful tools to hold large global firms to account for the risks they take” and, more specifically, to “develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future.”

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<sup>1</sup>The International Monetary Fund (IMF) has estimated that while the net direct fiscal cost of the crisis was on an average 2.7% of GDP for advanced G20 countries, the amount pledged including guarantees and other contingent liabilities averaged 25% of GDP. Government debt in advanced G20 economies is projected to rise by almost 40 percentage points during 2008-15.

**1.7** Learning the lessons from the crisis, the BCBS also published its Basel III Capital Regulations in December 2010. The objectives of Basel III are to ensure that a crisis of such magnitude does not recur. Towards this end, the Basel III has set its objectives to improve the shock absorbing capacity of each and every individual bank as the first order of defence and address systemic risks. In the worst case scenario, if it is inevitable that a bank fails, there are measures to effectively and efficiently resolve the failing institution without involving taxpayers' money so as to minimise its spill-over impact on the real economy.

**1.8** In October 2011, based on the results and key findings of the survey conducted by the Cross-border Bank Resolution Group (CBRG) of BCBS, and drawing on the CBRG Recommendations, the FSB proposed a set of twelve core elements viz. the "Key Attributes", as essential components for effective resolution of financial institutions. At the Cannes summit in November 2011, the G20 Leaders endorsed the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions"<sup>1</sup> (the Key Attributes) as the international standard for resolution regimes.

**1.9** The FSB's Key Attributes set out the core elements considered to be necessary to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms that make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims. The Key Attributes call for an effective "Resolution Regime" to be in place in all jurisdictions that provide the resolution authority with a broad range of powers, tools and options to resolve a variety of firms that are no longer viable and have no reasonable prospect of becoming so.

**1.10** The G20 countries and the FSB jurisdictions are expected to fully implement the Key Attributes in substance and scope, and for all parts of the financial sector that could cause systemic problems, by end-2015. By end-2015, the jurisdictions are also expected to adopt resolution regimes, crisis management groups (CMGs) or equivalent arrangements, and resolution planning, for financial market infrastructures (FMIs) that are systemically important in more than one jurisdiction and for systemically important insurers, consistent with the FSB Annexes to the Key Attributes that are in the process of finalization with inputs through a process of dialogue with the International Association of Insurance Supervisors (IAIS).

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<sup>1</sup>See [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

**1.11** The FSB in association with the International Monetary Fund and the World Bank is developing assessment criteria and methodologies to facilitate country assessments with respect to the Key Attributes.

## Constitution of the Working Group

**1.12** The sub-Committee of the Financial Stability Development Council (FSDC) had decided, in its meeting held on June 14, 2012, to set up a Working Group in order to examine and assess the current gaps, vis-à-vis the FSB's Key Attributes, in the Indian resolution framework for the financial sector as a whole and to recommend the legislative changes needed to address such gaps as also the required steps with anticipated timelines. Accordingly, the Reserve Bank of India, in January 2013, constituted a High Level Working Group with Shri Anand Sinha, Deputy Governor, RBI as Chairperson and Dr. Arvind Mayaram, Secretary, Department of Economic Affairs, Ministry of Finance, Government of India as co-Chairperson.

### Composition of Group

**1.13** The composition of the Working Group is as follows:

1.	Shri Anand Sinha	Deputy Governor, Reserve Bank of India	Chairperson
2.	Dr. Arvind Mayaram	Secretary, Department of Economic Affairs, Ministry of Finance, Government of India	Co-Chairperson
3.	Shri M. J. Joseph <sup>1</sup>	Additional Secretary, Ministry of Corporate Affairs, Government of India	Member
4.	Shri Ramesh Abhishek <sup>2</sup>	Chairman, Forward Markets Commission	Member
5.	Shri P. Vijaya Bhaskar	Executive Director, Reserve Bank of India	Member
6.	Shri B. Mahapatra	Executive Director, Reserve Bank of India	Member
7.	Shri Jasbir Singh	Executive Director, Deposit Insurance and Credit Guarantee Corporation (DICGC), Reserve Bank of India	Member
8.	Dr. C. S. Mohapatra	Adviser (FSDC), Department of Economic Affairs, Ministry of Finance, Government of India	Member
9.	Shri Alok Nigam	Joint Secretary, Department of Financial Services, Ministry of Finance, Government of	Member

<sup>1</sup>Shri M. J. Joseph was nominated by the Ministry of Corporate Affairs, Government of India, as member to the Group to replace Smt. Renuka Kumar, Joint Secretary, Ministry of Corporate Affairs. Shri M. J. Joseph did not attend any of the meetings of the Group.

<sup>2</sup>As per decisions taken in the first meeting of the Group held on April 11, 2013, the Ministry of Consumer Affairs, Government of India nominated Shri Ramesh Abhishek as a member of the Working Group.

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10.	Shri P. K. Nagpal	Executive Director, Securities and Exchange Board of India	Member
11.	Ms. Usha Suresh <sup>1</sup>	Economic Adviser, Forward Markets Commission	Member
12.	Shri G. S. Hegde	Principal Legal adviser, Reserve Bank of India	Member
13.	Shri G. Jaganmohan Rao <sup>2</sup>	Principal Chief General Manager, Department of Banking Supervision, Reserve Bank of India	Member
14.	Shri Vijay Chugh <sup>3</sup>	Chief General Manager, Department of Payment and Settlement Systems, Reserve Bank of India	Member
15.	Dr. Mamta Suri	Senior Joint Director, Insurance Regulatory and Development Authority	Member
16.	Ms. Deepa Kotnis	Chief General Manager, Pension Fund Regulatory and Development Authority	Member
17.	Shri Chandan Sinha <sup>4</sup>	Principal Chief General Manager, Department of Banking Operations and Development, Reserve Bank of India	Member-Secretary
18.	Ms. Uma Subramaniam	Chief General Manager and Principal, Reserve Bank Staff College, Reserve Bank of India	Permanent Invitee

### ***Terms of Reference of Group***

**1.14** The terms of reference of the Working Group are as follows:

- (i) To examine the existing resolution regime/framework for the entire financial sector as a whole (commercial banks, regional rural banks, non-banking financial institutions, securities firms, insurance companies, pension funds and financial market infrastructure) as also the current resolution tools and powers vested with the respective regulators of financial institutions/Government of India;
- (ii) To identify the current gaps in the national resolution regime/framework vis-à-vis the FSB Key Attributes;
- (iii) To study the resolution regimes/framework instituted/implemented by major jurisdictions;

<sup>1</sup>As per decisions taken in the first meeting of the Group held on April 11, 2013, The Forward Markets Commission nominated Ms. Usha Suresh as a member of the Working Group.

<sup>2</sup>As per decisions taken in the first meeting of the Group held on April 11, 2013, the RBI (Department of Banking Supervision) nominated Shri G. Jaganmohan Rao as a member of the Working Group. He resigned from Reserve Bank in December 2013 to join as Managing Director of Bank Note Paper Mill India Private Limited. He was replaced by Shri P. Vijaya Kumar, Chief General Manager, RBI.

<sup>3</sup>As per decisions taken in the first meeting of the Group held on April 11, 2013, the RBI (Department of Payment and Settlement Systems) nominated Shri Vijay Chugh as a member of the Working Group.

<sup>4</sup>Consequent upon transfer of Shri Deepak Singhal, CGM-in-Charge to New Delhi Regional Office as Regional Director, Shri Chandan Sinha, Principal Chief General Manager, Department of Banking Operations and Development was nominated as Member-Secretary to the Working Group.

- (iv) To recommend changes in the legal framework to facilitate the required resolution regime including cross-border resolution;
- (v) To make recommendations about the next steps to be taken in this regard along with anticipated timelines; and
- (vi) Any other matter germane to the issue.

The Group was required to submit its report within twelve months from the date of its first meeting.

**1.15** The Working Group held six meetings on April 11, August 19, October 17, November 7, December 27, 2013 and January 16, 2014. The Group while preparing this report has drawn primarily from the FSB's Key Attributes, the guidance on recovery and resolution planning issued by the FSB, the draft Assessment Methodology of resolution regime, the international practices and work in progress in major advanced jurisdictions, the extant legal framework in place in India and gaps in the resolution framework for financial institutions in India vis-à-vis the Key Attributes. The initial work done by the Internal Working Group<sup>1</sup> on Resolution Regime for banks and other RBI regulated entities (Chairman: Shri B. Mahapatra) has greatly helped this Group to frame its report. The Group has also considered the recommendations given by the Financial Sector Legislative Reforms Commission (FSLRC)<sup>2</sup> as far as it relates to resolution of financial institutions.

**1.16** The Group recognizes the fact that while all the essential features of a sound and effective resolution regime will be applicable in case of resolution of banks, many of them will not be applicable in resolution of other types of financial institutions and FMIs. The Key Attributes also consider this and have expressed that all resolution powers set out in the Key Attributes are not suitable for all sectors and all circumstances. In this context, the FSB, jointly with the other international standard-setting bodies, is in the process of extending its sector-specific standards on Key Attributes to cover a wider range of market participants in the financial sector, including FMIs, insurance companies and other non-bank financial institutions.

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<sup>1</sup>The members of the Internal Working Group include – Shri B. Mahapatra (Chairman), Shri Deepak Singhal, Shri G. Jagannathan Rao, Shri Vijay Chugh, Ms. Uma Subramaniam, Smt. Rekha Warrior, and Shri Sudhanshu Prasad (Member-Secretary). Permanent Invitees include – Shri A. Unnikrishnan, Ms. Kumudini Hajra, Shri I. S. Negi, and Shri M. Nandakumar.

<sup>2</sup>The FSLRC (Chairman: Justice (Retd.) B. N. Srikrishna) was constituted by the Government of India in March 2011 with a mandate to comprehensively review and rewrite and clean-up the legislations governing India's financial system to bring them in tune with current requirements. The Commission submitted its report to the Government in March 2013.

**1.17** In order to promote cross-border resolution planning for G-SIFIs and also to extend the scope of national resolution regimes beyond banks to cover non-bank financial institutions, the FSB is in the process of developing policy documents and guidance on the following:

- coordination and cooperation arrangements with home and host authorities;
- effective frameworks for information sharing including common data template for collection and sharing;
- coordination and information sharing between CMGs and non-CMG host authorities;
- detailed parameters for effective formulation of resolution strategy including nature, location and type of gone-concern loss absorbing capacity in G-SIFIs;
- methodologies to measure the funding requirements in resolution;
- treatment of financial contracts in a manner that supports effective implementation of resolution strategy and avoid contagion through early termination in resolution;
- framework for cross-border recognition of resolution actions, in particular bail-in and temporary stay of close-out rights;
- resolvability assessment process for G-SIFIs; and
- application of Key Attributes to Non-Bank Financial Institutions (NBFIs)<sup>1</sup>.

**1.18** The international consensus on a number of areas is evolving. The European Union's proposal for resolution framework is still in draft stage. This report, therefore, focuses more on banks, while making general recommendations for other financial institutions<sup>2</sup> and FMIs<sup>3</sup>. Care needs to be taken to fine tune the recommendations on the basis of policy documents and guidance when issued by the FSB and other international standard setting bodies, for application to other financial institutions.

**1.19** Even in the case of banks, the Group observes that the important and big banks in India are in the public sector, i.e., majority ownership is with the Central Government. Public ownership of banks has advantage of implicit government guarantee. Depositors, creditors and other stakeholders repose immense faith in these banks even if their financial positions may not be satisfactory. This was evidenced in late 1990s/early 2000s when three public

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<sup>1</sup>FSB has issued a consultative document in August 2013 for inviting comments. See [http://www.financialstabilityboard.org/publications/r\\_130812a.pdf](http://www.financialstabilityboard.org/publications/r_130812a.pdf).

<sup>2</sup> For the purpose of this report, the term "financial institutions" refers to banks (including public sector banks, private sector banks, foreign banks having branches in India, regional rural banks, state co-operative banks, district central co-operative banks, and primary urban co-operative banks), insurance companies, securities firms, pension funds and commodity market.

<sup>3</sup>For the purpose of this report, the term "financial market infrastructures" refers to payment systems, central counterparties (CCPs), securities settlement systems (SSSs), central securities depositories (CSDs), and trade repositories (TRs).

sector banks were identified as “weak” banks but could be turned around without the risk of run on these banks. The Group considers the issue of resolution of these banks on the same footing with other banks. The issue of resolvability of a financial institution stems from the basic premise of ‘ownership-neutrality’, and equally applies to government owned financial firms.

## Structure of the report

**1.20** The Report is organized into five chapters. After this introductory Chapter, Chapter 2 discusses the global initiatives and international practices in relation to implementation of Key Attributes. Chapter 3 presents in brief the Key Attributes and also identifies the current gaps *vis-à-vis* the Key Attributes in the Indian resolution framework for all financial institutions. Chapter 4 describes the institutional arrangements, design, coordination and preparedness that are necessary for orderly resolution of financial institutions in India. Lastly, Chapter 5 deals with the requirements for legal framework conditions for cross-border cooperation, information sharing, institution-specific cross-border cooperation agreements and crisis management groups.

## Acknowledgements

**1.21** The Group is grateful to the FSDC, its sub-Committee and the Reserve Bank of India for entrusting them the important task of reviewing the existing resolution regime for all financial institutions, identifying gaps *vis-à-vis* the Key Attributes, and suggesting the nature and extent of legislative changes required to address the identified gaps.

**1.22** As this Group set out on the challenging task of formulating the contours of the Financial Resolution Framework for all financial institutions in India in line with the Key Attributes, it acknowledges the valuable suggestions provided by the permanent invitee, Ms. Uma Subramaniam.

**1.23** The Group appreciates the extra ordinary work put in by Shri Sudhanshu Prasad, Deputy General Manager, Department of Banking Operations and Development, Reserve Bank of India in preparing the report and also giving it the final shape. The Group is immensely grateful to Ms. Kumudini Hajra, Director, Deposit Insurance and Credit Guarantee Corporation (DICGC) for sharing her insight on resolution frameworks, contributing during the discussions of the Group, for providing information on international practices and resolution funding arrangements for orderly resolution of financial institutions and also contributing very substantially in finalising this Report. Finally, the Group

acknowledges the efforts of Shri Jaikar Mishra, Manager, Department of Banking Operations and Development, Reserve Bank of India in preparing a framework of the existing legal framework as well as resolution regime for all financial institutions in India and also assessing the existing gaps vis-à-vis the Key Attributes. The Group is also grateful for the contributions made by Shri B. S. Bohra, Assistant Legal Adviser, Legal Department, Reserve Bank of India on legal aspects of existing resolution framework for entities falling within the regulatory jurisdiction of the RBI. The Group thanks the Secretariat for flawless arrangements for hosting the meetings.